

Attachment 9.01

Application and Demonstration of compliance with control mechanism for standard control services

20 January 2015



Introduction

This attachment provides Ausgrid's response to the AER's draft decision Attachment 14 Control Mechanisms for Standard Control Services. Ausgrid broadly agrees with the approach put forward in the AER's draft determination with respect to the application of and compliance with the control mechanisms. However, we have some specific concerns that we wish for the AER to address in the final decision, as summarised in the table below.

Table 1 – Overview of Ausgrid's response to the AER's Draft Determination on Control Mechanism for Standard Control Services

AER Decision	Ausgrid Response	Brief Description of Response
Revenue Cap Control Mechanism for Standard Control Services is revenue cap.	<ul style="list-style-type: none"> Accept as rules require that Control Mechanism be the same as that specified in the AER's Framework and Approach paper. 	
Application of Revenue Cap. Revenue cap comprised of Annual Revenue Requirement (ARR) for distribution and Maximum Allowed Revenue (MAR) for transmission services (dual function assets) calculated in accordance with revenue cap formulas in Figures 14-1.	<ul style="list-style-type: none"> In principle accept formula, but will seek further consideration of some elements of the formula and the treatment of CPI for transmission revenues as well as seek to clarify the operation of the revenue cap to Ausgrid's transmission revenues. 	<p>Ausgrid seeks reconsideration of the AER's rejection of its proposal to apply the same CPI definition to the revenue cap for distribution and transmission.</p> <p>Ausgrid's makes a further submission on the implications for our opex forecasts of not allowing recovery of certain emergency recoverable works through an E factor.</p> <p>Ausgrid seeks further consideration of mechanism for adjustments for incentives and the transitional year revenues for some alternative control services.</p> <p>Ausgrid request that the determination expressly provide that the "Price" component for year t in the Revenue Cap Formula includes the unders and overs adjustment.</p>
Side Constraints Side Constraints apply to price movements for each tariff class must be consistent with formula in Figure 14-2.	<ul style="list-style-type: none"> Ausgrid disagrees with the formula in Figure 14-2 on the grounds that it will unreasonably limit the scope for tariff re-balancing in FY 2015/16. Ausgrid have proposed an alternative formula that address our concerns and corrects for two unintended errors in the formula in Figure 14-2. 	<p>Ausgrid objects to the formula and proposes that the permissible percentage in the formula be expressed as the greater of a CPI-X limitation plus 2% or CPI plus 2%.</p> <p>Ausgrid is seeking to the AER to adopt a consistent CPI treatment.</p> <p>Ausgrid also notes that there are two unintended errors in formula in Figure 14-2:</p> <p>(1) The price change being both less than or equal to and equal to</p> <p>(2) The inclusion of " TUOS" in the side constrain formula is not correct.</p>
Unders and Overs Accounts Ausgrid must demonstrate compliance with the control mechanism for standard control services in accordance with Appendices A and B.	<ul style="list-style-type: none"> Ausgrid disagrees with aspects of Appendix A which addresses the DUOS unders and overs account. Appendix B addresses "TUOS" unders and overs account but should address "Designated Pricing Proposal Charges Unders and Overs Account. 	<p>Ausgrid does not accept the AER's draft decision not to apply interest to the opening balance in year "t"</p> <p>The AER's decision conflates Designated Pricing Proposal Charges and Ausgrid's recovery of revenue allocated to its transmission or dual function assets services. Ausgrid cannot account separately for its transmission revenue due to the application of the coordinating TNSP provisions of the rules.</p>
Application of Tolerance Limits	<ul style="list-style-type: none"> Ausgrid disagrees with the AER's approach to tolerance limits. 	<p>Ausgrid seeks reconsideration of the AER's rejection of our proposed approach to tolerance, particularly with respect to imposing a limit on the recoupment of residual metering asset costs.</p>
"TUOS" Under/ Over Recovery Ausgrid must submit as part of its annual pricing proposal, a record of the amount of revenue recovered from TUOS charges and associated payments in accordance with Appendix B.	<ul style="list-style-type: none"> Same issue as raised in Unders and Overs Account section above, the reference should be to "Designated Pricing Proposal Charges" not TUOS. 	
Jurisdictional Schemes Reporting Ausgrid must report to us its jurisdiction scheme amounts recover in accordance with Appendices C.	<ul style="list-style-type: none"> Accepted Ausgrid's proposed approach, except in respect to the inclusion of interest in year t. 	<p>Ausgrid does not accept the AER's draft decision not to apply interest to the opening balance in year "t" and seeks reconsideration of this issue.</p>

This section provides Ausgrid’s detailed response to the AER’s Attachment 14 Control Mechanism for Standard Control Services. It is structured as follows:

- Application of the Revenue Cap, which includes:
 - The definition of CPI in the control mechanism
 - Recovery of Emergency Recoverable Works (E Factor)
 - Incentive Adjustment, Pass Through Amount and Transitional Amount
 - Demand Management Embedded Generator Connection Incentive Scheme
 - Annual B Factor Adjustment
- Treatment of Unders and Overs Account for standard control distribution services
- Recovery Mechanism for Distribution Use of System Revenues Compliance with Control Mechanism for Distribution Services
 - Application of Formulas:
 - Tolerance Limits
 - Treatment of Interest in year t
 - Treatment of CPI in Revenue Cap Formula for Distribution Services
 - Application of Side Constraints.
 - Recovery of D Factor Amounts
- Compliance with Control Transmission Services (provided by Dual Function Assets) and reporting for Designated Pricing Proposal Charges.
 - Application of Formulas:
 - Treatment of CPI in Revenue Cap Formula for Transmission Services

Application of the Revenue Cap

CPI Definition

Ausgrid proposed that a single definition of CPI be applied to the revenue cap and side constraint mechanism for distribution standard control services and the revenue cap mechanism for standard control transmission services to ensure that the regulatory treatment of CPI does not distort the annual tariff setting process and impose unnecessary transaction costs on Ausgrid and the other NSW DNSPs. To achieve consistency in the treatment of CPI in this respect, Ausgrid proposed that the following definition of CPI apply to the revenue cap and side constraint mechanisms:

$$1. \quad \Delta CPI_t = \left[\frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} \right] - 1$$

Ausgrid believes that this definition of CPI is superior because the change in the average of the four quarterly indexes provides:

- a better measure of the inflationary impacts throughout the year given the underlying nature of Ausgrid’s cash flows ie Ausgrid earns revenue and incurs costs during the year.
- a more stable measure of CPI given it is less dependent on a single CPI index value for a single quarter.

The AER does not accept Ausgrid’s proposal to adopt a single definition of CPI on the grounds that changing the CPI definition for standard control transmission services will result in tariffs that do not match the expected

revenues. The AER believe that this mismatch will require a further calculation to be undertaken to account for the difference, which will create unnecessary complexity in the control mechanisms.”¹

Ausgrid does not agree with the AER’s position on this matter because a change to the CPI definition applying to the control mechanism and side constraint will not contribute to a CPI forecasting error. This is because:

- The CPI definition used to demonstrate that our proposed prices comply with the revenue cap and side constraint is a function of historical ABS CPI data. Given that the inputs to the CPI calculation for this purpose are historical in nature, the choice of CPI treatment is not a source of CPI forecasting error.
- Adopting a consistent definition of CPI in the control mechanism and side constraint will not influence the CPI forecast in the PTRM given that the AER’s Draft Decision is based on applying the same CPI forecast in the PTRM for both standard control distribution and transmission services despite the AER having adopted different CPI definitions from a pricing compliance perspective.

The key issue governing the AER decision on the treatment of CPI from an annual pricing compliance perspective is whether the definition of CPI is a reliable measure of the impact of inflation. Ausgrid believes that our preferred CPI approach produces a superior measure of inflation compared to the AER approach, as discussed above. This should not be a surprise to the AER given that the current differences in the treatment of CPI are the result of the different historic approaches adopted by the ACCC and IPART.

Ausgrid also notes that the AER have adopted an inconsistent approach to CPI definition in the respect to the side constraint mechanism and revenue cap mechanism for standard control distribution services. Ausgrid strongly disagrees with the AER position on this issue given that there is no justification whatsoever for applying a different CPI definition in this instance.

In light of the above concerns, Ausgrid requests that the AER reconsider its position on the treatment of CPI from an annual pricing compliance perspective.

Recovery of Emergency Recoverable Works (E Factor)

The AER did not accept our proposed E-factor for the recovery of costs associated with emergency works where the party responsible for the damages is not known or the costs are otherwise not recoverable. Our proposed approach was a practical way to implement the AER’s decision that costs for such works should be recoverable as standard control services.

The AER’s main concern was that these costs were already accounted for in the opex allowance. However, in our Regulatory Proposal we excluded these costs from the opex base year, due to the new approach to classification and the inherent uncertainty of predicting when costs won’t be recovered and hence the difficult of reliably forecasting for the purposes of an expenditure forecast. This mechanism provides for the recovery only of actual costs that cannot be recovered and is most consistent with the approach to classification and control adopted by the AER. It is also fairest to customers as it ensures that only costs that have not been recovered by the DNSP are ultimately recovered from customers.

The exclusion of these costs from the opex base year has resulted in a total of \$13.1m (\$’s 2013/14 real) being excluded from our forecast opex for the 2014/19 period.

STPIS Incentive, Pass Through Amounts and Transitional Adjustment

Ausgrid notes and accepts the AER’s position that adjustments be included in the control mechanism for STPIS and Approved Pass Through Amounts, and that a transitional adjustment is no longer required to account for the difference in the notional revenue for the 2014-15 regulatory year and the placeholder revenue in the transitional decision.

¹ AER 2014, Draft Decision, Ausgrid distribution determination 2015-16 to 2018-19 Attachment 14: Control Mechanisms, Attachment A, p.14-9.

Demand Management Embedded Generator Connection Incentive Scheme (DMEGCIS)

Ausgrid's maintains its position with respect to a proposal for a Demand Management Benefit Sharing Scheme (DMBSS) as set out in Attachment 3-03 of the May 2014 regulatory proposal. Ausgrid wishes to provide the AER with our position on how such a scheme should be incorporated into the revenue cap control mechanisms for standard control distribution services.

While the AER could adopt a specific factor to enable Ausgrid to recover these costs from customers under the revenue cap, Ausgrid believes that this is unnecessary as the simplest approach would be to expand the scope of the B-factor to also cover Ausgrid's proposed DMBSS.

Annual Adjustment (B Factor)

Ausgrid notes that the AER has agreed that any adjustment for Approved Pass Through amounts should be through the B Factor and that residual metering asset costs should be recovered as a standard control service and through the B Factor. This approach is broadly acceptable to Ausgrid.

Ausgrid also notes that the AER have applied tolerance limits to the recovery of residual metering asset costs. Ausgrid does not agree with the AER on this matter because we believe that the tolerance limit should only be applied to the DUOS overs and unders account. Ausgrid's approach will ensure that customers are protected for potential price shocks without unnecessarily restricting Ausgrid's recoupment of residual metering asset costs in a given year. This issue is explained in more detail in the section below on the application of tolerance limits.

Ausgrid is also concerned that the AER have not addressed in their Draft Decision the issue raised in our regulatory proposal of how to account for the revenue from ancillary network services and unclassified services included in our standard control DUOS revenue for FY 2014/15. As explained in our initial regulatory proposal at Attachment 9.02 (v) Annual Adjustment B Factor.. Ausgrid reiterates our proposal that the most practical resolution is to deduct the additional revenue amount for certain ancillary network services and unclassified services used to calculate the bundled DUOS charges in the transitional year from the total actual revenue collected for the transitional year. To illustrate our proposed approach, please consider the following illustrative in the table below.

Table 2 – Illustrative Example – Calculation of over/under recovery in transitional year

2014/15	Revenue used for calculation bundled DUOS price	Actual revenue collected from charging bundled DUOS prices
Revenue approved by the AER as annual revenue requirement in the transitional determination	\$200	
Additional revenues for certain alternative control services ACS and unclassified services	\$50	\$280
Total bundled revenue	\$250	

In the simple example in the above table Ausgrid's approach results in a DUOS over recovery of \$30 in FY 2014/15, which represents the difference between the AER approved DUOS revenue of \$200 and the deemed actual DUOS revenue of \$230 in FY 2014/15 i.e \$280 - \$50.

Treatment of Under and Over Recovery mechanism for DUOS

The AER's draft decision proposes a specific mechanism for the treatment of DUOS under and over recovery that is separated from the B Factor. Ausgrid has no objection dealing with these two issues separately. There are, however, a number of issues with the AER's proposed implementation that should be addressed prior to its finalisation, as explained in the following section.

Recovery Mechanism for DUOS and Compliance with Control Mechanism

Application of the Control Mechanism Formula

The AER Draft Decision requires Ausgrid to submit to the AER proposed DUOS tariffs as part of its annual pricing process that comply with the following control mechanism formula²:

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

Ausgrid considers this formula is not workable as it implicitly assumes that the DUOS tariffs (p_t^{ij}) are set to only recover the Annual Revenue Requirement (ARR_t). However the DUOS tariffs need to be set to include any balance in the DUOS unders and overs account. To assist the AER to address this issue and to provide for greater transparency over the treatment of the DUOS unders and overs account, Ausgrid's revised proposal includes the following control mechanism formulae:

$$3. \quad DUOS_t \leq R_t$$

$$4. \quad DUOS_t = \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij}$$

$$5. \quad R_t = ARR_t \pm U \& O_t$$

$$6. \quad ARR_t = AR_t \pm B_t$$

$$7. \quad AR_t = AR_{t-1}(1 + \Delta CPI_t)(1 - X_t)(1 + S_t)$$

$$8. \quad B_t = MC_t \pm PT_t$$

Where:

$DUOS_t$ is the expected DUOS revenue in year t .

p_t^{ij} is the proposed DUOS 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 .

R_t is the total DUOS revenue entitlement in year t .

ARR_t is annual distribution revenue requirement in year t .

$U \& O_t$ is the adjustment to the ARR in year t required to return the DUOS unders and overs account to a value compliant with the applicable tolerance limit in year t

AR_t is the annual smoothed distribution revenue requirement for year t .

² Note that Ausgrid is also required to demonstrate that its proposed DUOS tariffs comply with the side constraint mechanism

B_t is the adjustment factor relating to residual metering costs and AER approved pass-through events.

PT_t is the AER approved pass through amount (positive or negative) in regulatory year t .

MC_t is the residual metering costs in year t .

$$9. \Delta CPI_t = \left[\frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} \right] - 1$$

CPI means the all groups index number for the weighted average of eight capital cities as published by the ABS, or if the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best estimate of the index.

X_t is smoothing factor apply to year t calculated in accordance with the PTRM as approved in the AER's final decision, revised for the updated return on debt.

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 .

The application of Tolerance Limits to the DUOS Unders and Overs Account

It appears that the AER have not accepted Ausgrid's proposed approach of applying tolerance limits to the DUOS unders and overs account, as reflected in the following quote from the AER's Draft Decision:

"We do not approve this proposal because we consider that Ausgrid can smooth prices by working with its customers to smooth its revenue i.e by having a pricing strategy that would smooth out price shocks. Furthermore, a tolerance limit will allow Ausgrid to bank revenues that may result in greater price shocks in the future when they are ultimately recovered from customers. Our decision in applying a tolerance limit for Energex in 2010 has had this undesirable result".³

Ausgrid strongly disagrees with the AER on this matter. This is because the tariff reform process will take many years to complete due to the need to transition network tariffs to cost reflective levels and to replace the existing accumulation metering stock. Given that it will take time for Ausgrid to deliver efficient network tariffs, it is important that our customers are shielded from these residual volume risks under the revenue cap in the short to medium-term. Ausgrid believes that this outcome can only be achieved by the AER adopting our approach of applying tolerance limits to the DUOS unders and overs account.

Ausgrid also notes that AER's Draft Decision also appears to contradict the above position by applying a tolerance limit to the DUOS overs and unders account, as reflected in the following quote from the AER's Draft Decision:

"In proposing variations to the amount and structure of DUOS charges, Ausgrid must attempt to achieve an expected zero balance on their DUOS unders and overs accounts in each forecast year in its annual pricing proposals in the 2015-19 regulatory control period, unless it can demonstrate for a given year that such an adjustment exceeds the agreed tolerance limits set out in this decision. In such circumstances, the balance at the end of the regulatory control period will reflect the amount by which the adjustment exceeded the first tolerance limit (that is, the amount by which the under/over adjustment exceeded two per cent of Ausgrid's ARR for year t ."⁴

³ AER 2014, Draft Decision, Ausgrid distribution determination 2015-16 to 2018-19 Attachment 14: Control Mechanisms, Attachment A, p.14-11.

⁴ AER 2014, Draft Decision, Ausgrid distribution determination 2015-16 to 2018-19 Attachment 14: Control Mechanisms, Attachment A, p.14-17.

To assist the AER to make a decision on the application of tolerance limits, Ausgrid has resolved this contradiction in the AER Draft Decision by assuming that the AER's approach involved both general and specific applications of tolerance limits, as discussed below.

The following table summarises Ausgrid's interpretation of the AER's approach to tolerance limits in relation to the DUOS unders and overs account.

Table 3 – AER's Draft Tolerance Limits and actions – General Requirement

Tolerance	DNSP Action Required
Less than +/- 2 per cent of the ARR in year t	Ausgrid is required to set DUOS tariffs in year t to achieve a zero forecast value of the closing balance of the DUOS unders and overs account in year t.
Greater than +/- 2 per cent of the ARR in year t	Ausgrid is required to set DUOS tariffs in year t in a manner that ensures that the forecast closing balance of the DUOS unders and overs account at the end of the regulatory control period is equal to the over/under adjustment in excess of +/-2% of ARR in year t.

Ausgrid is concerned that the AER's approach may only be effective in managing this risk in the situation where the under/over adjustment each year is immaterial. This is because it does not impose an obligation on Ausgrid to actively manage a material under or over recovery of DUOS revenue on behalf of customers by developing and implementing a transitional DUOS plan to achieve a zero balance of the DUOS unders and overs account over a reasonable time.

Ausgrid believes that the best way to safeguard the long-term interest of consumers from the inherent risk of price shocks under the revenue cap is to design the tolerance limit to ensure that in the event of a material over/under recovery of DUOS revenue that Ausgrid has the flexibility to transition DUOS prices to achieve a zero balance of the DUOS unders and overs account over a reasonable time frame. In the case of a very large under/over recovery of DUOS revenue (i.e greater than 5% of the ARR in one year), Ausgrid believes that's it is in the long-term interest of customers for transitional DUOS pricing arrangement to extend over more than one regulatory control period as long as our customers have been consulted on the plan to address this issue.

To address our concerns, we have not revised this part of our proposal and we encourage the AER to adopt the approach to tolerance limits proposed by Ausgrid in our regulatory proposal, as shown in the table 4 below:

Table 4 – Ausgrid's Proposed Tolerance Limits and actions

Tolerance	DNSP Action Required
Less than +/- 2 per cent	If the audited over/under recovery of DUOS revenue in year t-2 is within +/- 2 per cent of the MAR for year t, the DNSP is required to set DUOS prices for year t to achieve a zero closing balance for the DUOS revenue overs and unders account in year t.
Between +/- 2 per cent and +/- 5 per cent	If the audited over/under recovery of DUOS revenue in year t-2 is greater than +/- 2 per cent of the MAR for year t, but less than +/- 5% of MAR for year t, the DNSP is allowed to set DUOS prices for year t to achieve a non-zero closing balance for the DUOS revenue overs and unders account in year t. The only requirement is that the DNSP sets DUOS prices in year t with the expectation of achieving a zero closing balance of the DUOS revenue overs and unders account in year t+1.
Greater than 5%	If the audited over/under recovery of DUOS revenue in year t-2 is greater than +/- 5 % of the MAR for year t, the DNSP is required to submit to the AER as part of its annual pricing proposal a medium-term plan to address the DUOS revenue overs and unders account.

Ausgrid also notes that the AER’s draft decision also requires that Ausgrid comply with specific tolerance limits in relation to its recovery of residual metering asset costs via the B-factor, see the table below:

Table 5 – AER’s Draft Tolerance Limits and actions – Specific Requirement

Tolerance	DNSP Action Required
Less than +/- 2 per cent of the ARR in year t	The residual metering asset costs under/over recovery will be cleared within one regulatory year.
Greater than +/- 2 per cent of the ARR in year t	The residual metering asset costs under/over recovery will be recovered in the remainder of the regulatory control period

Ausgrid believes that applying a tolerance limit to the recovery of residual metering asset costs defeats the purpose of moving the recovery of these costs from an alternative control services exit fee into a standard control services revenue. We understand this change by the AER was to facilitate the recovery of actual asset costs as customers exit our metering service but not specifically charge individual customers. Further, it is also unnecessary for a specific tolerance limit for metering as the general tolerance limit applying to the DUOS unders and overs will safeguard our customers from potential DUOS price shocks under the revenue cap.

Treatment of Interest Charge for year t in the DUOS Unders and Overs Account

The AER Draft decision is to not apply interest to the opening balance in year t and the under/over recovery amounts during year t.

Ausgrid does not support the AER’s draft decision to exclude the interest calculation in year t from the DUOS unders and overs account because it will result in Ausgrid earning more or less than its annual revenue requirement entitlement under the determination in present value terms. In other words the exclusion of interest in year t will result in an outcome that contravenes the following formula:

$$10. \text{PVof} \sum_{t=1}^{\infty} \text{ARR}_t = \text{PVof} \sum_{t=1}^{\infty} \text{DUOS}_t$$

Where:

DUOS_t is DUOS revenue in year t.

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

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

ARR_t is the Annual Revenue Requirement in year t.

To assist the AER to understand our position, Ausgrid has provided the following illustrative example of a DUOS unders and overs account.

Table 6 – Illustrative Example of AER Approach to DUOS Unders and Overs Account

DUOS Unders & Overs Account	Audited Actual Period t-2	Estimate Period t-1	Forecast Period t
Revenue from DUOS Tariffs	50	100	157.7
DUOS Revenue Requirement	100	100	100
WACC interest	10%	10%	10%
Opening Balance	0	-52.4	-57.7
Interest on Opening Balance	0.0	-5.2	0.0
Forecast over/(under) recovery for financial year	-50	0	57.7
Interest charged on over/under recovery for financial year	-2.4	0	0
Closing Balance	-52.4	-57.7	0

If it is assumed that the DNSP has perfect foresight in the sense that the forecast volumes used to set prices in year t-1 and year t equal the actual volumes, the DUOS revenue outcomes for period t-1 and period t will perfectly match actual outcomes. Under this assumption, the AER approach will result in the DNSP recovering an additional \$57.7m of DUOS revenue in year t to compensate for the under-recovery of \$50m during year t-2.

It is clearly evident from this simple example that the AER approach of excluding interest in year t does not fully compensate the DNSP for the opportunity costs associated with the under-recovery of DUOS revenue in year t-2 given that the DNSP receives its DUOS revenue (cash inflow) during the course of year t, rather than the first day of the year t.

It should also be noted that without present value neutrality Ausgrid is presented with an incentive to defer rebating over-recoveries as long as possible and ensure any under recovery is recouped as fast as possible, which ignores our belief that price shocks should be managed under the revenue cap.

Ausgrid encourages the AER to reconsider its position on this issue and require the DUOS unders and overs account to include a calculation of interest for the opening balance in year t and the over/under recovery of forecast DUOS revenue during year t.

Treatment of CPI in Revenue Cap Formula for Distribution Standard Control Service

Ausgrid supports the AER's Draft Decision to adopt Ausgrid's proposed treatment of CPI formula in the revenue cap control mechanism for distribution standard control services, as expressed in the formula below:

$$11. \quad \Delta CPI = \left[\frac{CPI_{Mar,t-2} + CPI_{June,t-2} + CPI_{Sept,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{June,t-3} + CPI_{Sept,t-2} + CPI_{Dec,t-2}} - 1 \right]$$

Where

CPI means the all groups index number for the weighted average of eight capital cities as published by the ABS, or if the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best estimate of the index.

Side Constraint

Ausgrid notes that the AER's Draft Decision on side constraints is that Ausgrid will be required to demonstrate in its annual pricing proposal that proposed DUOS prices for the next year (t) will satisfy the following side constraint formula for each tariff class:

$$12. \frac{\left(\sum_{t=1}^m d_t^j q_t^j\right)}{\left(\sum_{t=1}^m d_{t-1}^j q_t^j\right)} \leq (1 + \Delta CPI_t)(1 - X_t)(1 + 2\%)(1 + S_t) \pm PT_t \pm DUoS_t \pm TUoS_t$$

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

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

d_{t-1}^j is the price charged by the Ausgrid 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

Ausgrid does not support the AER's draft decision on the side constraint mechanism to apply to setting of tariffs for standard control distribution services for the following reasons.

- The permissible percentage is expressed on the basis of a CPI-X limitation plus 2%. This approach is inconsistent with section 6.18.6(c) of the NER and will prevent Ausgrid from undertaking efficient tariff reform in an environment of declining allowed revenues and prices.
- The AER side constraint formula:
 - Includes a parameter relating to the TUOS overs and unders account. Ausgrid believes that it is not appropriate to use the side constraint mechanism to link the setting of DUOS and TUOS prices.
 - Requires that the proposed % increase in Ausgrid's expected weighted average revenue in year t is both "≤" and "=" to the permissible percentage.⁵
 - The treatment of CPI is inconsistent with the revenue cap formula for distribution control services. Ausgrid wishes the AER to use the same CPI approach as the previous regulatory control period.⁶

To assist the AER to make a decision on the side constraint mechanism to apply to the setting of DUOS tariffs in the next regulatory control period, Ausgrid wishes to put forward its preferred approach, as set out in the following formula:

$$13. \frac{\left(\sum_{t=1}^m p_t^j q_t^j\right)}{\left(\sum_{t=1}^m p_{t-1}^j q_t^j\right)} \leq \text{PermissiblePercentage}$$

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

p_t^j is the proposed DUOS price for component 'j' of the tariff class for year t

⁵ Note: Ausgrid has assumed that the inclusion of "=" is an error given the compliance issues that this contradiction would cause.

⁶ AER 2009, Final Decision, New South Wales distribution determination 2009-10 to 2013-014, 28 April, page 56.

p_{t-1}^j is the DUOS price charged by the Ausgrid 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

The Permissible Percentage is the greater of:

$$14. (1 + \Delta CPI_t)(1 - X_t)(1 + 2\%)(1 + S_t) \pm PT_t \pm U \& O_t$$

or

$$15. CPI_t + 2\%$$

Where

X_t is 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.

PT_t is an annual adjustment factor that reflects the pass through amounts approved by the AER with respect to regulatory year t

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.

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

$$14. \Delta CPI = \left[\frac{CPI_{Mar,t-2} + CPI_{June,t-2} + CPI_{Sept,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{June,t-3} + CPI_{Sept,t-2} + CPI_{Dec,t-2}} - 1 \right]$$

Where

CPI means the all groups index number for the weighted average of eight capital cities as published by the ABS, or if the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best estimate of the index.

Recovery of D-factor amounts

Ausgrid notes that the AER's transitional decision allows distributors to recover the costs and foregone revenues of applicable demand management projects in the 2009-14 regulatory control period in the transitional and subsequent regulatory control periods.⁷

Ausgrid is concerned the AER's Draft decision is silent on the issue of how our entitlements under the D-factor will be recouped from our customers under the revenue cap control mechanism during the regulatory control period.

Ausgrid also notes that there are two potential options for the AER to adopt in the Final Decision to ensure that Ausgrid can recoup our entitlements under the D-factor via the revenue cap, as summarised below:

⁷ AER 2014, Transitional Distribution Decision 2014-15, page 47

- **X-factor Approach** – to set the X-factor under the revenue cap for distribution standard control services on the basis that an estimate of our entitlement under the D-factor in FY 2014/15 and FY 2015/16 is included in the building block revenue requirement.
- **Annual pricing proposal Approach** – Allow Ausgrid to include a proposed D-factor amount in its annual pricing proposal for FY 2015/16 and to account for this amount in the B-factor under the revenue cap.

Ausgrid estimates a D-factor amount of about \$1.07m for 2015/16. We have not included this in our PTRM, however, we propose that the AER’s final determination should apply the X-factor approach to allow the recovery of this \$1.07m.

Application and Demonstration of compliance with control mechanism for standard control (transmission) services

This section provides our response to the AER’s draft decision on the control mechanism for our standard control (transmission) services.

In summary, the AER’s decision conflates Designated Pricing Proposal Charges and Ausgrid’s recovery of revenue allocated to its transmission or dual function assets services. Ausgrid cannot account separately for its transmission revenue due to the application of the coordinating TNSP provisions of the rules.

Application of the Control Mechanism Formula

AER’s draft decision is to apply a revenue cap to our transmission standard control service.

The AER stated that:

“Ausgrid’s revenues must be consistent with the MAR formula set out below plus any unders and overs adjustment needed to move the balance of its TUOS unders and overs account to zero:

$$16. \text{MAR}_t = \text{AR}_t \pm \text{PT}_t$$

$$17. \text{AR}_t = \text{AR}_{t-1}(1 + \Delta\text{CPI}_t)(1 - X_t)$$

Where:

MAR_t is the maximum allowed revenue in year t .

AR_t is annual transmission revenue requirement in year t .

AR_{t-1} is the transmission revenue requirement in year $t-1$.

PT_t is the AER approved pass through amount (positive or negative) in year t .

ΔCPI_t is the annual percentage change in the ABS Consumer Price Index All Groups, Weighted Average of Eight Capital Cities from December in year $t-2$ to December in year $t-1$

X_t is 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.”⁸

⁸ AER 2014, Draft Decision, Ausgrid distribution determination 2015-16 to 2018-19 Attachment 14: Control Mechanisms, Attachment A, p.14-16.

The AER's draft decision appears to propose the same approach to the compliance/form of control for our transmission and distribution revenue caps. The AER stated that:

“As part of its pricing proposal, Ausgrid must submit to us proposed tariffs and charging parameters which lead to expected revenues consistent with the ARR(distribution Services) and MAR (transmission services) formulas set out below, plus any unders and overs adjustment needed to move the balance of its DUOS and TUOS account to zero”.

Ausgrid is concerned that the AER may not have not properly factored in TransGrid's role in setting TUOS tariffs in NSW and coordinating the recovery of our transmission revenue, which requires us to account for the transmission revenue cap differently to the distribution revenue cap. Ausgrid strongly urges the AER's to reconsider this aspect of its draft decision in because:

- TransGrid sets all transmission tariffs for NSW in its annual pricing proposal. This means Ausgrid does not have the ability to set its own specific transmission tariffs or charging parameters for the recovery of its transmission revenue.
- Ausgrid cannot demonstrate that the TUOS tariffs set by Transgrid for NSW will recover its forecast designated pricing proposal charges⁹ in a manner that complies with Ausgrid's MAR (transmission services). This is because clause 6.18.7 of the Rules requires Ausgrid, in its capacity as a DNSP, to set *designated pricing proposal charges* to recover the forecast cost of designated pricing proposal charges, which comprise:
 - Charges by TransGrid and Ausgrid in its capacity as a TNSP.
 - Avoided TUOS payments to eligible embedded generators.
 - Distribution services provided by other DNSPs.
 - Adjustment (positive or negative) to transition towards a forecast zero balance of the overs and unders account for designated pricing proposal charges in year t.

Consistent with this, Ausgrid should not be required to maintain a TUOS unders and overs account (as opposed to such an account for designated pricing proposal charges) and instead the treatment from the 2009/10 to 2013/14 period should be maintained. This is because under the current arrangements Ausgrid is not exposed to the risk of over or under recovering its transmission MAR. Instead, Transgrid manages this risk as the co-ordinating TNSP in NSW.

To assist the AER, Ausgrid has provided a general explanation of our transmission pricing arrangements in Attachment A.

It is for this reason that Ausgrid strongly submits that the AER in their Final Decision must treat the revenue cap applying to standard control distribution services in a different manner to the revenue cap control mechanism for Ausgrid's standard control transmission services and that part of the AER's draft decision that refers to TUoS Unders and Overs Account should instead to ***Designated Pricing Proposal Charges***, in the same way as currently occurs for these charges.

Treatment of CPI in Revenue Cap Formula for Standard Control Transmission Services

As we have explained in the section above “Definition of CPI”, to ensure that our allowed revenue under the revenue cap for standard control transmission services appropriately reflect the time value of money, Ausgrid believes that it is appropriate for the forecast CPI in year t to be calculated on the basis of the formula below:

⁹ Ausgrid has assumed that the AER have used TUOS and designated proposed pricing charges interchangeably in their Draft Decision.

$$18. \Delta CPI = \left| \frac{CPI_{Mar,t-2} + CPI_{June,t-2} + CPI_{Sept,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{June,t-3} + CPI_{Sept,t-2} + CPI_{Dec,t-2}} - 1 \right|$$

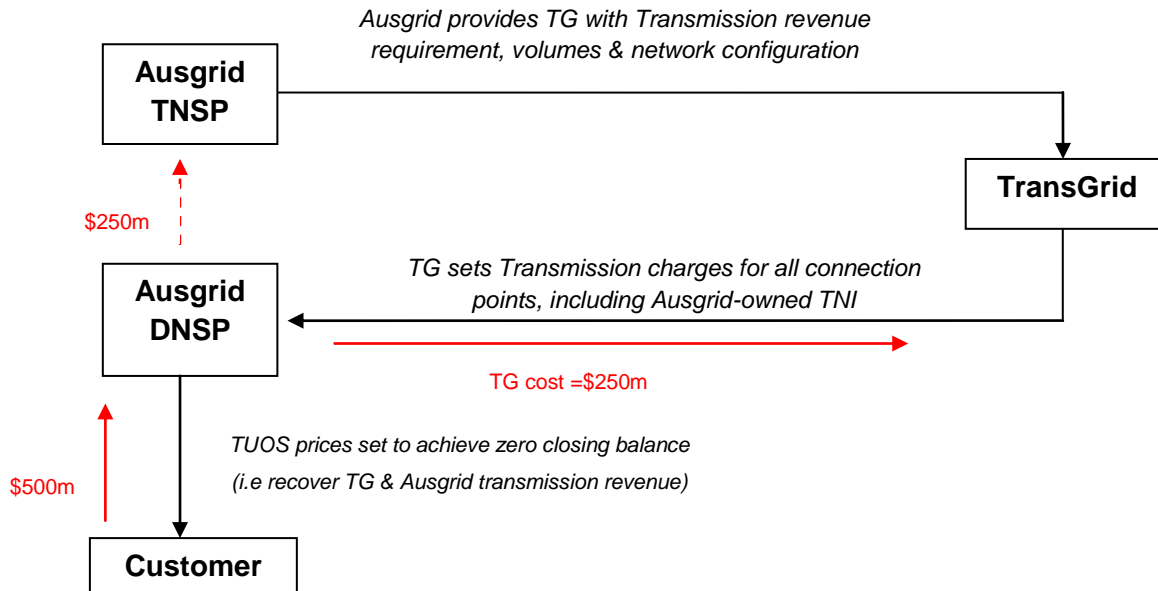
Where

CPI means the all groups index number for the weighted average of eight capital cities as published by the ABS, or if the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best estimate of the index.

Attachment A: Explanation of Transmission Pricing Arrangements

The complex nature of the transmission pricing relationships between TransGrid, Ausgrid (DNSP), Ausgrid (TNSP) and customer is illustrated in the figure below:

Figure A.1: Illustrative Representation of Transmission Pricing Inter-relationships



The key points from the illustrative figure above are:

- TransGrid sets transmission charges for all transmission connection points in NSW, including those owned by Ausgrid.
- Ausgrid provides TransGrid with information on Ausgrid’s transmission allowed revenue (eg. \$250), volumes and dual function network configuration;
- Ausgrid pays TransGrid for transmission services provided at the TransGrid-owned Transmission connection points (eg. \$250m);
- Ausgrid sets TUoS tariffs in its capacity as a DNSP to recover Ausgrid’s allowed revenue (eg.\$250m) and the Ausgrid share of the TransGrid allowed revenue (eg.\$250m)
- Ausgrid accounts for volume risk only in its capacity as a DNSP via the transmission overs and unders account.