EnergyAustralia®

AER Issues paper

Matters most relevant to 2009-2014 distribution determinations for NSW/ACT businesses

December 2007

1 Introduction

EnergyAustralia is pleased to respond to the AER issues paper on matters it is required to address for NSW/ACT businesses under the new National Framework.

The matters the AER seeks feedback on form an integral part of the regulatory proposal that EnergyAustralia is required to submit to the AER in June. EnergyAustralia looks forward to working closely with the AER on these issues and other elements critical to the development of our regulatory proposal.

Given the short turnaround for responses, the AER's issues paper and EnergyAustralia's response has not been considered by our executive at this stage. Our response therefore represents a preliminary view from EnergyAustralia staff. We note that this issues paper is the first phase in a series of consultations on these issues and intend to work closely with the AER over the period leading up to our regulatory proposal.

2 Demand management incentive scheme

2.1 Scope, and related incentives and disincentives, for DNSPs to contribute towards efficient demand management

Based on our own experience and feedback from consumer organisations and service providers, EnergyAustralia believes there are three important categories of demand management activities. These are described below. Active involvement in all three is necessary if we are to realise the full potential of network demand management and meet the legitimate expectations of our customers.

EnergyAustralia supports the incentive mechanism that applies to the current regulatory control period (the D-factor). This provides a positive incentive for demand management activity under the first category. We believe it could be readily enhanced to provide a positive incentive for global demand management initiatives and innovation activity in addition to its current scope.

2.1.1 Existing incentives for non tariff demand management

Existing incentives for non-tariff demand management apply when a demand-side option is identified as being an efficient alternative to a supply-side (network) solution to address specific network capacity constraints. These types of projects are location specific and can be linked explicitly to a supply side project that is capable of being deferred or potentially removed from the capital program.

In the absence of the D-factor, a non-tariff demand management solution may result in revenue loss for the DNSP under the WAPC form of price control if a reduction in demand occurs as a result of the initiative. In addition, the inherently riskier business profile of demand management activities and the risk due to unfamiliarity and regulatory uncertainty mean that some incentive is appropriate to enable network businesses to make prudent commercial decisions to prefer a demand management solution to a traditional network option.

The existing D-factor mechanism effectively compensates DNSPs for the tariff revenue loss, neutralises the risk driven disincentives and provides a positive incentive by allowing recovery of the project cost (usually an opex cost rather than capex) and any associated time value of money due to the two year lag. The D-factor as administered by IPART has been an effective mechanism for promoting the wider use of this category of demand management activity.

2.1.2 Incentives for global demand management initiatives

Some demand management opportunities, while well understood and able to reduce peak demands predictably, are not suitable for implementation at a localised scale. This means that, while they can be reliably linked to demand reductions across the network, they cannot be linked to the deferral of a specific capital project. EnergyAustralia has had limited success in recovering the costs associated with this type of activity under the existing D-factor regime. There would be benefit in expanding the D-Factor incentive mechanisms to provide some greater certainty in this area so that the incentive for these types of programs was more explicit.

An example might be a broad based equipment efficiency initiative where involvement of a large number of equipment suppliers and intermediaries would be impractical in a small, concentrated area. However, if applied at a global level (ie across a whole network territory) such a program might be much more practical and cost effective.

2.1.3 Incentives for Innovation

One of the key barriers to more rapid and wider adoption of demand management options by network businesses is the relatively undeveloped state of many of the DM options that have been proposed. Lack of experience with real world impacts and costs of many demand management options makes it very difficult for a network business to make prudent commercial decisions to implement demand management options. A key activity that will accelerate the currently slow progress in this area is the expansion of the current incentive mechanism to include innovation and development initiatives. These are projects that have the potential to deliver cost effective demand reductions in appropriate circumstances, but are untested and there is a significant risk that the initiative will not perform as hoped. In these circumstances, the network solution is invariably adopted. This issue has been dealt with in other jurisdictions by the establishment of learn by doing incentives as the first step in promoting network demand management.

Expenditure in this category cannot usually be justified under the current D-factor mechanism. These types of projects would be pilot programs or research projects aimed at developing a demand management tool to be used (if found to be successful) to defer capital when future opportunities arise.

One example of this type of project is EnergyAustralia's CBD Demand Curtailment Project, which was a pilot program that investigated opportunities and implemented strategies in premises of a sample of customers within the CBD. The potential for demand management in the CBD was then extrapolated from the sample, and in this case, this approach was found to be a very expensive option to manage demand.

A second area of innovation that arose during the course of the current determination was EnergyAustralia's Strategic Pricing Study. This is a pilot program involving 1,300 customers whose premises have been equipped with advanced meters and two way communications. The purpose of this pilot is to gauge customer acceptance of and reaction to short term, high price levels accompanied by prior notification. Research to define customer response to different and more cost reflective tariff forms is an essential part of this demand management program.

2.1.4 How the D-Factor applies to each category

The existing D-factor as administered by IPART works adequately for the first category of demand management activity only. The current determination provided some encouragement for global initiatives, but it is very difficult to justify them under the current approach and additional guidance on how these should be included would meet the expectations of our customers to undertake more broadly based, long term focussed demand management activities.

EnergyAustralia strongly supports the expansion of the current D-factor to include a "learn-by-doing" style approach to ensure innovative approaches to capital deferral which are at a conceptual stage can be investigated, developed and, if successful, implemented when future opportunities arise. This approach would supplement the existing D-Factor.

EnergyAustralia believes that customers are willing to pay to ensure innovations lead to more energy and cost efficient solutions in the future, particularly when the incremental impact on tariffs is very, very small.

2.2 The role and effectiveness of the D-factor scheme in achieving its aims and objectives in the current regulatory period in NSW

The D-factor scheme in NSW has provided the necessary framework for the wider use of well understood demand management alternatives to traditional network options in specific investment cases.

EnergyAustralia believes it is appropriate that a D-factor mechanism continue under a National framework. However, as mentioned above, EnergyAustralia considers that the D-factor arrangements can be complemented and improved by incorporating a "learn by doing" style mechanism and providing greater guidance on its application to global initiatives.

2.3 The structure of a potential demand management scheme, the costs and benefits of this scheme and the expected impact on the efficiency of the National Electricity Market.

EnergyAustralia believes that a successful approach to economic regulation of demand management and other non-network initiatives requires:

- the continuation of existing D-Factor arrangements to ensure that DNSPs are incentivised to undertake demand management under a weighted average price cap; and
- a scheme to incentivise DNSPs to invest in non-network solutions where the investment cannot be tied to specific proposed capital projects, or where it is considered too uncertain to proceed as a stand-alone alternative to a network alternative.

2.3.1 Mechanism to establish the scheme

EnergyAustralia notes that the AER guidelines limit the expansion of the scheme to supplementing the scheme with another existing demand management model, such as a learn by doing fund.

Existing funding arrangements in Victoria and South Australia provide capped operating expenditure allowances over the regulatory control period. The AER notes that ESCOSA offered $20 million for a range of pilot demand management initiatives over the regulatory period. In Victoria, the ESC allowed $0.6 million in each of the DNSPs' budget to investigate or implement demand management initiatives.

The following options appear to be available to the AER to implement such a mechanism:

- AER allows operating costs as part of the revenue building blocks;
- AER provides funding via a pass-through mechanism upon application by the DNSP;
- AER could provide expand the current D-Factor arrangements, where research projects meet a set of criteria, they would be eligible for funding (upon application by the DNSP) up to a dollar cap (e.g. 2 million p.a.).

EnergyAustralia supports the steps taken in Victoria and South Australia but believes it would be simpler to deal with all demand management related activities within the one mechanism.

2.3.2 Suggested EnergyAustralia approach

EnergyAustralia believes that the existing D-factor mechanism can be readily expanded to include costs for innovation and development (learn by doing) and global demand management programs. This approach would maximise incentives for businesses to undertake non-network investments while minimising administrative costs.

Under this approach, the D-factor allowance would include costs and related revenue forgone for both development and innovation and broad based demand management projects. Total costs claimable for the combination of these two would be subject to a predetermined annual cap (somewhere in the order of 0.5%-1% of revenues). Like the existing D-factor regime, there would need to be a continuation of this incentive scheme beyond the next regulatory control period.

The determination would identify the criteria for inclusion of projects under this cap, but indicatively thy would include:

- Demand reduction projects and programs in specific areas that could be used in future to defer or avoid growth related capex, but where the current levels of experience and confidence in out-turn impact or costs are insufficient to make a prudent business decision; and
- Broad based demand management program that will result in a clear reduction in demand but cannot be allocated to a specific identifiable capex deferment. Costs limited to a specific $/kVA value that represents a generalised average value of demand reduction.

If a project falls under these criteria, and is also under the cap, a claim under the D factor can be made for costs, revenue foregone and the time value of money.

There are many advantages to an expansion of the existing D-Factor mechanism:

- The cap ensures that impacts on customer bills are limited to a very small amount. Bills are only impacted upon application for D-Factor payments. The AER may consider a higher value of cap in early years of the regulatory control period. This would boost the incentive to undertake innovation and development projects early. This would give earlier signals for projects that could deliver cost effective DM options under the “normal” D-Factor;
- A $/kVA limit on broad based programs would ensure that longer term reductions in capex will exceed costs (noting the existing D factor does not consider the longer term flow-on benefits of demand reductions over time); and
- The introduction of a cap and inclusion in the existing D-Factor removes the need for up-front initial approval and funding. This means that customers only bear the costs of the actual investment. Administrative costs of justifying and approving projects ex-ante of the investment under a funding option and reconciling these costs to the underlying incentive regime for opex and capex make a modification to the existing D-Factor a more attractive option.
- In the event that sufficient projects are not identified and implemented by the DNSP, customers would face no additional costs.

2.4 Other issues

2.4.1 Interaction with other incentive mechanisms

Costs associated with demand management usually involve a high proportion of operating expenditure. This represents in many circumstances a trade-off between a reduction in the cost of capex to defer a project, by increasing opex. Any EBSS intended to incentivise reductions in operating costs must exclude spending on demand management to avoid these incentive schemes acting in opposition to one another. If these costs are subject to disclosure and review under a D-factor submission process, these will be clearly identified and their exclusion relatively straightforward.

2.4.2 Costs associated with more general network research and development and consumer education activities

The issues paper notes that the mechanism must look at incentives for DNSPs to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way. Consequently, the discussion above relates specifically to the incentivisation of DNSPs to develop and undertake demand management activities.

It is now widely recognised that network businesses such as EnergyAustralia need to invest more broadly in research and development as standard practice across their businesses. This is particularly the case in the current climate where businesses are seeing new and innovative ways to response to issues such as aging assets, increasing customer needs and climate change. The education of customers in the safe and efficient use of the product EnergyAustralia delivers is also recognised as an integral part of carrying on such a business.

EnergyAustralia believes that the operating expenses it sets aside for consumer education, and network research and development purposes represent efficient costs for a benchmark DNSP. This would mirror how non-regulated businesses in capital intensive industries cater for such expenditures.

It is important to recognise that these activities include a much wider range of matters than the focus on demand management in the discussion above.

The current D-factor does not, and should not, cater for investments in education or research into network and energy issues more generally. These costs should be considered a standard part of DNSP's operations. EnergyAustralia will include these costs as part of its normal operating and capital expenditure forecast as part of its regulatory proposal.

3 Control Mechanisms for Alternative Control Services

3.1 Overview of the Rule requirements

Clause 6.2.2(b) of the draft transitional rules (the Rules) notes that for the purposes of the regulatory control period 2009-2014, the excluded distribution service of the construction and maintenance of public lighting infrastructure (referred to here as public lighting) is to be classified as a direct control service and further classified as an alternative control service.

The AER has responsibility for setting the control mechanism and the approach for setting the control mechanism for public lighting in a manner consistent with clause 6.2.5(c) of the Rules. The control mechanism for alternative control services may consist of:

(1) a schedule of fixed prices;
(2) caps on the prices of individual services;
(3) caps on the revenue to be derived from a particular combination of services;
(4) tariff basket price control;
(5) revenue yield control;
(6) a combination of any of the above.

In deciding on the control mechanism, the AER must have regard to:

(1) the potential for development of competition in the relevant market and how the control mechanism might influence that potential; and
(2) the possible effects of the control mechanism on administrative costs of the AER, the Distribution Network Service Provider and users or potential users; and
(3) the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination; and
(4) the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction); and
(5) any other relevant factor.

Under clause 6.2.5(e) of the Rule, the AER must, before 1 March 2008 or the date that is one month after the commencement date (whichever is the later), publish a statement indicating its likely approach to the control mechanisms for alternative control services.

Clause 6.8..2(3A) states the DNSP must submit as part of its regulatory proposal a proposed control mechanism, demonstration of the application of the proposed control mechanism and necessary supporting information. This clause makes it clear that the DNSP's proposal may depart from the likely approach indicated in the AER's statement, but must state reasons justifying the departure.

Clauses 6.12 and 6.13 provide for the AER to make a decision on the DSNP's proposed control mechanism and its application to alternative control services based on the regulatory proposal.

The policy intent behind this is straightforward. The nature of services classified as alternative control means that the regulatory impost on the service should not be as prescriptive as for standard control services. In exercising its discretion in relation to the appropriate control mechanism, the NEL requires the AER to take into account the Revenue and Pricing Principles in Section 7A of the NEL. The AER Statement provides additional guidance on the AER's preferred approach which may give a DNSP comfort if it proposes an approach consistent with the AER's statement.

EnergyAustralia believes therefore the AER's statement should be broad-based, and where possible, be consistent with the approach offered by IPART under the current regulatory control period.

3.2 Is the current approach to public lighting consistent with National Electricity Rules?

EnergyAustralia believes that the implementation of IPART's current regulatory approach to public lighting is consistent with the available control mechanisms in clause 6.2.5 of the Rules, albeit with minor modifications as outlined in the following section. Anchoring the control mechanism so that it is consistent with the current IPART approach is preferable to a complete review of the control mechanism and approach. Any major change in control mechanism or approach would make it most difficult for DNSPs to submit a compliant regulatory proposal on time.

Public lighting is currently regulated under IPART's Regulation of Excluded Distribution Services Rule 2004/1 of June 2004 (the IPART Rule). Public lighting is subject to the same regulatory obligations as other excluded services and must comply with the following:

Pricing principles – prices must signal the economic cost of providing the services and the underlying cost data in support of those prices must be periodically reviewed (2.2(a)(1));

Information disclosure – the DNSP must provide a description of the service, the standard prices (or applicable methodology) at which the services are provided and the terms and conditions of service (2.2(a)(2)).

However, Section 2.3 of the IPART Excluded Services Rule places further controls on the revenues earned by DNSPs under public lighting by effectively requiring IPART's approval of any change to the pricing of public lighting. Before a DNSP can seek that approval it must provide detailed cost, service standard and customer impact information to IPART under the following process.

No later than 2 months before changing its prices the DNSP must prepare a report for the Tribunal which sets out the following information:

Costs and costing methodology – DNSPs must provide the Tribunal with information on the overall costs of construction and maintenance of public lighting services undertaken by the DNSP and the basis of that costing methodology, the service standards associated with the public lighting service, any proposed changes in prices and the reasons for those changes, and how customer impacts have been considered (2.3(a)(2)). This information must relate to the period since the beginning of the regulatory control period or the previous report.

IPART subjected public lighting to an alternative form of regulation compared to a more onerous building block assessment of prescribed services. If it had desired the more onerous building block assessment, it would never have separated the service from the main form of regulation. The alternative approach seeks to allow the business to justify its costs and costing methodology rather than have one imposed. We believe such an approach is entirely consistent with what policy makers intended when creating a separate regulatory approach for alternative control services.

Customer impact – the DNSP must implement transitional procedures where pricing changes are likely to impose significant adjustment costs on customers (2.3(a)(3)).

IPART is required to assess the report and if it is not satisfied that the DNSP has complied with Clause 2.3. IPART may reject the business' proposal and require it to re-file its application with alternative prices (2.3(e)). There is no clear formal determination process which means that there is no requirement for IPART to formally set out the prices/revenues determined or to justify reasons or its basis for acceptance or rejection.

In 2005, EnergyAustralia resubmitted a report under Clause 2.3 which sought price increases of CPI+26% in the first year and further price increases in following years.[1] IPART decided under 2.3(e) not to accept the application and requested EnergyAustralia to resubmit alternative prices.

EnergyAustralia's resubmitted report proposed public lighting service revenue be subject to a defined 4 year transitional path (in this case CPI+10%, 5%, 5%, 5%), subject to the additional constraint that the total costs of SLUOS services paid by any public lighting customer should not exceed 10% in the first year of the price path (ie. no scope for tariff rebalancing) and 7.9% thereafter (the same side constraint as was applicable to network tariffs). No side constraints are applicable to particular prices – only that the total cost of the services to any particular customer does not exceed the stated side constraint. The revenue path and the "total bill side constraints" are based on a fixed inventory; total revenues and total council bills will also vary according to the inventory of installed equipment grows.

[1] IPART's 2004 determination, in which it changed the classification of public lighting services to an Excluded Service, exposed significant chronic cross subsidies from the network business to the public lighting business.

We believe the IPART Rule is broadly consistent with the Rules. While the IPART Rule does not expressly give IPART powers to set public lighting prices, it effectively fixes prices until IPART is satisfied that a change to prices is justified. In this way, the IPART Rule does set out a process for establishing a control mechanism and allows IPART to require the DNSP to resubmit the report if it believes the control mechanism is not consistent with the IPART Rule. The IPART Rule also provides for negotiated prices to be accepted under the Rule (2.3(g))

Therefore IPART's determination in respect of EnergyAustralia and the Excluded Service Rule is consistent with the requirements of the Rules for a control mechanism for alternative control services in that it:

- places a control on the total revenue the DNSP can earn for public lighting infrastructure in each year of the regulatory control period;
- places a further control on the movement in revenues earned from a customer (such as councils);
- the control mechanism requires separate submission of the cost/price/service offering which can be rejected by IPART; and
- explicitly provides for negotiable aspects of the service.

3.2.1 Modifications required to make the IPART approach consistent with the Rules

We believe that the existing regulatory framework under the IPART Rule could be modified in order to meet the requirements of Part B and Part E of the Rules without substantially changing current regulatory arrangements. Some of the changes include:

- The control mechanism would need to explicitly state:
    - a schedule of fixed prices for the opening year of the regulatory control period;
    - a control on the total revenues to be earned from the service over the regulatory control period;
    - a separate constraint on prices charged to each customer (ie. council) for each year of the regulatory control period (recognising the balance between cost reflective pricing and impacts on customers); and
- The costs proposed need to be consistent with the revenue and pricing principles. This would reflect a demonstration of the valuation of the assets used in providing the service which EnergyAustralia will provide. However, an AER sponsored independent valuation of assets for streetlighting is unwarranted under the existing rules framework.
- We would consider it pragmatic to propose prices consistent with the control mechanism and the pricing principles identified in the Excluded Services Rule.

On this basis, we believe the AER should consider the following approach when providing a statement in respect of its likely approach for making a decision on a control mechanism:

- DNSP to provide a regulatory proposal which would include in respect of public lighting:
    - an overview of the services provided;
    - DNSP to propose a proposed control mechanism (preferably a cap on revenue movements) over the regulatory control period consistent with Part B of the Rules.
    - DNSP to demonstrate application of the control mechanism;

- DNSP to provide the underlying costs that support the control mechanism proposed. This includes:
  - a justification of those prices (based on a demonstration of efficient costs in accordance with the principles of the Excluded Services Rule);
  - a demonstration of price and cost movements over the previous regulatory control period; and
  - where prices are above or below efficient costs, demonstration of how prices will move to efficient costs during the next regulatory control period.
- DNSP to provide likely costs over the next regulatory control period and why those costs are necessary to provide the service.; and

- As part of its Draft Determination, the AER will determine whether the proposal:
  - meets the requirements of Part B of the Rules.; and
  - is consistent with the pricing principles, costs and costing methodology and customer impact provisions of the Excluded Services Rule

  And specify how compliance with the control mechanism is to be demonstrated.

EnergyAustralia believes that such an approach is a proportional balance between maintaining elements of the existing regime and ensuring compliance with the new one.

3.3 AER consideration of alternative control services and implications for the next reset

If the AER comes to the conclusion that the current mechanisms applied to each DNSP to control revenue and/or prices should not be maintained, the AER would necessarily be required to develop a "clean slate" consultation process. Invariably, a number of different regulatory regimes will be canvassed and assessed. Many of these approaches were considered by IPART during its canvassing of issues prior to the 2004 determination. EnergyAustralia believes that 4 months to consult and consider on methodologies is not enough time for proper consideration of all issues, and to the extent that there is a deviation from the current approach to public lighting regulation, 3 months following the release of any guidelines would not allow EnergyAustralia the opportunity to consider the new approach in a pragmatic way.

It is proposed that while the approach to control mechanism is in need of reform, 4 months is not enough time to fix it without either reverting to the current approach to establishing control mechanisms or creating significant difficulties in the DNSP being able to respond to any new approach for its regulatory proposal.

EnergyAustralia notes that the AER is interested in feedback on a number of issues associated with the form of control mechanism for public lighting. We are concerned with any approach that would lead to alternative control services being treated as, or subject to a heavier hand of regulation, than standard control services. This would not have been the intent of the policy makers at the time of writing the Rules. Nevertheless, we provide our response to the issues raised below.

3.3.1 Should a building block approach be adopted for public lighting?

The AER notes in its issues paper that "…a building block assessment provides a firm basis for estimating the efficient costs of providing services" and is therefore seeking comment on whether a limited form of building block assessment is appropriate for the next regulatory control period.

EnergyAustralia has no fundamental concerns with building block analysis. Some form of analysis would be appropriate under the current regime and it is likely that IPART would have used a building

block assessment to ensure prices signal the economic cost of service provision (required under the Excluded Services Rule).

Our concern is less about the phrase "building block analysis" and more about the phrase "limited". Included in the AER's proposal for a limited review is:

- establishing a new regulatory asset base;
- requiring the DNSP to include forecast capex and opex "as part of or in addition to the capital and operating expenditure proposals for standard control services"; and
- the AER determining an appropriate price or revenue path for the period.

EnergyAustralia has for some time noted that public lighting, per dollar of revenue, is the most regulated service EnergyAustralia provides. We agree that an approach should look at the AER assessing efficient costs of providing a service, but should also aim to provide a regulatory regime that is less onerous that the one provided for Standard Control Services.

We therefore support a building block analysis that requires the DNSP to demonstrate, to the AER's satisfaction, the efficient costs of providing the service and the proposed control mechanism that allows the DNSP the opportunity to recover those efficient costs.

This gives more flexibility to approaches undertaken by DNSPs, and in the approach to assessing the proposal.

3.3.2 Should the AER escalate current allowances?

EnergyAustralia believes that any regulatory period extending beyond one year will require some form of escalation and in the interests of consistency, escalation of prices based on a CPI adjusted price or revenue path seems the most practical alternative.

However, EnergyAustralia does not agree that revenues should be escalated irrespective of costs. For example, if the costs of providing the service were to decrease, it would not be appropriate to escalate revenues irrespective.

Similarly, if a DNSP can demonstrate that the revenues currently provided do not allow the DNSP a reasonable opportunity to recover efficient costs in the future, then the NEL revenue and pricing principles would dictate that escalation to ensure the DNSP can recover its efficient costs.

3.3.3 Should the AER undertake a building block analysis?

The AER has asked whether it should undertake a building block analysis, and if a building block analysis is undertaken:

- should the AER roll forward the existing asset base?; or
- should a new asset base be established?

EnergyAustralia does not support at this time an independent, bottom up AER assessment of the regulatory asset base for public lighting. Placing such a requirement during a resource constrained period in assessing the asset base is inappropriate.

Nevertheless, as part of its regulatory proposal, EnergyAustralia will demonstrate the basis of its efficient costs using a regulatory asset value. Implicit in this value are several assumptions which reflect the legacy assets which EnergyAustralia holds. For example, EnergyAustralia makes some high level assumptions about remaining life of some legacy assets. A more in depth analysis would require an audit of around 1.3 million different assets.

We understand that businesses will differ in terms of how they establish an opening asset value. EnergyAustralia believes there may be more benefit in the AER establishing how it will assess the

asset value as a basis for determining efficient costs rather than establishing an asset valuation method and dictating it to all businesses (at least as part of this regulatory control period).

3.3.4 Administrative Costs

EnergyAustralia reiterates the importance of keeping "cool heads" in respect of regulating public lighting in the next regulatory control period. The predicament that places NSW and ACT businesses in a regulatory process with rules that are yet to be formalised is an unfortunate one which is outside the control of DNSPs and the AER.

There are a multitude of interpretational issues that the AER and businesses will have to deal with leading up to the regulatory proposal. While the service of public lighting is a vital one and should not be ignored, the resources and costs associated with the development of the regulatory framework should be proportional to the total task at hand.

4 Guideline for Materiality on pass through events

4.1 Overview

While EnergyAustralia notes that the intent of this guideline is limited to developing an approach to materiality for pass through events, we believe that all stakeholders would benefit from additional guidance from the AER on the following issues:

- Approach to specific pass through: there is a strong inter-relationship between the forecast capital program which is incentive based on an ex ante approach, and the appetite for off-ramps (or exceptions to the rule), which has the effect of decreasing the power of the opex and capex (ex ante) incentive implicit in the Rules. In the transmission sector, EnergyAustralia notes an obvious movement toward contingent projects in circumstances where there is uncertainty as to the timing or scope of the project. A better understanding of whether the AER intends to use specific pass through events as a surrogate for the contingent project mechanism for the next regulatory control period, and the proposed approach taken, will assist with the development of EnergyAustralia's regulatory proposal. EnergyAustralia would also like an understanding of whether the approach will differ between distribution and transmission investment.
- "Dead zone" events: EnergyAustralia has raised informally with the AER the potential for a pass through event to be triggered during the current regulatory control period but after the lodgement of the regulatory proposal. Further guidance on how the AER would be prepared to address such issues as part of the 2009-2014 determination would be of great assistance to DNSPs in developing their approach to the specific pass through clauses they are required to submit as part of their regulatory proposal.

4.2 The appropriate threshold

The definition of positive change event is "a pass through event that materially increases the cost of providing direct control services". The concept behind pass through events is to offer the DNSP a degree of protection from the impact of changes in costs outside its control.

It is important to note that under a heavily codified regulatory framework a pass through mechanism may be the only opportunity for the DNSP to recover efficient costs not included in the forecasts accepted (or substituted) by the AER at the beginning of the regulatory control period. In the previous regulatory regimes, NSW DNSPs had the opportunity to recoup foregone return for efficient costs in the subsequent regulatory control period. The incentive regulation framework (providing a

lock-in of asset value and an ex ante incentive mechanism for opex and capex during the period) under the national framework does not allow this. Therefore a reconsideration of how pass through works is necessary.

Incentive-based regulatory regimes focus on driving businesses towards improved service delivery at lower cost. Including costs outside the DNSP's control within an incentive mechanism runs counter to the purpose of incentive regimes and the NEL revenue and pricing principles which state the DNSP should be given the opportunity to recover the efficient costs of providing the service. The AER should therefore consider the incentive properties of the new framework when deciding an appropriate mechanism to pass through uncontrollable and unforecast costs.

One key issue to this consideration is the materiality threshold that will apply. EnergyAustralia's view is that the threshold should not be set so high as to preclude recovery of efficient costs. On the other hand, setting the threshold too low could potentially make the regulatory costs of administering the pass through arrangements outweigh the benefits of the pass through mechanism under incentive regulation.

EnergyAustralia believes that the following approach would achieve a balance of ensuring protection for DNSPs against certain categories of uncontrollable costs and minimising the costs of administering the pass through arrangements.

EnergyAustralia proposes that the materiality threshold for a pass through event would be met if either:

- the total revenue impact in the regulatory period (as a result of the pass through event) is greater than 1% of the annual allowable revenue requirement (AARR) in any single year during that period; or
- the costs of the pass through event are equal to or greater than:

  $25 million in capital costs[2]; or

  $5 million in operating costs,

  whichever is lower.

EnergyAustralia also proposes a mechanism to consolidate pass through events over the period in the event that a number of uncontrollable events combined exceed the materiality threshold.

4.3 Alternative approaches

Other approaches proposed by the AER have some shortcomings. These include:

- Uncertainty: The approach imposed by IPART in the previous regulatory control period was subject to interpretation. It was difficult to identify and apply the threshold of the pass through mechanism.
- Inconsistency: Other approaches, such as applying a straight percentage threshold, have the effect of discriminating between DNSPs on the basis of their size. For example a pass through event may have substantial cost impacts that impact equally on all DNSPs. A DNSP with a high revenue allowance may find the costs do not meet the materiality threshold, whereas a DNSP with a lower revenue allowance may be able to pass the costs through. In these circumstances, one DNSP is able to recover its efficient costs while the other is not able to do so. EnergyAustralia's view is that a DNSP should not be precluded from

[2] Alternatively, the AER may consider linking the revised threshold for the regulatory test proposed by ETNOF for large network augmentations ($35 million) in respect of capital costs as a the second threshold limb for materiality (EnergyAustralia would consider the existing $10m threshold too low for both the regulatory test and pass through).

recovering the efficient costs of certain uncontrollable events purely because it has a higher revenue allowance than another DNSP.

This issue is quite important for a large DNSP such as EnergyAustralia. Should a threshold based on a percentage of revenue be introduced without a dollar threshold alternative, EnergyAustralia would need to take events with an opex or capex value beneath the revenue threshold into account in its capex and opex forecasts.