

Control mechanism - only relevant to distribution

The AER's proposal highlighted the potential mismatch in the thresholds for changing the control mechanism and the service classification following the relevant framework and approach paper for distribution. This could cause a problem where the service classification changes but the control mechanism is not able to be changed as a result. In the directions paper, the Commission took the view that the AER may need some flexibility to adjust the control mechanism following the framework and approach paper when unforeseen circumstances occur. Following further clarification from the AER regarding the differences between the form of control mechanism and the formulaic expression of the control mechanism, the Commission has decided to revisit this issue.

For clarity, clause 6.2.5(b) of the NER lists the available options for the form of control mechanisms, which are:

- a schedule of fixed prices;
- caps on the prices of individual services e.g. a price cap;
- caps on the revenue to be derived from a particular combination of services e.g. a revenue cap;
- a tariff basket price control e.g. a weighted average price cap (WAPC);
- a revenue yield control e.g. an average revenue cap; or
- a combination of any of the above.

The formulaic expression of the control mechanism is the formula associated with that form of control mechanism. An example of the formulaic expression of the control mechanism is provided in Appendix B to illustrate the clear distinction between the "formulaic expression" of the control mechanism and the "control mechanism" itself.

The joint submission of ETSA, CitiPower and Powercor stated in an earlier submission that they support providing some flexibility to revisit the formulaic expression of the control mechanisms.⁴⁵³ However, they consider that the form of the control mechanisms should be fixed in.⁴⁵⁴ Otherwise, this would create an unacceptable degree of regulatory uncertainty for the NSP, place a prohibitive administrative burden on NSPs, and may constrain the NSP's ability to properly assess any new proposed form of control mechanism.⁴⁵⁵ The AER and NSPs clarify their support for the joint submission of ETSA, CitiPower and Powercor's in the second round of consultation.

The Commission accepts that the amount of time required for a NSP to accommodate changes to the form of control mechanism would be significant. As a result, the form of

⁴⁵³ ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, p. 37.

⁴⁵⁴ Ibid.

⁴⁵⁵ Ibid.

control mechanism should be fixed in the framework and approach paper. However, if the formulaic expression of the control mechanism was able to be amended, a measure of flexibility would be afforded. The joint submission of ETSA, CitiPower and Powercor supports this approach, and notes that the AER has previously observed the benefits of a change to the formulaic expression of the control mechanism.⁴⁵⁶ This includes in the South Australian distribution regulatory determination regarding the WAPC, and in the Victorian distribution regulatory determination regarding the S factor true-up correction factor. It would appear that the burden on a NSP to accommodate a change to the formulaic expression is not so great as to be prohibitive of this approach.

The benefit of this approach is that there would be sufficient flexibility in being able to change the formulaic expression of the control mechanism during the regulatory determination process. This flexibility is balanced with certainty in fixing in the form of the control mechanism at the framework and approach paper stage. In addition, the formulaic expression of the control mechanism could be changed when the service classification is changed, addressing the AER's concern.

Threshold for changing service classification and formulaic expression of the control mechanism in regulatory determinations - only relevant to distribution

In respect of changes to service classification, the Commission maintains its position from the directions paper that the threshold to allow the AER to depart from its framework and approach paper will be in the event of unforeseen circumstances.

In contrast to the term "unforeseen circumstances", the Commission considers that the term "good reasons" and "persuasive evidence" are unclear and ambiguous, and are open to differing interpretations. What the AER considers to be "good reasons" or "persuasive evidence" may differ from the NSP. This creates unnecessary uncertainty in the process. On the other hand, the threshold of "unforeseen circumstances" has a more definitive meaning, and has been applied in other parts of the NER.⁴⁵⁷ The "unforeseen circumstances" threshold should therefore narrow the scope for protracted debate over interpretation. This provides a degree of certainty compared to the "good reasons" and "persuasive evidence" thresholds, and also allows the AER some flexibility where "unforeseen circumstances" arise. The "unforeseen circumstances" threshold would not allow for changes due to reasons which ought to reasonably have been considered at the time that the decision was made in the framework and approach paper.

In addition, the Commission confirms its view in the directions paper that the threshold for departing from the service classification should be the same as that for departing from the formulaic expression of a control mechanism. Otherwise, a mismatch between the two triggers may mean an appropriate formulaic expression of

⁴⁵⁶ Ibid.

⁴⁵⁷ For example, the term "unforeseen circumstances" appears under NER rule 3.7A(p)(3) and clause 11.30.2(i)(3). In addition to this, the term "unforeseen" appears under clauses 5.6.2A(b)(7), 5.6.5C(a)(1), 5.6.5C(b), 5.6.5C(c), and S8.11.1(b).

the control mechanism would not be able to be set for an altered service classification. Given the approach taken to service classification, this suggests an "unforeseen circumstances" test for the formulaic expression of the control mechanism as well. This provides the necessary consistency to properly change both components.

10.9.2 Guidance on draft rule

Triggering the framework and approach paper

The AER is being given the discretion to trigger the framework and approach paper stage. The circumstances in which the framework and approach stage would be required are if:

- there is no previous framework and approach paper on a particular component; or
- it may be necessary or desirable for a particular component from the previous framework and approach paper to be amended or replaced.

The circumstances above ensure that there must always be in place a framework and approach paper on a particular component, even if that is a previously existing framework and approach paper. A corollary of this is that, where a framework and approach paper on a particular component has previously been put in place, the requirement for a framework and approach paper on that particular component can be bypassed if the existing framework and approach for that component is still appropriate. In other words, the framework and approach paper would only be reopened for the particular components that the AER decides should be consulted upon. In other words, the framework and approach paper would not need to be reopened on all matters.

The AER will be given the responsibility to consider all stakeholder comments, including the relevant NSP's, on whether a revised framework and approach paper is necessary to address a particular component. This will be done prior to the AER making a decision on whether to trigger the framework and approach paper stage. This will give relevant stakeholders, and especially the relevant NSP, an opportunity to make a submission to the AER. It will also promote transparency in the process.

To this end, the draft rule requires the AER to issue an invitation for comment at least 32 months before the end of the current regulatory period. The draft rule also requires that stakeholders, including the relevant NSP, provide their comments on the need for a revised framework and approach. The AER would then be required to consider any stakeholder proposals and must decide whether to trigger the process at least 31 months before the end of the current regulatory period. Alternatively, the AER may not receive any submissions on triggering a framework and approach paper, but could still decide to trigger the framework and approach paper stage.

If there is to be a framework and approach paper stage on a particular component, then the AER must issue a notice to this effect by at least 31 months before the end of the

current regulatory period. The AER must then commence consultation on the framework and approach paper on that particular component. By at least 25 months prior to the end of the current regulatory period, the AER must have completed and published the framework and approach paper.

As there must be a framework and approach paper in respect of dual function assets, it is necessary for the determination on the price regulation of dual function assets to be brought forward to be aligned with the framework and approach paper process. To give the AER enough notice, the value of the relevant dual function assets will need to be advised to the AER before it commences consultation on whether to initiate a framework and approach paper. This means that this value will need to be advised to the AER at least 33 months prior to the end of the current regulatory control period. Given that the value ascribed to the relevant dual function assets must correspond to an opening value for a regulatory year, the time at which this value must be determined will need to be 36 months prior to the end of the current regulatory period.

Threshold for departing from a component in the framework and approach paper

Except as described above, the AER can depart from the framework and approach paper in respect of the components covered by it during the regulatory determination process. For example, service classifications and the formulaic expression of the control mechanisms can depart from the framework and approach paper for unforeseen circumstances. Another example is the AER can depart from the relevant framework and approach paper for the application of incentive schemes during the regulatory determination stage, although it should give reasons for doing so. However, the form of the control mechanism and dual function assets will continue to be set in the framework and approach paper.

An example of how the "unforeseen circumstance" threshold could be applied may be with respect to a pending judicial decision where a service classification is contingent on that decision. Here, the pending judicial decision is one event and the actual judicial decision is another event. Although it may be argued that the pending judicial decision is foreseeable, the actual judicial decision could probably not be reasonably foreseen until the decision has been made. The service classification would have to be based on what is known at the time the framework and approach paper is made, but could be departed from once the actual judicial decision is made.

11 Diverse issues

Summary

- The capex reopener and contingent project mechanisms will be introduced in Chapter 6 of the NER (distribution) to allow for efficient costs to be recovered for unexpected events. A materiality threshold of one per cent of the annual revenue requirement will apply to cost pass through applications in distribution. These changes bring the uncertainty regime for distribution into line with transmission.
- The AER's decision-making timeframe for applications made under the uncertainty regime will be aligned between distribution and transmission. Some flexibility will be given in the timeframe to account for complex or difficult issues, and waiting on information from certain third parties. This will provide the appropriate balance between certainty and finality with flexibility in the process.
- The AER's power to revoke and substitute a decision for a material error or deficiency under Chapter 6A will be limited to "computational" errors by the AER or false or misleading information provided to the AER by another party. This brings into line the AER's power with Chapter 6, as well as providing for finality and certainty in the process.
- The AER will be given the power to establish shared assets cost adjustment mechanisms. This will apply to existing assets where those assets provide distribution or transmission services as well as other services. The mechanism will be designed in accordance with specific principles and guidelines. This will allow for innovation by NSPs and cost reflectivity for customers of the regulated service.
- Balancing the promotion of innovation and flexibility in regulation with good regulatory practice, the AER will be able to develop small scale pilot or test incentive schemes. This will allow the potential impact of such an incentive scheme to be understood before full implementation.

The AER has raised in its rule change request certain diverse issues. These relate to:

- the appropriateness of applying particular uncertainty regime mechanisms in distribution and aligning decision-making timeframes for the uncertainty regime mechanism (section 11.1);
- when the AER can revoke and substitute regulatory determinations to address material errors (section 11.2);
- how shared assets should be regulated (section 11.3); and
- the development of small scale incentive schemes (section 11.4).

11.1 Uncertainty regime

11.1.1 Introduction

For the purposes of this draft rule determination, the "uncertainty regime" under the NER comprises contingent projects, capex reopeners and pass through events. These mechanisms deal with expenditure that is required to be undertaken during a regulatory period but which is not able to be predicted with reasonable certainty at the time of preparing or submitting a regulatory proposal to the AER for the start of the next regulatory period. A more accessible uncertainty regime will, on the one hand, facilitate certain capex or opex projects being undertaken, though on the other hand it may reduce the incentive to undertake only efficient capex and opex in some circumstances. An appropriate uncertainty regime will contribute to efficiency of investment by allocating risks to the party best able to deal with them, including appropriately sharing the risks of external events.

Capex reopeners and contingent projects

The AER proposes to include capex reopener and contingent project provisions in Chapter 6 of the NER.⁴⁵⁸ In general, these would operate in distribution in the same way as they currently operate in transmission in Chapter 6A.

The threshold for a capex reopener would be five per cent of the value of the roll-forward RAB for the first year of the period, as in transmission. The threshold for a contingent project in distribution would be \$10 million; however, the AER has also proposed that it have the ability to specify a different threshold for both distribution and transmission contingent projects in guidelines.

In respect of pass through events, the AER's proposal is that a materiality threshold of one per cent of the annual revenue requirement should be applied to distribution.⁴⁵⁹

The AER has also proposed that, where as a result of a pass through application the AER allows capex which is fully recovered during the regulatory period in which the relevant event occurs, the capex should not be rolled forward into the RAB at the next regulatory determination.

The Commission received a related rule change request from Grid Australia on the cost pass through arrangements in Chapter 6A of the NER. The final rule determination was published on 2 August 2012 and is available on the AEMC's website. While that rule change request does not directly relate to the issues proposed by the AER in the current rule change request, there is some overlap in respect of pass through events. The Commission has taken into account that rule determination as part of this rule making process.

⁴⁵⁸ AER, Rule change request, Part B, 29 September 2011, pp. 46-52.

⁴⁵⁹ Id., p. 50.

Timeframes for AER decision-making under the uncertainty regime

When the AER receives an application for cost pass throughs, contingency projects or capex reopeners, it has a set time to make its decision which varies according to the type of application.⁴⁶⁰ The AER considers that it does not have enough time for more complex applications, and proposes that it should have the ability to extend these time limits up to a set maximum period, as well as that the current decision-making periods across all types of applications should be aligned. In particular, the AER proposes a common default decision-making period of 40 business days from the date the application is received for positive pass throughs, negative pass throughs, contingent projects and capex reopeners.⁴⁶¹ For complex or difficult applications or where the AER requires further information from the NSP, the AER proposes to extend this decision-making period by an additional maximum period of 60 business days.⁴⁶²

11.1.2 Submissions

Capex reopeners and contingent projects

Most submissions maintain their objection from first round submissions to the proposed inclusion of the capex reopener and contingent project mechanisms in distribution.⁴⁶³ Their reasons were similar to those provided by the MCE SCO in developing Chapter 6 of the NER.⁴⁶⁴ That is, distribution projects are significantly different to transmission; being smaller in size, greater in volume, with shorter lead times, and more integrated and therefore difficult to divide.⁴⁶⁵ To introduce such mechanisms may increase the administrative burden on the NSP, cause delays in projects, and avoid the merits review process.⁴⁶⁶

In addition to NSPs, consumer representative groups continue to express concern that extending the uncertainty regime would lead to a potential increase in intra-period determinations, an administrative burden placed on them to participate in each application, and a weakening of the expenditure discipline and price or revenue cap regime.⁴⁶⁷ As an alternative, some consumer representative groups suggest that the

⁴⁶⁰ An exception to this is for negative pass throughs which have no set time limit.

⁴⁶¹ AER, Rule change request, Part B, 29 September 2011, p. 100.

⁴⁶² *Id.*, pp. 99-100.

⁴⁶³ Ausgrid, Directions Paper submission, 16 April 2012, p. 7; ENA, Directions Paper submission, 16 April 2012, pp. 27-28, 34-35; Essential Energy, Directions Paper submission, 20 April 2011, p. 8; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, pp. 30-32; IPART, Directions Paper submission, 16 April 2012, pp. 9-10; Jemena, Directions Paper submission, 16 April 2012, p. 24; MEU, Directions Paper submission, 17 April 2012, pp. 47-48, 60; SP AusNet, Directions Paper submission, 16 April 2012, p. 5.

⁴⁶⁴ *Ibid.*

⁴⁶⁵ *Ibid.*

⁴⁶⁶ *Ibid.*

⁴⁶⁷ Ethnic Communities Council of NSW, Directions Paper submission, 16 April 2012, p. 3; EUAA, Directions Paper submission, 16 April 2012, pp. 24, 26.

NSP should be better at reprioritising or substituting its projects to avoid seeking cost recovery through the uncertainty regime mechanisms.⁴⁶⁸

Notwithstanding the general opposition against contingent projects in distribution, there continue to be mixed responses from NSPs as to whether the threshold is too low or high. Some consider the mechanism would be too resource intensive if the threshold is too low.⁴⁶⁹ Others consider the threshold to be so high that the mechanism would be rarely utilised.⁴⁷⁰ The Vic DPI has previously proposed in first round submissions that the contingent project threshold and the other thresholds for capex reopeners and cost pass through applications should be indexed by inflation.⁴⁷¹

With respect to the materiality threshold for cost pass through applications in distribution, some DNSPs suggest various thresholds including \$1 million.⁴⁷² Other DNSPs have previously suggested in first round submissions that the threshold should remain flexible to capture all non-trivial matters, and reflect less lumpy capex in distribution, failing which they would be exposed to unrecoverable risks.⁴⁷³

NSPs maintain the position from first round submissions that the current uncertainty regime for transmission is not effective.⁴⁷⁴ They suggest this may be to do with the regime not being: applied in full or at all; practical and efficient; or sufficiently flexible.⁴⁷⁵ Further, they consider that uncertainty regime applications are inappropriate for addressing projects based on meeting customer or network demand, which may require a short lead time.⁴⁷⁶

Timeframes for AER decision-making under the uncertainty regime

Most NSPs maintain support for their previous proposal from first round submissions to include a "stop the clock" mechanism with respect to the AER's decision-making timeframe for complex circumstances relating to uncertainty regime applications.⁴⁷⁷ This would cater for circumstances which require more time than proposed by the AER e.g. as where the AER is awaiting a decision by a third party or requires further information.⁴⁷⁸

⁴⁶⁸ MEU, Directions Paper submission, 17 April 2012, pp. 47-48, 60.

⁴⁶⁹ Ausgrid, Directions Paper submission, 16 April 2012, p. 7.

⁴⁷⁰ SP AusNet, Directions Paper submission, 16 April 2012, p. 5.

⁴⁷¹ Vic DPI, Consultation Paper submission, 8 December 2011, pp. 5, 8.

⁴⁷² ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, pp. 31-32.

⁴⁷³ Ausgrid, Consultation Paper submission, 8 December 2011, pp. 30-32.

⁴⁷⁴ ENA, Directions Paper submission, 16 April 2012, pp. 27-28, 34-35.

⁴⁷⁵ Ibid.

⁴⁷⁶ Ibid.

⁴⁷⁷ ENA, Directions Paper submission, 16 April 2012, pp. 80-81; Ergon Energy, Directions Paper submission, 16 April 2012, p. 17; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 53; Grid Australia, Directions Paper submission, 16 April 2012, p. 13; Jemena, Directions Paper submission, 16 April 2012, p. 58.

⁴⁷⁸ Ibid.

Upon further consultation on the NSPs' proposed "stop the clock" mechanism, the AER also supports this but considers that the mechanism should be limited to uncertain circumstances which cannot be resolved within an extended but limited timeframe.⁴⁷⁹ In particular, the "stop the clock" mechanism should only apply to more uncertain circumstances related to waiting on information from third parties, awaiting the outcome of an external event impacting on the assessment, or where the AER has to make a relevant inquiry as part of its assessment and that enquiry requires additional time.⁴⁸⁰

With respect to contingent projects, the AER submits that it has experienced circumstances where contingent projects have required further assessment where there has been a change in scale, scope and schedule which requires it to assess the application afresh e.g. as receiving external advice on a detailed examination of a change in the expenditure profile associated to the expenditure allowance for the project.⁴⁸¹ However, Grid Australia suggests that the "stop the clock" mechanism should not apply to contingent projects.⁴⁸²

Some NSPs support the Commission's proposal to introduce a notification step where the NSP would be required to notify the AER if it was aware that there may be external events that could have an impact on an application before the NSP makes its application.⁴⁸³ However, most NSPs do not support this, suggesting that the AER provide guidelines on its expectations.⁴⁸⁴

11.1.3 Analysis

Background

In the AEMC's Chapter 6A rule determination, the AEMC considered that, like most businesses, a TNSP operates in an uncertain environment.⁴⁸⁵ Uncontrollable external events can alter the quantity and nature of services required to be provided.⁴⁸⁶ In a normal competitive environment, production and pricing behaviour would adjust to respond to these changes where efficient producers can recover their costs and should generally earn at least a normal return on their investments.⁴⁸⁷ The regulatory arrangements, including the uncertainty regime, attempt to mimic the competitive

⁴⁷⁹ AER, Directions Paper submission, 2 May 2012, pp. 63, 75-77.

⁴⁸⁰ Ibid.

⁴⁸¹ Id., pp. 75-76.

⁴⁸² Grid Australia, Directions Paper submission, 16 April 2012, p. 13.

⁴⁸³ ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 53.

⁴⁸⁴ ENA, Directions Paper submission, 16 April 2012, pp. 80-81.

⁴⁸⁵ AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 54.

⁴⁸⁶ Ibid.

⁴⁸⁷ Ibid.

market by allowing the TNSP to alter its production behaviour to meet market demand and undertake unexpected investment in new network capacity.⁴⁸⁸

For distribution, contingent projects and capex reopeners were excluded from Chapter 6 by the MCE SCO because it was considered that distribution projects were different to transmission with respect to their nature and profile of capex.⁴⁸⁹ The MCE SCO considered that uncertainty around capex projects could be dealt with via pass through provisions to the extent the DNSP can demonstrate that the cost is outside of its control.⁴⁹⁰ Further, the MCE SCO considered that this would strike a reasonable balance between not penalising the DNSP for events outside its control and ensuring appropriate operation of the incentives regime within the regulatory framework.⁴⁹¹

Need for capex reopeners and contingent projects in distribution

As described in other parts of this draft determination, the Commission's starting point is that chapters 6 and 6A of the NER should be consistent unless there are substantive reasons for a difference. In respect of the uncertainty regime, the directions paper set out a range of reasons why the TNSP and DNSP face similar levels of uncertainty. Unlike competitive businesses, which are better able to adjust their behaviour in response to uncontrollable factors, the TNSP and DNSP are both generally obliged to continue to supply services even where their equipment is exposed to significant risks. In the absence of an uncertainty regime, the added risk for a regulated business would be factored into the cost of capital, forcing it up. A regulated business might also have more of an incentive to increase the forecast of capex or opex in its regulatory proposal to factor in circumstances which it cannot predict.

The Commission accepts that there are certain disadvantages of an expanded uncertainty regime. It could dampen the incentive effects of an ex ante allowance in certain circumstances. It could also create administrative burden for the AER and stakeholders in responding to "mini-determinations" during the regulatory period. On balance, however, the Commission has decided to maintain its position from the directions paper and include contingent projects and capex reopener mechanisms for distribution. This would better harmonise transmission and distribution, as well as making the NSP more accountable rather than relying on cost pass through applications for uncertain circumstances.

By setting the thresholds for these mechanisms at the correct level, as further discussed below, only the largest projects or events, which could be expected to have longer lead times, would be captured. Accordingly the administrative burden on stakeholders would be limited. In addition, experience with the uncertainty regime in Chapter 6A

⁴⁸⁸ Ibid.

⁴⁸⁹ MCE SCO, *Response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing*, 1 August 2007, pp. 29, 48.

⁴⁹⁰ Id., p. 29.

⁴⁹¹ Id., p. 48.

indicates that the incentive effects of the ex ante allowance provided under the regulatory determination process would not be substantially weakened.⁴⁹²

In respect of whether pass throughs provide sufficient protection, capex reopeners are intended to fulfil a different function by extending protection to very large events which are more difficult to predict and are more difficult to fully provide for as pass through events. Contingent projects, on the other hand, apply to a matter which is more specific to a particular business and more likely to occur than a pass through.

In addition to NSPs, other stakeholders, including consumer representative groups, are concerned with the potential increase in intra-period determinations, administrative burden placed on them to participate in each application, and weakening the expenditure discipline and price/revenue cap regime.⁴⁹³ As an alternative, some suggest that a NSP should be using up its existing expenditure allowance, or reprioritising or substituting its projects, to avoid seeking cost recovery through the uncertainty regime mechanisms.⁴⁹⁴ In general, the Commission would expect a NSP to act in this way in respect of smaller projects. The threshold for capex reopeners and contingent projects means that these can only be used for larger projects. For such projects, it will be more difficult for the NSP to accommodate these within the existing allowance.

Finally, NSPs also suggest that the current uncertainty regime for transmission is not effective.⁴⁹⁵ However, the Commission is of the view that it is outside the scope of this rule making process to review the effectiveness of the uncertainty regime for transmission. Issues specifically associated with the effectiveness of the cost pass through regime have been addressed as part of another rule change process. If there is any reason that the current threshold in transmission should be changed, it should be addressed in another rule change request.

Threshold for capex reopener and contingent project applications in distribution

For contingent projects, the AER proposed a threshold of \$10 million which it considered was consistent with the AEMC's original intention in 2006 to align this with the regulatory test threshold.⁴⁹⁶ There have been mixed responses from DNSPs; some suggesting the contingent project threshold is too low, while others suggesting it is too high.⁴⁹⁷ The Commission maintains its position from 2006 and considers that the threshold should be aligned to the regulatory test threshold i.e. the RIT-T and the

⁴⁹² It is noted that under Chapter 6A, these mechanisms have not so far created a significant burden, given that contingent project has been used twice while capex reopeners have never been used.

⁴⁹³ Ethnic Communities Council of NSW, Directions Paper submission, 16 April 2012, p. 3; EUAA, Directions Paper submission, 16 April 2012, pp. 24, 26.

⁴⁹⁴ MEU, Directions Paper submission, 17 April 2012, pp. 47-48, 60.

⁴⁹⁵ ENA, Directions Paper submission, 16 April 2012, pp. 27-28, 34-35.

⁴⁹⁶ The regulatory test threshold in transmission has now been superseded by the Regulatory Investment Test for Transmission (RIT-T).

⁴⁹⁷ Ausgrid, Directions Paper submission, 16 April 2012, p. 7; SP AusNet, Directions Paper submission, 16 April 2012, p. 5.

proposed Regulatory Investment Test for Distribution (RIT-D). For this reason, it is unnecessary for guidelines to be produced to vary the contingent project threshold or for the contingent project threshold to be indexed by inflation.⁴⁹⁸ The contingent project threshold will now be directly linked to the estimated capital cost of the most expensive option to address the identified need under the RIT-T, as varied, for transmission and the proposed RIT-D, as varied, for distribution.⁴⁹⁹

By aligning the contingent project threshold with the estimated capital cost of the most expensive option to address the identified need under the RIT-T and the proposed RIT-D, in addition to alternative threshold of five per cent of the maximum allowed revenue (MAR) or annual revenue requirement, whichever is higher, the contingent project threshold will have a practical application as it can be applied to transmission and distribution projects which would be considered significant enough to warrant regulatory scrutiny and administrative resources. Therefore, the concerns raised in submissions with respect to the inappropriateness of applying contingent projects in distribution should be addressed as the threshold will be consistent with the proposed RIT-D.⁵⁰⁰ The Commission notes this is consistent with ETSA, CitiPower and Powercor's joint proposal of a \$5 million threshold for contingent projects in distribution.⁵⁰¹

Materiality threshold for cost pass through applications in distribution

The materiality threshold for cost pass through applications in transmission was seen as important to promote stability and predictability of the revenue cap regime for both the regulator and the NSP.⁵⁰² Without such a threshold, it was considered that this would lead to greater uncertainty and an increase in administrative costs for the AER to determine a material event.⁵⁰³ Hence, it was determined that the threshold should be one per cent of the MAR for transmission.

Some DNSPs propose that the materiality threshold for distribution should not be set as a value in the NER.⁵⁰⁴ Instead, they consider that it should remain flexible to capture all non-trivial matters and reflect less lumpy capex in distribution.⁵⁰⁵ Otherwise, the DNSP would be exposed to unrecoverable risks.⁵⁰⁶ However, the Commission is of the view that such an approach introduces an undesirable degree of subjectivity into cost pass through determinations, and gives the DNSPs too much of

⁴⁹⁸ Vic DPI, Consultation Paper submission, 8 December 2011, pp. 5, 8.

⁴⁹⁹ In distribution, this value is equivalent to the estimated capital cost to the NSP affected by the RIT-D project of the most expensive potential credible option to address the identified need of \$5 million. In transmission, this value is equivalent to the estimated capital cost of the most expensive option to address the identified need which is technically and economically feasible of \$5 million.

⁵⁰⁰ ENA, Directions Paper submission, 16 April 2012, pp. 27-28, 34-35.

⁵⁰¹ ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 75-76.

⁵⁰² AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 106.

⁵⁰³ Ibid.

⁵⁰⁴ Ausgrid, Consultation Paper submission, 8 December 2011, pp. 30-32.

⁵⁰⁵ Ibid.

⁵⁰⁶ Ibid.

an avenue to submit applications, which may or may not be trivial in nature. On balance, the Commission considers that a materiality threshold needs to be specified to provide for greater certainty to both the regulator and the DNSP.

The Commission understands that the AER has applied the one per cent threshold in practice for distribution, even though it is prescribed only for transmission. Therefore, there should not be a significant impact on DNSPs in codifying existing AER practices. Further, there does not appear to be a reason for a difference between transmission and distribution. For similar reasons expounded by the AEMC in 2006 for transmission, the Commission considers that there should be a one per cent materiality threshold for distribution. This will provide for consistency, transparency, predictability and certainty on when the AER would be required to consider cost pass through applications.

Double recovery of capex arising from cost pass through applications

The AER has raised the issue that there would be a potential double recovery of capital costs through both cost pass through applications and including that incurred capex again when establishing the roll-forward RAB for the next regulatory period. The Commission maintains its support from the directions paper for the AER's proposal to avoid this potential unintended double counting. This will be done by the draft rule excluding the capital costs recovered through approved cost pass through applications during the current regulatory period from the calculation of the roll-forward RAB for the next regulatory period.

Timeframes for AER decision-making under the uncertainty regime

In the directions paper, the Commission considered extending the timeframe for decision-making on cost pass throughs and capex reopeners, but not in respect of contingent projects. Upon further reflection, it would be appropriate to align the extended timeframes for all three of these mechanisms, including contingent projects. In addition to the benefits that come from consistency in general, the AER's submission provides evidence of the detail and complexity that may be involved in the AER's assessment of contingent project applications.⁵⁰⁷ This includes an example of an ElectraNet contingent project application where the expenditure sought after the trigger event had occurred was significantly different from what had been envisaged in the determination. Assessing such applications may require a contractor to be engaged, adding to assessment time. This appears to justify the same changes being made for the assessment time for contingent projects as for cost pass throughs and capex reopeners.

In considering the circumstances in which the AER may extend its decision-making time and the extent of time required, sufficient certainty and finality must be taken into account. To a certain extent, fixing the timeframe will promote certainty and finality; however, it would not necessarily allow the NSP the ability to recover efficient costs for unforeseen events if there is a substantial delay that is outside of the NSP's control. For this reason, the Commission supports the AER's suggested principle that the "stop the

⁵⁰⁷ AER, Directions Paper submission, 2 May 2012, pp. 75-76.

clock" mechanism should apply in those circumstances which are outside of the AER or NSP's control. Such circumstances would be where the AER is waiting on the provision of information by a governmental authority, or is waiting on a judicial body or royal commission to make relevant information publicly available.

With respect to the time taken for the AER to wait on additional information from the NSP, the default decision-making time of 40 business days will be subject to the later of the date that the AER receives the NSP's information or any additional information associated with the NSP's written application. This requirement for the NSP to provide the AER with additional information the AER requires to make a determination under the uncertainty regime is currently unique for negative cost pass throughs, and has now also been extended to positive cost pass throughs, capex reopeners and contingent projects. This way, it is unnecessary to apply an extended decision-making timeframe to circumstances where the AER is waiting for additional information from the NSP.

Where the issues being considered are complex or difficult, but the AER has all the information that it needs, then the AER should be able to determine the issues within a set timeframe, albeit perhaps an extended timeframe. The Commission considers that the AER's proposal for an extended timeframe in these circumstances would provide the appropriate balance between giving the AER flexibility and offering some degree of finality and certainty in relation to the making of a decision by the AER. For these purposes, the draft rule adopts similar wording to that in section 107 of the NEL, which describes the relevant issues as being of sufficient complexity or difficulty to warrant an extension of time.

The Commission had also proposed an option to introduce a notification step where the NSP would be required to notify the AER if it was aware that there may be external events that could have an impact on the application before it makes its application. However, given the flexibility that has now been built into the timeframe, such a notification appears unnecessary. Nevertheless, the Commission encourages NSPs to notify the AER in advance of its application if it becomes aware of matters that could potentially delay the AER in making its decision. This will assist in allowing the application to be processed more efficiently.

Some NSPs had proposed in first round submissions that the AER should issue a draft of its decision where there are complex circumstances.⁵⁰⁸ However, to the extent the complex circumstances or any lack of information preclude the AER from forming a view, there does not seem to be any value in requiring the AER to make a draft decision at that stage. The Commission considers that it would be difficult to expect the AER to prepare a draft decision in these circumstances and will not be prescribing such a requirement. Nevertheless, the AER may also wish to seek to informally consult in the course of considering such matters.

⁵⁰⁸ ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 196-197.

11.1.4 Guidance on draft rule

Capex reopener and contingent projects in distribution

Generally, the Commission has decided to align the uncertainty regime in distribution with transmission. This means that the capex reopener, contingent project and cost pass through arrangements will be broadly the same.

Threshold for capex reopener and contingent project applications in distribution

For capex reopeners, the threshold for distribution will be capex that exceeds five per cent of the value of the roll-forward RAB for the first year of the regulatory period. This ensures that the same threshold applies to both transmission and distribution.

As noted earlier, the original intention of the contingent project threshold was for it to be aligned with the regulatory test and five per cent of the MAR, whichever is higher. Under the regulatory test for transmission, the threshold was \$10 million. With the implementation of the RIT-T, with a threshold of \$5 million, this value was not updated to reflect either the lower threshold or the fact that the RIT-T threshold could be varied by the AER. Therefore, the Commission has updated the threshold for transmission to reflect the RIT-T. Similarly, the contingent project threshold for distribution will be linked to the proposed RIT-D threshold which is also \$5 million, taking into account that this threshold may also be varied by the AER, and five per cent of the annual revenue requirement, whichever is higher.

Materiality threshold for cost pass through applications in distribution

The materiality threshold for cost pass through applications in distribution has now been defined by the draft rule to be one per cent of the NSP's annual revenue requirement. This brings it into line with the threshold applied in transmission.

Other aspects of cost pass through applications

Under the existing rules, the roll-forward RAB for the next regulatory period must include all capital costs incurred in the current regulatory period. This may unintentionally include pass through amounts associated with capital costs which have already been approved for under the cost pass through arrangements. For clarity, the NER will be amended to reflect the fact that cost pass through amounts that have already been recovered in a regulatory period cannot be recovered again in the roll-forward of the RAB for the next regulatory period.

For the reasons explained above, the timeframe for the AER to make a decision on applications related to cost pass throughs, contingent projects and capex reopeners will be aligned at 40 business days from the time the AER receives the application and any additional information it requires from the NSP. This timeframe can be extended by up to a further 60 business days if the AER determines that there are issues of sufficient complexity or difficulty that warrant such an extension. Such issues may require the AER to seek expert advice or consult with interested parties on a particular matter.

If the decision needs to be delayed to wait for further information from a third party, then a "stop the clock mechanism" will apply. Such a third party may be a governmental authority from which the AER has requested information or a judicial body or a royal commission that the AER anticipates will make publicly available information that is relevant to the NSP's application.

In the case of either a time limit extension or the application of the "stop the clock" mechanism, the AER must notify the NSP of the extension or delay and also publish notice of this on its website no later than ten business days before the date that the AER would normally have to make its default decision. The AER must also advise the NSP when the "stop the clock" mechanism has ceased to apply, in which case it must again publish a notice on its website to this effect.

Case scenario – example of the "stop the clock" mechanism and extending timeframe by 60 business days

- On 1 July 2013, the AER receives from a NSP in New South Wales an application for a positive cost pass through within 90 business days of the positive event occurring. The application relates to a bushfire.
- At the time of the application, the AER is informed by the NSP that there is a royal commission on the bushfire and the outcome of the decision by the royal commission may have an impact on whether the NSP can recover for that cost pass through and, if allowed, potentially also the amount that the NSP can recover. The royal commission decision will not occur until after the normal decision-making timeframe for the AER i.e. more than 40 business days after the AER received the NSP's application and such additional information regarding the application as the AER requires from the NSP.
- On 15 July 2013, the AER notifies the NSP that in order to determine the NSP's application, it requires information that it anticipates will be made publicly available by the royal commission. This notification occurs no later than ten business days before it would have had to make the default decision. The AER also publishes a notice on its website stating that the clock has stopped.
- On 29 November 2013, the royal commission publishes its decision. As a result of this, the "stop the clock" mechanism ceases to apply. The AER would inform the NSP and publish a notice on its website stating that the clock has restarted. The Commission would also expect the AER to state in that notice the date on which the AER will make its decision. In this case, it will be 30 business days after 29 November 2013, which will be 15 January 2014, taking into account public holidays. This is because ten business days have already elapsed between 15 July 2013 and the time the clock stopped.
- However if, upon reviewing the royal commission decision, the AER determines that it requires more time to address a complex question related

to the application, the AER could extend the decision-making period by a maximum period of a further 60 business days. To do so, the AER would need to notify the NSP of its decision to extend by no later than ten business days before it would otherwise have had to make its decision on 15 January 2014. Therefore, the AER would need to give its notice, with respect to extending the period by the maximum of 60 business days, no later than 31 December 2012. The AER would also need to publish notice of the extension on its website as soon as reasonably practicable. The maximum additional period for the AER to make its decision will then expire on 10 April 2014.

- Note: In the scenario above, the "stop the clock" mechanism could only be triggered by the royal commission. The "stop the clock" mechanism does not apply to considering complex or difficult questions on the matter, where the timeframe can only be extended by a maximum additional period of 60 business days.

Given the introduction of capex reopeners and contingent projects for distribution, the timeframes for the AER to decide on these applications will also be aligned with those in transmission.

Another consequential change relates to the decision making timeframe for negative cost pass through applications. The Commission notes that there is currently no set decision-making timeframe for this type of application, although a timeframe exists on when the application needs to be made. Previously in the Chapter 6A rule determination, the AEMC noted that there are asymmetries between positive and negative pass through applications that justify a difference in their treatment. However, with respect to decision-making timeframes, there should be no difference as the AEMC in 2006 recognised for capex reopeners and contingent projects. The decision-making timeframe for negative pass through applications has therefore been aligned so that there is a "standard" 40 business day timeframe with an option to extend as with the other types of applications. In addition, the AER is now expressly required to notify all NSPs of the occurrence of a negative change event if that event is not notified by the NSP to the AER and the AER proposes to determine a pass through amount.

However, unlike for positive change events, if the AER fails to make a pass through determination in respect of a negative change event within the 40 business day time limit, then the AER will be taken to have determined a zero pass through amount, noting that this 40 business day period can still be extended to accommodate issues that are difficult, and that the "stop the clock" mechanism will still apply where the AER is waiting on information from a governmental authority, judicial body or royal commission. As noted above, the reason for the different treatment of a default decision for negative cost pass throughs compared to positive cost pass throughs is due to the asymmetries between positive and negative pass through applications.

11.2 Material errors

11.2.1 Introduction

The NER allow the AER to revoke and substitute regulatory determinations where a material error arises. Depending on whether it is a distribution or transmission regulatory determination, there are different types of material errors which allow for revocation and substitution of regulatory determinations.

The AER is concerned that there may be the potential for a material error that is outside the currently prescribed list for distribution regulatory determinations.⁵⁰⁹ In transmission, uncertainty is created by the power to correct material errors caused by false or misleading information provided by the TNSP as there is no express limit placed on correcting such errors only to the extent necessary.⁵¹⁰ There may also be circumstances in which it may be more preferable or appropriate to amend a regulatory determination, as opposed to revoking and substituting the entire regulatory determination.⁵¹¹

The AER seeks to remove these differences by broadening its ability to revoke and substitute for material errors in Chapter 6 of the NER. In particular, the AER proposes to replace the prescribed list of material errors in Chapter 6 with a more general reference to material errors or deficiencies.⁵¹² The AER also proposes to limit changes related to false and misleading information under Chapter 6A "only to the extent necessary".⁵¹³ The AER also sought to expand the circumstances for revoking and substituting regulatory determinations to address deficiencies, in addition to material errors, under Chapter 6A.⁵¹⁴ The AER also proposes to have the ability to amend, in addition to revoke and substitute, regulatory determinations in response to material errors.⁵¹⁵

11.2.2 Submissions

NSPs maintain their previous position from first round submissions that the current scope for material errors should be retained under Chapters 6 and 6A, and that the AER should not be given the ability to "amend" for a material error.⁵¹⁶ They consider

⁵⁰⁹ AER, Rule change request, Part B, 29 September 2011, pp. 95-96.

⁵¹⁰ Ibid.

⁵¹¹ Ibid.

⁵¹² Id., p. 96.

⁵¹³ False and misleading information is already limited in Chapter 6 in this way. For further information, see AER, Rule change request, Part B, 29 September 2011, p. 96.

⁵¹⁴ "Deficiency" is already included in Chapter 6. For further information, see AER, Rule change request, Part B, 29 September 2011, p. 96.

⁵¹⁵ AER, Rule change request, Part B, 29 September 2011, p. 96.

⁵¹⁶ ENA, Directions Paper submission, 16 April 2012, pp. 78-79; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 52; Grid Australia, Directions Paper submission, 16 April 2012, p. 13; Jemena, Directions Paper submission, 16 April 2012, pp. 57-58.

that the current scope of material errors is sufficient and no evidence has been provided to suggest otherwise.⁵¹⁷ Instead, they consider that there have been instances where the AER should have revoked and substituted regulatory determinations for material errors, but the AER did not do so.⁵¹⁸ Specific to transmission, Grid Australia agrees with limiting corrections related to false and misleading information only to the extent necessary.⁵¹⁹

The AER also maintains the position from its original proposal that it prefers the broader scope for material errors under Chapter 6A over Chapter 6 to allow it to make corrections for material errors, especially once the merits review process takes place.⁵²⁰ To balance the broad scope available under Chapter 6A for correcting material errors and to allow for some certainty and finality in the process, the AER proposes a six month time limit following the final regulatory determination.⁵²¹

11.2.3 Analysis

Scope for material errors

The Commission considers that the AER has essentially proposed to broaden the scope of material errors under Chapter 6. In the directions paper, the Commission sought supporting evidence to justify broadening the scope for material errors under Chapter 6, in particular as proposed by the AER. There has been no evidence provided to support the view that the AER's current powers have constrained its ability to revoke and substitute a regulatory determination for material errors.

NSPs state that there may have been opportunities for a material error to be corrected in a draft regulatory determination, but the AER has not always utilised its discretion to address the material error.⁵²² In respect of examples about where the AER has previously been constrained by the NER in correcting material errors, no evidence has been provided that the AER has been constrained in this way. The AER itself observes that the circumstances justifying correction of a material error would be exceptional.⁵²³ On this basis, the Commission maintains the view from the directions paper that, after the final regulatory determination is made, the regulatory determination should only be able to be changed as a result of merits review outcomes or in very clear and exceptional circumstances. Therefore, the Commission is in favour of keeping the scope of the material error provisions under Chapter 6 narrow and focussed on "computational" errors by the AER or situations where the AER has received false or

⁵¹⁷ ENA, Directions Paper submission, 16 April 2012, pp. 78-79; Jemena, Directions Paper submission, 16 April 2012, p. 57.

⁵¹⁸ Ibid.

⁵¹⁹ Grid Australia, Directions Paper submission, 16 April 2012, p. 13.

⁵²⁰ AER, Directions Paper submission, 2 May 2012, pp. 63, 74.

⁵²¹ Ibid.

⁵²² ENA, Directions Paper submission, 16 April 2012, pp. 78-79; Jemena, Directions Paper submission, 16 April 2012, pp. 57-58.

⁵²³ AER, Directions Paper submission, 2 May 2012, p. 74.

misleading information. Provisions such as pass throughs, capex reopeners and contingent projects are the appropriate means by which more substantive changes to the regulatory determination should be made.

In addition, the AER proposal would detract from the finality of its decisions. That said, the AER has expressed its support for the need for finality in a regulatory determination and proposes limiting the timeframe for correcting material errors to six months following the making of the final regulatory determination, which would balance off the AER's proposed expansion of the scope of material errors.⁵²⁴ Given the Commission's decision to maintain a narrow scope for material errors under Chapter 6, this proposed time limitation for addressing material errors does not warrant further consideration. However, this leaves the question of whether the current scope for material errors under Chapter 6A is still appropriate.⁵²⁵

In the Chapter 6A rule determination, the AEMC stated that the circumstances in which a regulatory determination can be revoked and substituted for a material error under Chapter 6A need to be clear.⁵²⁶ This would increase certainty, transparency and maintain the incentives built into the framework. Subsequent to this, the MCE SCO developed Chapter 6 and prescribed more specific circumstances for when a regulatory determination can be revoked and substituted for a material error.

To further expand on its previous position in 2006, the Commission considers that in addition to providing certainty and transparency and maintaining the incentives built into the framework, the finality of the regulatory determinations must be preserved. Consistent with this position, the Commission considers that the Chapter 6 provisions provide more certainty and finality in the framework than the equivalent provisions under Chapter 6A. Further, there should be no reason why Chapters 6A and 6 should be any different with respect to these types of material errors, which should only relate to computational errors or situations where the NSP has submitted false or misleading information. Therefore, the Commission has decided that the broader Chapter 6A provisions should be narrowed down and aligned with the narrower Chapter 6 provisions. Consequently, the AER's proposal for a six month limitation for correcting material errors will also be unnecessary for Chapter 6A.

Associated with aligning the Chapter 6A provisions with the Chapter 6 provisions, submissions support limiting material errors in regulatory determinations caused by false or misleading information by reference to "to the extent necessary". This is currently the case for distribution regulatory determinations, but not for transmission revenue determinations. The Commission has therefore decided to align the Chapter 6A provision, by aligning the Chapter 6A provisions in this regard with the Chapter 6 provisions.

A further approach to promote certainty and finality in the final regulatory determination is to not permit it to be revoked and substituted for material errors. This

⁵²⁴ Ibid.

⁵²⁵ Grid Australia, Directions Paper submission, 16 April 2012, p. 13.

⁵²⁶ AEMC, *Economic Regulation of Transmission Services*, Rule Determination, 16 November 2006, p. 122.

²⁰⁴ Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services

has been the approach of the regulator Ofgem in the Great Britain. However, in the Australian environment, the Commission considers that there should be a limited degree of flexibility for the AER to address errors in its final regulatory determinations in very clear and exceptional circumstances.

Amending material errors

The AER proposes that it should be able to amend, as an alternative to revoking and substituting, a regulatory determination as a result of a material error or deficiency where it is more preferable or appropriate to do so. In the directions paper, the Commission considered that the power to amend regulatory determinations will impact on the NSP's ability to have any such amendments reviewed in a merits review, as noted in some submissions.⁵²⁷ The Commission maintains its view from the directions paper that the provisions relating to material errors should not be changed to include a power for the AER to amend a determination as a result of a material error.

11.2.4 Guidance on draft rule

Aligning the Chapter 6A provisions with the Chapter 6 provisions with respect material errors will mean that the AER may now only revoke and substitute a transmission revenue determination or amend a pricing methodology for the following kinds of material errors or deficiencies:

- a clerical mistake or an accidental slip or omission;
- a miscalculation or misdescription;
- a defect in form; or
- a deficiency resulting from the provision of false or materially misleading information provided to the AER by another party.

As with Chapter 6, for Chapter 6A the substituted revenue determination or amended pricing methodology will only be able to be varied from the revoked revenue determination or existing pricing methodology to the extent necessary to correct the relevant material error or deficiency.

11.3 Shared assets

11.3.1 Introduction

In this draft rule determination, shared assets refer to assets used to provide both regulated and unregulated services. For distribution, the shared asset could be providing a combination of standard control services, alternative control services, or

⁵²⁷ ENA, Directions Paper submission, 16 April 2012, pp. 78-79; Grid Australia, Directions Paper submission, 16 April 2012, p. 13.

unregulated services. For transmission, the shared asset could be providing both prescribed transmission services and unregulated services. This issue is likely to become more relevant in light of the potential for electricity network assets, such as poles and pits, to be used to provide access for the National Broadband Network (NBN).

The AER proposes shared assets cost adjustment mechanisms to allow consumers to benefit where distribution assets are used to provide non-standard control services, including alternative control services and unregulated services.⁵²⁸ One option is for an ex ante forecast revenue adjustment to the annual revenue requirement. Alternatively, there could be an ex post control mechanism adjustment. This approach could entail an adjustment to annual prices, as opposed to ex ante adjustment to the annual revenue requirement, which could reflect the portion of revenue from the unregulated service. The AER did not propose equivalent changes for transmission assets.

11.3.2 Submissions

In general, stakeholders support the concept that where assets used to supply standard control services are shared with other services, consumers should receive some benefit. Similarly, there was also some support for this concept to be included in transmission. However, there are differences in views on how a shared assets cost adjustment mechanism should operate.

Grid Australia and the Vic DPI consider that the existing cost allocation principles under the NER could be used or, if not, modified to take into account shared assets in transmission and distribution.⁵²⁹ Aurora Energy also suggests that the term "distribution services" in the NER could include use of assets for non-electrical purposes.⁵³⁰

A number of NSPs consider that the shared assets cost adjustment mechanism should be flexible.⁵³¹ Ergon Energy and ENERGEX considered that no shared assets cost adjustment mechanism should be prescribed in the NER.⁵³² UE and MG do not support the AER's proposal on the basis that it is tantamount to transferring the value of existing assets out of the roll-forward RAB, and network prices should be insulated from the profits and losses in unregulated activities.⁵³³ Jemena proposes that the shared assets cost adjustment mechanism should be based on an annual revenue

⁵²⁸ AER, Rule change request, Part B, 29 September 2011, p. 60.

⁵²⁹ Grid Australia, Directions Paper submission, 16 April 2012, p. 2; Vic DPI, Consultation Paper submission, 8 December 2011, p. 9.

⁵³⁰ Aurora Energy, Consultation Paper submission, 15 December 2011, p. 11.

⁵³¹ ENA, Consultation Paper submission, 8 December 2011, pp. 38-39; ENERGEX, Consultation Paper submission, 8 December 2011, p. 4; Ergon Energy, Consultation Paper submission, 8 December 2011, p. 14; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

⁵³² ENERGEX, Consultation Paper submission, 8 December 2011, p. 4; Ergon Energy, Consultation Paper submission, 8 December 2011, p. 14.

⁵³³ UE and MG, Consultation Paper submission, 8 December 2011, p. 18.

forecast with an ex post true-up adjustment.⁵³⁴ The joint submission of ETSA, CitiPower and Powercor states that, in order to maintain predictability and transparency, the AER should be required to set out its approach to any adjustment in a framework and approach paper, and adhere to this approach unless there are any unforeseen circumstances or circumstances to justify departing from it.⁵³⁵

NSPs consider that alternative control services should be excluded from the uses of assets which would result in additional compensation to consumers as their costs are already recovered through a separate control mechanism.⁵³⁶ However, the AER considered that excluding alternative control services from a shared assets cost adjustment mechanism would prevent customers of alternative control services from being compensated if those services were provided by a shared asset.⁵³⁷

Submissions also suggest that there should be guiding principles for the exercise of the AER's discretion. These might include: any adjustment should be subject to a positive commercial outcome having been achieved; the level of compensation should take into account the risks involved; incentives should be maintained for the NSP to apply assets to non-regulated activities; regulatory oversight should only be imposed where benefits exceed costs; the mechanism should be administratively simple to implement; legacy arrangements and maturity of the market for alternative arrangements should be recognised; the adjustment should be proportionate to the benefits; the adjustment should apply only to revenues after netting of all relevant costs; and there should be an exemption for sharing of new forms of unregulated services for an initial short period.⁵³⁸

11.3.3 Analysis

General position

The Commission maintains its position from the directions paper that customers who pay for one type of regulated service that is provided by a shared asset should not be paying for the full cost of the asset. Instead, those customers should be receiving some benefit from the asset being used for a service other than a regulated service.

Submissions also generally support this concept; however, there are differences in views regarding the appropriate sharing mechanism that should be used.

⁵³⁴ Jemena, Consultation Paper submission, 8 December 2011, pp. 107-109.

⁵³⁵ ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 35.

⁵³⁶ Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 35; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

⁵³⁷ AER, Directions Paper submission, 2 May 2012, pp. 33-35.

⁵³⁸ Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ENA, Consultation Paper submission, 8 December 2011, p. 39; ENA, Directions Paper submission, 16 April 2012, pp. 36-37; ENERGEX, Consultation Paper submission, 8 December 2011, p. 4; ENERGEX, Directions Paper submission, 16 April 2012, pp. 2-3; ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 23, 97-98; Jemena, Consultation Paper submission, 8 December 2011, pp. 107-109; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

In a competitive market, a business would seek ways to provide its customers with the lowest possible price, in order to retain its existing customers and gain new ones. One way to do this could be to make more efficient use of the business' assets by employing them for new services. This would increase the number of customers having access to the asset, and allow the business to spread the fixed costs of the asset over this greater number of customers, therefore reducing costs for consumers of the services.

Where a business in a competitive market innovates in this way, it would usually be able to increase its profits for a short period of time, as it would have reduced its average costs below those of its rivals. This provides the incentive for the business to seek such innovations. Over time, however, competitive rivals would employ similar cost-reducing practices, and the additional margin would be competed away so that consumers gained the full benefit of the cost reductions.

Whilst there are differences between a regulated network service and a typical competitive market which mean that a comparison has limits, the key principles still apply. In this case, the competitive market comparison is instructive in highlighting that both the business and consumers of the regulated service should gain some benefit from cost savings brought about by innovations such as sharing of assets. If a NSP uses an asset to provide more than one service, any sharing mechanism should allow the NSP to keep some of the reward for making efficiency gains, but would require the reduction in costs to be passed onto consumers of the regulated service in the long term.

Making prices cost reflective should encourage the NSP to make efficient use of its existing assets. Further, cost reflectivity in prices should result in customers of the regulated service not subsidising the provision of unregulated services. Therefore, by incentivising the NSP to be innovative in its investments by retaining some of the benefits, but also requiring it to reduce the costs to consumers to reflect this innovative use, the shared assets cost adjustment mechanism will be in the long term interests of consumers and promote the NEO.

In the directions paper, the Commission noted that a shared assets cost adjustment mechanism could apply to transmission as well as distribution. This is consistent with the overall principle of harmonising Chapters 6 and 6A of the NER. There were submissions both in support of, and opposed to, this approach.⁵³⁹ Grid Australia has commented that the cost allocation principles in transmission already provide for asset sharing.

However, the cost allocation principles only allocate costs for future assets, as opposed to existing assets. This creates a problem when an existing asset that is used to provide a regulated service later becomes used to also provide an unregulated service. Under the cost allocation principles, as the costs have already been allocated to this asset, the mechanism cannot accommodate this change in circumstances, unless there has been a reclassification of service.

⁵³⁹ AER, Directions Paper submission, 2 May 2012, p. 34; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32; MEU, Directions Paper submission, 17 April 2012, p. 62.

For these reasons, a shared assets cost adjustment mechanism should be available to the AER to apply to existing assets that provide both distribution or transmission services and any unregulated service. To avoid any doubt, in developing any shared assets cost adjustment mechanism the AER must have regard to the cost allocation principles and the NSP's cost allocation method, and any incentives under the NER.

Restrictions on the shared assets cost adjustment mechanism

As discussed in the directions paper, the AER proposed two shared assets cost adjustment mechanisms in the form of an ex ante revenue adjustment and an ex post control mechanism adjustment.⁵⁴⁰ It stated that the control mechanism adjustment could be used for sharing a proportion of the pre-tax profits from the unregulated activities with the users of the regulated services.⁵⁴¹

The Commission does not consider a shared assets cost adjustment mechanism that shares a portion of the profit or revenue from unregulated services will be possible. By transferring a portion of this profit or revenue to customers of regulated services, the mechanism would be limiting the revenue that the NSP could earn from the unregulated service. This would have the same effect as regulating the unregulated service, which does not appear to be permitted under the NEL and NER.

Shared assets cost adjustment mechanism – cost reduction

Instead, the shared assets cost adjustment mechanism should operate in a way that is not based on the profit or revenue received by the NSP from the unregulated service. The best way this could work is if the sharing was implemented through a reduction in the costs of the shared asset that are recovered from consumers of the regulated service. That is, instead of recovering 100 per cent of the costs of the shared asset from consumers of the regulated service, a lower proportion would be recovered. A number of principles would be taken into account by the AER in determining this proportion, discussed further below, one of which could be the revenue received by the NSP from the unregulated service. However, the shared assets cost adjustment mechanism would not apportion part of the revenue or profit from the unregulated service.

Sharing the benefit resulting from the asset being used to provide an unregulated service, as well as a regulated service, via a reduction in the costs recovered from the consumers of the regulated service, rather than by passing through a portion of the revenue or profits received from the unregulated service, means that there will be a limit on the amount of benefit sharing that is possible. For example, if the costs of the shared assets that are recovered from standard control service customers each year are \$1 million in the absence of any sharing, but revenue from the unregulated use is \$3 million per year, the maximum benefit that could accrue to standard control service customers would be \$1 million per year.

⁵⁴⁰ AER, Rule change request, Part B, 29 September 2011, p. 60.

⁵⁴¹ Id., p. 61.

Where the shared assets cost adjustment mechanism takes the form of a reduction in costs apportioned to consumers of the regulated services, a control mechanism adjustment including annual pricing adjustments would not appear to be appropriate. A control mechanism adjustment would only be appropriate if the adjustment was linked to an external factor, such as the amount of profit or revenue received under a contract with a third party, and this could be converted into a price or revenue adjustment in the control mechanism in a "mechanistic" way without the AER having to make a subsequent decision. Such an approach would be administratively inefficient, given that the AER would be required to annually make these adjustments, and would create too much uncertainty for the NSP.

Instead of an adjustment to the control mechanism, the reduction in the costs allocated to consumers of the regulated services will feed through the building block determination into the annual revenue requirement. This reduction will be determined by the AER at a regulatory determination according to guidelines based on the principles set out below. It should reflect the part of the costs of the relevant asset which are being recovered through charging for the provision of the unregulated service. By reducing the annual revenue requirement for the NSP, the amount recovered from consumers will also be reduced. By including the decision in a regulatory determination, the cost reduction will be fixed for the regulatory period covered by that determination, which provides certainty for the NSP. In addition, this decision would be subject to the scrutiny that comes from consultation as part of the regulatory determination process and any subsequent merits review.

Timing

The cost reduction would only be implemented at a regulatory determination, regardless of when the sharing arrangement actually commences. This means that the NSP would be required to disclose information on its shared assets as part of its regulatory proposal to the AER. It would be possible for the reduction to occur in respect of a sharing arrangement which had not yet commenced, provided it was known with enough certainty at the time of the regulatory determination. If it was not known with enough certainty then the reduction could not apply until the next regulatory determination, even if the sharing arrangement commenced prior to that determination. There would be no reconciliation or "ex post adjustment" in respect of any sharing arrangement that was put in place during the middle of a regulatory period; the cost reduction would only start from the beginning of the next regulatory period. However, the historical use or revenue of the asset could be used as a factor to forecast future sharing of such an asset. Overall, this should provide the NSP who has a sharing arrangement some certainty as to what cost reduction could be expected. The proposed shared assets cost adjustment mechanism could also take into account Jemena's proposal for an exemption period to be given to newly shared assets for a period of several years.⁵⁴²

⁵⁴² Jemena, Consultation Paper submission, 8 December 2011, p. 107; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

In respect of proposals for an ex post adjustment, or "true up", once the actual benefits in a period of a sharing arrangement are known, the Commission considers that this should not be necessary.⁵⁴³ First, if the sharing arrangements are set on the basis of a contract the revenue received should be relatively easy to predict. Second, the revenue received will be only one factor to consider in setting the cost reduction for consumers, which must be based on the cost of assets shared. Third, to the extent revenues received through the sharing arrangements change, the cost reduction can be adjusted at the next regulatory determination for the next regulatory period.

Other issues

As referred to in the AER's original proposal, shared assets cost adjustment mechanisms currently exist under jurisdictional arrangements.⁵⁴⁴ The approach that has been previously used in Queensland has been grandfathered in NER clause 11.16.3. This grandfathering extends until the next Queensland distribution determination in 2015. Since the mechanism applied is a forecast revenue adjustment made to the building blocks, this could be accommodated under the proposed rules. In South Australia, a profit sharing mechanism has been used, with a portion of the profits from unregulated activities passed onto regulated service users of the shared asset.⁵⁴⁵ As described above, such a mechanism would not seem to be permitted under the general NEL and NER provisions.

In respect of distribution, the above approach only addresses the situation where the one use of the asset is to provide standard control services and another use is to provide an unregulated service. The AER also points out that there may be the circumstance where the asset is used to provide both alternative control services and unregulated services.⁵⁴⁶ The Commission accepts that alternative control service customers of a shared asset should be paying costs reflective of its use for the provision of alternative control services, and agrees with the AER that there should be no reason why standard control service customers benefit from the use of a shared asset to provide unregulated services, while alternative control service customers do not.

Nevertheless, some submissions state that the AER's proposal would result in customers of alternative control services being over-compensated through a revenue decrement as well as a separate control mechanism, and that alternative control services should be excluded.⁵⁴⁷ The Commission considers that the AER has considerable discretion in setting the control mechanism for alternative control services under NER clauses 6.2.6(b)-(c) and 6.2.5(a)-(b) and so may impose requirements that only permit the NSP to recover such costs associated with the provision of alternative

⁵⁴³ AER, Rule change request, Part B, 29 September 2011, p. 61; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

⁵⁴⁴ AER, Rule change request, Part B, 29 September 2011, p. 59.

⁵⁴⁵ Ibid.

⁵⁴⁶ AER, Directions Paper submission, 2 May 2012, pp. 34-35.

⁵⁴⁷ Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 35; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

control services as are appropriately allocated to those services. Therefore, in respect of distribution, the shared assets cost adjustment mechanism to be created only deals with the circumstance where the asset is used to provide a standard control service.

Where one use of the asset is for standard control services and the other use is for alternative control services, the standard cost adjustment described above should still apply for the costs recovered from the standard control service customers.

Guidelines and principles

Bearing in mind the shared assets cost adjustment mechanism described above, the Commission considers that to facilitate NSPs seeking out and entering into sharing arrangements of the kind discussed here, NSPs will need some certainty about how the AER would determine the cost adjustment appropriate for a particular sharing arrangement.

Part of this certainty will be provided by principles guiding the AER's determination, and which will be set out in the NER. NSPs raised a number of principles that could be applied in this regard.⁵⁴⁸ In setting these principles, consistent with the NEO, the Commission takes the view that the approach to a shared assets cost adjustment mechanism should:

- provide clarity and certainty on how the AER would approach sharing the costs;
- provide cost reflective prices to consumers;
- promote innovation in NSP investments; and
- be able to be implemented in practice.

On this basis, the principles to which the AER must have regard are:

- the NSP should be encouraged to use assets that provide standard control services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of standard control services;
- a shared assets cost adjustment should not be dependent on the NSP deriving a positive commercial outcome from the use of the asset other than for standard control services;
- a shared assets cost adjustment should be applied where the use of the asset other than for standard control services is material. This means the benefit of

⁵⁴⁸ Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ENA, Consultation Paper submission, 8 December 2011, pp. 38-39; ENA, Directions Paper submission, 16 April 2012, pp. 36-37; ENERGEX, Directions Paper submission, 16 April 2012, pp. 2-3; Ergon Energy, Consultation Paper submission, 8 December 2011, p. 14; ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 23, 97-98; Jemena, Consultation Paper submission, 8 December 2011, pp. 107-109; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

sharing the cost of the asset based on use should outweigh the administrative costs of implementing the shared asset cost adjustment mechanism;

- the manner in which costs have been recovered or revenues adjusted in respect of the relevant asset in the past and the reasons for adopting that manner of recovery or adjustment should be taken into account;
- a shared assets cost adjustment should be compatible with the cost allocation principles and cost allocation method; and
- a shared assets cost adjustment should be compatible with incentives that the NSP may have under the NER.

The Commission considers that the above principles promote its objectives on what the shared assets cost adjustment mechanism should achieve.

With respect to determining the appropriate portion of costs for the purposes of a shared assets cost adjustment, the most obvious approach is for the AER to base this on the relative use of the asset for the provision of the different kind of services such as the technical use or physical use. Another possible way could include using the ratio between the proportion of revenue from the asset for standard control services and the proportion of revenue from the asset for other than for standard control services over the current regulatory period. However, this should not be taken as precluding the AER from considering other possible bases for sharing the costs of the asset.

The Commission does not accept the principle that the NSP should only have to pass on the benefit of a shared asset if it receives a net profit as a result. This was proposed to recognise the associated risks of the NSP with sharing arrangements.⁵⁴⁹ In general, the NSP should bear the risk so it takes this into account when deciding whether to enter a sharing arrangement. The NSP is the party best able to assess and manage this risk.

In addition, for added certainty, the draft rule requires the AER to set out in guidelines what its approach will be for determining the appropriate cost reduction for sharing arrangements, having regard to the above principles. Such guidelines may, for example, set out a particular methodology which the AER intends to use.

In the directions paper, the Commission considered including a draft rule requiring the AER to specify the shared assets cost adjustment mechanism at the framework and approach paper stage. Given that the shared assets cost adjustment mechanism will now be prescribed in the NER, with supporting guiding principles and guidelines, it is unnecessary for a framework and approach paper to deal with this matter. This means the NSP would need to submit information on its shared assets to the AER in the regulatory proposal.

⁵⁴⁹ Ausgrid, Consultation Paper submission, 8 December 2011, p. 33; ENA, Consultation Paper submission, 8 December 2011, pp. 38-39; Jemena, Directions Paper submission, 16 April 2012, pp. 26-27, 31-32.

For the reasons previously given, the Commission has also decided that a similar regime regarding shared assets should be implemented in the context of transmission.

11.3.4 Guidance on draft rule

The following case study is provided in this section to explain how the shared assets cost adjustment mechanism would work.

Case scenario

- In year 2 of a regulatory period the NSP enters into a commercial agreement with NBN Co to allow NBN Co to use electricity poles currently used for standard control service purposes. The rate is \$2,000 per pole per year. The NSP's costs are \$500 per pole per year.
- Given that this occurs during a regulatory period, no shared assets cost adjustment mechanism is applied until the next regulatory determination.
- In its regulatory proposal for the next regulatory determination, the NSP provides details of the shared assets in accordance the AER's regulatory information instrument.
- During the regulatory determination process, the AER decides whether to apply the shared assets cost adjustment mechanism in respect of the NBN arrangements for the next regulatory period. In making this decision, the AER takes into account the guidelines on how to apply the shared assets cost adjustment mechanism and the principles on whether a shared assets cost adjustment mechanism should apply. Some considerations at this point could include the materiality of the shared asset.
- Next, the AER would need to decide on the reduction in the costs for the assets that should not be recovered from standard control customers based on the guidelines. However, it would not directly pass through any of the profits or revenue gained from the NSP as a result of providing NBN Co access to its asset. A possibility could be to base this decision on the number of customers who will benefit from the electricity poles being used to provide NBN services compared to the number of customers who receive standard control services through the use of those electricity poles. For the purposes of this exercise, it may be too difficult to determine the number of customers, but it may be easier to determine that there is an equal share in the technical and/or physical use of that pole for standard control services and NBN services. It may decide the cost reduction should be on a pole by pole basis over the forthcoming regulatory period.
- Once the AER determines the appropriate reduction of costs for standard control service customers, the AER needs to incorporate this into its building block determination. This determination leads to adjustments being made to the annual revenue requirement and therefore being

reflected in pricing to customers in the annual pricing approval process. In this case, based on the asset being shared according to physical and/or technical use, which has been attributed at 50 per cent, the reduction in the annual revenue requirement is \$250 per pole per year. This reduction only starts to apply from the following regulatory period and there would be no cost reduction for the period in which the commercial agreement was first put in place.

11.4 Small scale incentive schemes

11.4.1 Introduction

The AER proposes that it should have the power to develop incentive schemes outside of those already provided for in the NER.⁵⁵⁰ The AER also proposes to amend Chapter 6A of the NER such that it would have discretion to decide whether or not to apply the existing incentive schemes to NSPs at the time of the regulatory determination.⁵⁵¹ The Commission's initial view as set out in the directions paper was that the NER should allow the AER to develop small scale pilot or test incentive schemes within an environment that limits the sum of money at risk and the length of time of the scheme.⁵⁵² In addition, it suggested that it is appropriate for the AER to have discretion to determine whether or not incentive schemes should apply at the time of a regulatory determination in Chapter 6A of the NER, consistent with Chapter 6.

11.4.2 Submissions

In response to the directions paper, the AER maintains that it should be given discretion to introduce new incentive schemes, not just small scale pilot or test incentive schemes.⁵⁵³ It suggests that small scale pilot or test incentive schemes will not be effective and will make the process of introducing new incentive schemes even more cumbersome than the current arrangements.⁵⁵⁴ NSPs consider that there is merit in allowing the AER to develop small scale pilot or test incentive schemes.⁵⁵⁵ Their views are generally reflected by the ENA which is not supportive of giving the AER a broad power to develop new incentive schemes.⁵⁵⁶ Most of the consumer representative groups that responded and IPART query the ability of small scale pilot or test incentive schemes to establish the effectiveness of an incentive scheme. No

⁵⁵⁰ AER, Rule change request, Part B, 29 September 2011, pp. 56-58.

⁵⁵¹ Id., p. 57.

⁵⁵² AEMC, *Consolidated Rule Request – Economic Regulation of Network Service Providers*, Directions Paper, 2 March 2012, p. 62.

⁵⁵³ AER, Directions Paper submission, 2 May 2012, pp. iii, 31.

⁵⁵⁴ Id., pp. 31-33.

⁵⁵⁵ Ergon Energy, Directions Paper submission, 16 April 2012, p. 8; ETSA, CitiPower and Powercor, Directions Paper submission, 13 April 2012, p. 33-34; Jemena, Directions Paper submission, 16 April 2012, p. 25-26.

⁵⁵⁶ ENA, Directions Paper submission, 16 April 2012, p. 36.

stakeholders commented on giving the AER discretion to apply the current incentive schemes at the time of a determination.

11.4.3 Analysis

The Commission maintains its position to allow the AER to develop small scale pilot or test incentive schemes. The AER should have the ability to innovate in this way without having to go through the full rule making process, which may be overly burdensome. It is good regulatory practice to test or pilot a scheme before full implementation as incentive schemes could otherwise be introduced that lead to unexpected and perhaps unwelcome outcomes as identified by Professor Littlechild.⁵⁵⁷ A permanent scheme should, however, be subject to the rule making test given the potential impact of the scheme.

The extent of a small scale incentive scheme should be limited by the sum of money at stake, i.e. revenue at risk, and the period for which the scheme lasts. In addition the scheme should be subject to consultation with relevant NSPs and other stakeholders before being implemented.

The sum of money at stake should balance the need to be high enough to understand how the scheme is likely to operate but not so high that there is a significant impact on a NSP if the scheme does not operate as intended. The Commission considers that this balance would be met if the revenue at stake was one per cent of revenue for a regulatory year if the NSP agrees with the scheme, or up to 0.5 per cent of revenue for a regulatory year if the NSP does not agree with the scheme. The lower revenue at risk that can be placed on the scheme if the NSP does not agree to it is to reflect that the NSP will have no choice as to whether a scheme is applied to it and the scheme will not have been subject to the rule making process. The AER should also be able to undertake paper trials, i.e. a scheme in which no money is at risk, as part of its discretion. Concerns have been raised by stakeholders about the ability of small scale incentive schemes to establish the effectiveness of an incentive scheme.⁵⁵⁸ The limits described above should be high enough such that the effectiveness of a scheme will be able to be determined.

In terms of a restriction on the period of a scheme, any scheme should last for a maximum of two regulatory periods. If the AER wishes the scheme to continue after this point then it will need to apply for the scheme to be made permanent through the rule change process. This length of time should be long enough for the AER to make a decision on whether the scheme is effective and therefore whether it should be a permanent scheme in the NER.

⁵⁵⁷ Stephen Littlechild, Advice to the AEMC on Rule Changes, 11 February 2012, p. 19.

⁵⁵⁸ AER, Directions Paper submission, 2 May 2012, pp. 31-33; Consumer Action Law Centre, Directions Paper submission, 16 April 2012, p. 5; EUAA, Directions Paper submission, 16 April 2012, p. 25; IPART, Directions Paper submission, 16 April 2012, p. 10; UnitingCare Australia, Directions Paper submission, 9 May 2012, p. 48.

In addition to these requirements, the ENA suggested that there should be a draft rule requiring the AER to seek the agreement of the NSP before commencing the trial and that a scheme should be limited to only parts of a NSP's operations, for example, certain regions or certain classes of customers. The Commission does not agree that the draft rule should require the AER to seek the agreement of the NSP before commencing the trial as this would simply give the NSP a right of veto. However, as noted above, the revenue that can be put at risk from the scheme is lower if the NSP does not agree to the scheme. Restricting the scheme to only parts of a NSP's operations would also overly restrict the AER.

Consistent with the general approach in respect of this rule change, the AER should have to take into account certain factors when developing these schemes. The principles developed for capex sharing schemes are broadly appropriate here. These address key issues, such as the fact that a scheme should not penalise efficient NSPs. At the same time, the principles are broad so that they do not overly restrict the AER. These factors are also in line with those put forward by the AER for its proposed power to develop other incentive schemes.⁵⁵⁹ The Commission considers that those factors put forward in the joint submission of ETSA, CitiPower and Powercor are too restrictive.⁵⁶⁰

The Commission maintains that it is appropriate to allow the AER to have discretion to determine whether incentive schemes should apply at the time of a regulatory determination in Chapter 6A of the NER, consistent with Chapter 6.

11.4.4 Guidance on draft rule

The draft rule is intended to give the AER a broad discretion as to the schemes it may design. The schemes are intended to provide for incentives not already covered by the existing incentive schemes in the NER and may cover matters not related to expenditure by NSPs. For example, the AER could design a scheme which provides rewards for NSPs which engage more effectively with consumers. The draft rule is intended to provide broad discretion so that the AER could develop any type of scheme that contributes to the NEO.

The AER will apply the schemes consistently with the way that other incentive schemes are applied. That is, the AER will set out its likely approach to the application of a scheme to a particular NSP in the framework and approach paper for the NSP. The NSP would then set out in its regulatory proposal how it proposes the scheme should apply, including any proposed values. The AER would then set out how the scheme will apply to the NSP in the draft and final determination for the NSP.

⁵⁵⁹ AER, Rule change request, Part B, 29 September 2011, p. 57.

⁵⁶⁰ ETSA, CitiPower and Powercor, Consultation Paper submission, 8 December 2011, pp. 22, 90-91.

12 Proposed transitional arrangements

12.1 Introduction

The draft rule provides for significant changes regarding capital expenditure incentives, the determination of the rate of return and the overall regulatory determination process. The latter will involve changes in timing as well as substance.

The package of changes included in the draft rule requires a period of time for implementation. For example, the rate of return provisions involve the AER, and the ERA, making a number of guidelines, schemes and instruments, including one which is the reference point for the NSP's proposal on what it considers should be its allowed rate of return. Also, the AER must make capex incentive guidelines, setting out how the AER proposes to apply the capex incentive tools generally. The draft rule allows varying periods of up to 12 months for the making of the first versions these guidelines, given the complexity of the subject matter and the requirement to consult thoroughly with stakeholders.

These implementation tasks will not be finalised by the time a number of NSP regulatory proposals are due, which would make the application of the draft rule to these particular regulatory determination processes problematic. Therefore, additional provisions are required to enable these NSPs to transition to the new arrangements. Some transitional provisions are also required for certain gas service providers.

12.2 Commission's general approach to transitional arrangements

The Commission's intention is that the package of provisions contained in the draft rule would commence and be applied to the maximum extent possible for each NSP's next regulatory determination, once a final rule determination is made in mid-November 2012. For reasons of practicality, timing and fairness, however, arrangements are required to transition NSPs to the provisions contained in the draft rule.

The Commission intends to release a paper on transitional arrangements by mid-September 2012.

Abbreviations

ACCC	Australian Competition and Consumer Commission
ACT	Australian Competition Tribunal
ADIs	Australian Deposit-taking Institutions
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
APIA	Australian Pipeline Industry Association
Brattle	The Brattle Group
capex	capital expenditure
CAPM	Capital Asset Pricing Model
CIA	corporation initiated augmentation
CICW	customer initiated capital works
Commission	see AEMC
CPA	Competition Principles Agreement
CPI	consumer price index
CUAC	Consumer Utilities Advocacy Centre
DBNGP	Dampier to Bunbury Natural Gas Pipeline
DBP	See DBNGP
DNSP	distribution network service provider
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ENA	Energy Networks Association
ERA	Economic Regulation Authority of Western Australia

ERA	Economic Regulation Authority of Western Australia
ESAA	Energy Supply Association of Australia
ESCOSA	Essential Services Commission of South Australia
ESCV	Essential Services Commission of Victoria
EUAA	Energy Users Association of Australia
EURCC	Energy Users Rule Change Committee
GDP	Gross Domestic Product
GFC	global financial crisis
IPART	Independent Pricing and Regulatory Tribunal
LMR	Limited Merits Review
MAR	maximum allowed revenue
MCE	Ministerial Council on Energy
MEU	Major Energy Users
NBN	National Broadband Network
NEL	National Electricity Law
NEM	National Electricity Market
NEO	national electricity objective
NER	National Electricity Rules
NGL	National Gas Law
NGO	national gas objective
NGR	National Gas Rules
NPV	net present value
NSP	network service provider
NSW T-Corp	New South Wales Treasury Corporation

OEB	Ontario Energy Board
Ofgem	Office of Gas and Electricity Markets
Ofwat	Office of Water Services Regulation Authority
opex	operating expenditure
OTTER	Office of the Tasmanian Economic Regulator
PIAC	Public Interest Advocacy Centre
QCA	Queensland Competition Authority
QTC	Queensland Treasury Corporation
RAB	regulatory asset base
RIIO	Revenue = Incentives + Innovation + Outputs
RIN	Regulatory Information Notice
RIPUC	Rhode Island Public Utilities Commission
RIT-D	Regulatory Investment Test for Distribution
RIT-T	Regulatory Investment Test for Transmission
RPP	Revenue and Pricing Principles
SA DMITRE	South Australian Department of Manufacturing, Innovation, Trade, Resources and Energy
SCER	Standing Council on Energy and Resources
SCO	Standing Committee of Officials
SFG	Strategic Finance Group Consulting
SKM	Sinclair Knight Merz
SORI	Statement of Regulatory Intent
STPIS	service target performance incentive scheme
TEC	Total Environment Centre
TNSP	transmission network service provider

UE and MG	United Energy and MultiNet Gas
Vic DPI	Victorian Department of Primary Industries
WACC	Weighted Average Cost of Capital
WAPC	weighted average price cap

A Detailed examples of potential capex sharing schemes

This appendix includes a non-exhaustive list of possible ways in which the AER might design a capex sharing scheme under the draft rules.⁵⁶¹

Figure A.1 below presents two different models: Model 1 presents a stylised example similar to that provided by the ENA's consultants of a capex efficiency carry-over scheme with a five year carry-over period using a WACC of 7.5 per cent; Model 2 presents a stylised example of the ex-ante or fixed incentive rate scheme previously used by Ofgem.

Figure A.1 Examples of efficiency carryover scheme and ex ante incentive rate scheme with periodic true-up

Model 1: ESC "capex efficiency carry over" scheme										
Year	1	2	3	4	5	6	7	8	9	10
Forecast capex	300	330	270	300	330					
Actual capex	280	310	300	290	320					
Underspend	20	20	-30	10	10					
Annual financing benefit	1.50	1.50	-2.25	0.75	0.75					
Year 1 benefit	1.50	1.50	1.50	1.50	1.50					
Year 2 benefit		1.50	1.50	1.50	1.50	1.50				
Year 3 benefit			-2.25	-2.25	-2.25	-2.25	-2.25			
Year 4 benefit				0.75	0.75	0.75	0.75	0.75		
Year 5 benefit					0.75	0.75	0.75	0.75	0.75	
Benefit / Carry over	1.50	3.00	0.75	1.50	2.25	0.75	-0.75	1.50	0.75	0.00
Discount factor (to end of year 5)	1.38	1.29	1.20	1.11	1.04	0.96	0.90	0.83	0.78	0.72
Total benefits (PV at end year 5)	39.02									
DB benefits (PV at end year 5)	12.73									
Incentive rate	32.62%									
Model 2: Ex-ante incentive rate with true-up at start of regulatory period										
Annual underspend	20	20	-30	10	10					
Total Benefits (PV at end year 5)	39.02									
Target share of underspend (PV at end	12.73									
Benefit already received										
Cumulative underspend	20	40	10	20	30					
Financing benefit from underspending	1.5	3	0.75	1.5	2.25					
Total benefit already received (PV at end	10.84									
Additional benefit required (PV at end	1.88									
Realised incentive rate	32.62%									

In the Model 1 scheme, the business has a total underspend across the five years of \$30 million in nominal terms. This has a present value of \$39 million at the end of year 5. In keeping with earlier Australian schemes the benefit to the business is taken to be the financing cost forgone from having underspent the capex allowance contained in the allowed revenue requirement. This has a present value of \$12.7 million (at the end of year 5) leading to the business retaining 32.6 per cent of the available benefit.

The Model 2 scheme is designed to achieve the same incentive rate as that obtained from Model 1, namely 32.6 per cent, for illustrative purposes. Again, the NSP obtains a financing benefit from having underspent its capex allowance although in this case that only goes through to the end of the current regulatory period. Again the present value of the underspend is \$39 million (at the end of year 5) and the NSP receives a financing benefit of \$10.8 million through to the end of the regulatory period. To achieve the specified incentive rate of 32.6 per cent the NSP requires total benefits of \$12.7 million in present value terms (at the end of year 5) meaning an additional benefit of \$1.9

⁵⁶¹ These examples have been developed with advice from Economic Insights.

million will have to be given to the NSP in the form of additional allowed revenue requirement at the start of the next regulatory period.

Figure A.2 provides a stylised example of how a scheme involving an annual true up of efficiency gains and losses (as Ofgem plans to use) might work (Model 3).

Figure A.2 Example of ex ante incentive rate scheme with lagged annual true-up

Model 3: Ex-ante incentive rate with annual lagged true-up										
Year	1	2	3	4	5	6	7	8	9	10
Forecast capex	300	330	270	300	330					
Actual capex	280	310	300	290	320					
Underspend	20	20	-30	10	10					
Year 1 effect										
Underspend	20									
Total Benefits (PV at end year 2)	22.29									
DB's target share of benefit	7.27									
Benefit already received										
Financing benefit from underspending	1.50									
Benefit already received (PV at end year 2)	1.67									
Additional benefit required (PV at end year 2)	5.60									
Year 2 effect										
Underspend		20								
Total Benefits (PV at end year 3)		22.29								
DB's target share of benefit		7.27								
Benefit already received										
Financing benefit from underspending		1.50								
Benefit already received (PV at end year 3)		1.67								
Additional benefit required (PV at end year 3)		5.60								
Year 3 effect										
Underspend			-30							
Total Benefits (PV at end year 4)			-33.44							
DB's target share of benefit			-10.91							
Benefit already received										
Financing benefit from underspending			-2.25							
Benefit already received (PV at end year 4)			-2.51							
Additional benefit required (PV at end year 4)			-8.40							
Year 4 effect										
Underspend				10						
Total Benefits (PV at end year 5)				11.15						
DB's target share of benefit				3.64						
Benefit already received										
Financing benefit from underspending				0.75						
Benefit already received (PV at end year 5)				0.84						
Additional benefit required (PV at end year 5)				2.80						
Year 5 effect										
Underspend					10					
Total Benefits (PV at end year 6)					11.15					
DB's target share of benefit					3.64					
Benefit already received										
Financing benefit from underspending					0.75					
Benefit already received (PV at end year 6)					0.84					
Additional benefit required (PV at end year 6)					2.80					
Summary										
Financing benefits (nominal)			1.67	1.67	-2.51	0.84	0.84			
Financing benefits (PV at end year 5)			2.08	1.93	-2.70	0.84	0.78			
Total financing benefits (PV at end year 5)						2.93				
Additional benefits required (nominal)			5.60	5.60	-8.40	2.80	2.80			
Additional benefits required (PV at end year 5)			6.96	6.47	-9.03	2.80	2.60			
Total additional benefits required (PV at end year 5)										
Total DB benefits (PV at end year 5)						9.80				
Realised incentive rate						12.73				
						32.62%				

Again the same data as used in Models 1 and 2 are used and the same ex-ante incentive rate of 32.6 per cent is chosen for illustrative purposes. The underspend from year 1 is now trued-up at the start of year 3 and so on leading to the year 5 underspend being trued-up at the start of year 7. The NSP now effectively only retains one year of financing benefits on a rolling basis through the regulatory period. In Model 3 the year 1 true-up is done at the start of year 3 in present value terms at the end of year 2, the year 2 true-up is done at the start of year 4 in present value terms at the end of year 3 and so on.

Converting the smaller financing benefits to present values terms at the end of year 5 for comparison with Model 2, the NSP has retained benefits of \$2.9 million out to year 7. Converting the larger additional benefits required series to present value terms at the end of year 5, the NSP requires additional revenue of \$9.8 million (delivered in a series of annual revenue requirement additions in years 3 through to 7) to achieve the specified ex-ante incentive rate.

The main difference between Models 2 and 3 is that the periodic true-up in Model 2 allows the financing benefit to make up most of the NSP's overall benefit whereas the lagged annual true-up in Model 3 requires most of the NSP benefit to come from additional allowances.

B Example of a formulaic expression of a control mechanism

The formulaic expression of the control mechanism is the formula associated with that form of control mechanism. For example, for a WAPC (a form of control mechanism), the formulaic expression is a formula such as in Figure B.1.⁵⁶²

Figure B.1 Example of a formulaic expression of a control mechanism

$$\frac{\sum_{i=1}^n \sum_{j=1}^m p_t^j \times q_{t-2}^j}{\sum_{i=1}^n \sum_{j=1}^m p_{t-1}^j \times q_{t-2}^j} \leq (1 + CPI_t) \times (1 - X_t) \times (1 + S_t) \times (1 + L_t)$$

where a DNSP has n distribution tariffs, which each have up to m distribution tariff components, and where:

regulatory year "t" is the *regulatory year* in respect of which the calculation is being made;

regulatory year "t-1" is the *regulatory year* immediately preceding *regulatory year "t"*;

regulatory year "t-2" is the *regulatory year* immediately preceding *regulatory year "t-1"*;

p_t^j is the proposed *distribution tariff* for component j of *distribution tariff i* in *regulatory year t*;

p_{t-1}^j is the *distribution tariff* being charged in *regulatory year t-1* for component j of *distribution tariff i*;

q_{t-2}^j is the quantity of component j of *distribution tariff i* that was delivered in *regulatory year t-2*;

CPI_t is calculated as follows:

The Consumer Price Index, All Groups Index Number (weighted average of eight capital cities) published by the Australia Bureau of Statistics for the March Quarter immediately preceding the start of *regulatory year t*,

divided by

The Consumer Price Index, All Groups Index Number (weighted average of eight capital cities) published by the Australia Bureau of Statistics for the March Quarter immediately preceding the start of *regulatory year t-1*;

X_t to be determined using the building block approach;

S_t is the Service Target Performance Incentive Scheme factor to be applied in *regulatory year t*; and

L_t is the licence fee pass through adjustment to be applied in *regulatory year t*.

⁵⁶² AER, *Framework and approach paper for Victorian electricity distribution regulation*, May 2009, p. 140.