



Response to the AER Preliminary Positions - Framework and Approach Paper

Control Mechanisms for Standard Control Services

***Ausgrid, Endeavour Energy and Essential Energy
regulatory control period commencing 1 July 2014***

1. Overview

The Energy Networks Association (ENA) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) *Preliminary Positions - Framework and Approach Paper: Ausgrid, Endeavour Energy and Essential Energy regulatory control period commencing 1 July 2014* (Preliminary Positions Paper) published on 25 June 2012. In this submission ENA addresses its concerns in relation to the AER's proposal on the control mechanism to be applied to NSW Distribution Network Service Providers (DNSPs) for the next regulatory control period.

In the Preliminary Positions Paper the AER stated that its initial preference is to apply a revenue cap form of regulation to standard control services for the NSW electricity businesses for the 2014-19 regulatory control period. This would represent a departure from the weighted average price cap (price cap) control mechanism that was historically applied in NSW for standard control services. ENA is concerned that the AER has not made a compelling case for a change of the control mechanism and that such a decision will negatively impact on the regulatory certainty intended to be fostered by the regime without having identified a clear benefit.¹

2. Background

Under the *National Electricity Rules* (NER), the AER is required to make a decision on the appropriate control mechanisms for standard control and alternative control services in the Framework and Approach Paper (cl 6.8.1). Once such a decision is made, the regulatory determination must proceed on the basis of the control mechanisms set out in the relevant Framework and Approach Paper (cl. 6.12.3). ENA considers that a decision to change a form of regulation for NSW DNSPs can only be made if there is sufficient evidence that, given advantages and downsides of the variety of control mechanisms available, one option is superior to the other for the regulation of electricity distribution businesses. ENA does not believe there is sufficient evidence to justify such a departure and therefore a price cap control mechanism should remain for the 2014-19 regulatory control period.

3. AER's approach to assessment of available forms of regulation

ENA welcomes the AER's decision to introduce additional criteria under the clause 6.2.5 (c) against which it assessed the two alternative control mechanisms (revenue cap and price cap) that they considered appropriate for the regulation of standard control services. The additional factors proposed by the AER included volume risk and revenue recovery, price flexibility and stability and incentives for demand side management.² While these are important issues, however, ENA has significant concerns that the AER did not give sufficient regard to the factors that are specified in the NER.

3.1 Consistency with previous arrangements

ENA is concerned that the AER did not have sufficient regard to 'the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination' (cl 6.2.5 (c) (3)). It is understood that for the next regulatory period the AER is no longer bound by the requirements of Transitional Rules to maintain the form of regulation that was applied by the previous jurisdictional regulator. However, it is clear that the inclusion of 6.2.5 (c) (3) was intended to promote regulatory certainty and stability, and to ensure that any changes from the previous approach are carefully considered. ENA believes that the AER's approach has failed to provide sufficient and fundamental weight to this factor in comparison to other assessment criteria.

¹ ENA notes that AER also expressed its initial preference to change the control mechanism for standard control services in the ACT, without placing appropriate weight on the need to take account of the current control mechanism.

² AER Discussion paper *Control mechanisms for standard control electricity distribution services in the ACT and NSW*, April 2012, p.6.

ENA is also concerned that the AER has appeared to disregard a factor concerning ‘the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction)’. ENA notes that there are different control mechanisms that are applied to standard control services in the National Electricity Market (NEM). However, the price cap is the most common form of regulation for standard control services. It is applied for regulation of distribution businesses in Victoria and South Australia, as well as the three distribution businesses in NSW. It appears to ENA that the AER’s proposal would lead to a shift from a more consistent approach to a less consistent approach with little justification.

ENA considers that there are some valid reasons as to why the NER regulate prescribed transmission services by means of a revenue cap; however allow a variety of control mechanisms to be applied for regulation of direct control services, including standard control services. For example, when considering an appropriate control mechanism for regulation of transmission network service providers in 2006, the Australian Energy Market Commission (AEMC) recognised that for transmission businesses, costs are largely fixed and do not vary significantly with the quantity of service provided.³ There is arguably larger scope for variable costs in distribution when compared to transmission. The AER observes correctly that costs for distribution do not vary significantly with small short term variations in the volume of throughput.⁴ However, a significant proportion of distribution businesses’ costs and capital costs in particular, is driven by new connections, load growth and consequent network extensions and reinforcements. These costs are a function not only of the quantities of new connections and load growth but where on the network that growth occurs. If growth occurs at a location where upstream capacity is constrained then the costs of servicing that growth are significantly greater than if the growth occurs in an unconstrained location. These factors are much more uncertain and difficult to forecast for distribution networks than for transmission networks. Therefore, while a revenue cap is arguably a ‘safe’ form of control for transmission businesses that is not necessarily the case for distribution businesses.

3.2 Demand side management incentives

ENA agrees with the AER in relation to the importance of the demand side management and incentives to implement non-network solutions to address peak demand issues. However, ENA does not consider that this issue is necessarily most appropriately addressed through choices relating to the control mechanism.

Under the existing rules this matter is already considered in a number of ways. The AER has to have regard to whether the DNSP considered, and made provisions for, efficient non-network alternatives when assessing proposed expenditure (cl 6.5.6 (e) (10) and 6.5.7 (e) (10)). Also, clause 6.6.3 provides the AER with power to develop a demand management scheme in order to provide businesses with incentives to implement efficient non-network alternatives. ENA considers that the short run incentives for demand side management provided by revenue caps do not represent an optimal means of directly incentivising efficient levels of demand side management. This is because revenue caps do not provide incentive to share the benefits derived from cost savings with the consumers. The AER should focus on developing a more efficient and targeted solution to address demand side management. The AER should not be assessing choices regarding control mechanisms with undue emphasis on this factor in circumstances where alternative, more directly targeted approaches, can and would provide a better means of addressing this issue.

3.3 Volume forecasts and revenue recovery

ENA is also concerned with the AER’s conclusion that the accuracy of sales forecasts is not as crucial under the revenue cap as under the price cap, because under the price cap volume forecasts are used in setting the price constraint over the entire regulatory period. While any forecast is prone to error and, as the AER recognised in its Preliminary Positions Paper, there are a number of factors that

³ AEMC *Economic Regulation of Transmission Services, Rule determination*, 16 November 2006, p.41.

⁴ AER *Preliminary Positions - Framework and Approach Paper: Ausgrid, Endeavour Energy and Essential Energy regulatory control period commencing 1 July 2014*, June 2012, p.54.

can impact the accuracy of volume forecasts during the course of the regulatory period,⁵ ENA considers that the accuracy of the initial forecasts is of significant importance under both control mechanisms. This is because in a case in which the *original* forecast is not accurate, the revenue cap derived from such a forecast will either underestimate or overestimate costs and hence the maximum revenue allowed to a business. It is not clear how such an outcome can be superior to that under the price cap and better promote the National Electricity Objective (NEO) and Revenue and Pricing Principles (RPP). Furthermore, under the revenue cap the accuracy of forecasts *during* the regulatory control period is also important. The less accurate the sales forecast, the greater the need for unders and overs adjustments and the greater the price instability for consumers.

4. AER's proposal to adopt a price cap correction factor

In the Preliminary Positions Paper the AER suggested that the volume risks associated with price cap could be mitigated by the adoption of a correction factor that would provide an adjustment when demand forecasts exceed pre-determined levels.⁶ The AER does not provide details on the potential design of the correction factor in its Preliminary Positions Paper. However, it is understood that the suggested correction factor is intended to remove the effect of fixed cost incorporated in the price for all units sold above the forecast quantity.

ENA's preliminary view is that introduction of such a correction factor to address demand forecast variations may introduce unnecessary uncertainty for businesses and contribute to greater price volatility for consumers. However, ENA is supportive of further investigation of this option. In doing so the AER should consider whether application of a correction factor would undermine any incentives provided to businesses within the existing regulatory framework and whether the businesses will be able to recover at least efficient costs. Also, the design of such a correction mechanism could potentially specify a threshold, having exceeded which the correction factor will apply. In this situation if the volume of sales does not vary materially from the forecast the control mechanism will remain unchanged. Notwithstanding the above position, ENA considers that, in this review context, the price cap mechanism is appropriate for the regulation of standard control services in its current form.

Energy Networks Association

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⁵AER *Preliminary Positions - Framework and Approach Paper: Ausgrid, Endeavour Energy and Essential Energy regulatory control period commencing 1 July 2014*, June 2012, p.56.

⁶AER *Preliminary Positions - Framework and Approach Paper: Ausgrid, Endeavour Energy and Essential Energy regulatory control period commencing 1 July 2014*, June 2012, p.56.