

ATTACHMENT 10.1
**CONTROL MECHANISM FOR STANDARD
CONTROL SERVICES**

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1. Introduction

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

Table 1-1: Overview of Essential Energy’s response to the AER’s Draft Decision on Control Mechanism for Standard Control Services

AER Decision	Essential Energy Response	Brief Description of Response
<p>Revenue Cap</p> <p>Control Mechanism for Standard Control Services is revenue cap.</p>	<p>Accept as rules require that Control Mechanism be the same as that specified in the AER’s Framework and Approach paper.</p>	
<p>Application of Revenue Cap.</p> <p>Revenue cap comprised of Annual Revenue Requirement (ARR) for standard control services calculated in accordance with revenue cap formulas in Figures 14-1.</p>	<p>In principle accept formula, but will seek further consideration of some elements of the formula.</p>	<p>Essential Energy request that the determination expressly provide that the “Price” component for year t in the Revenue Cap Formula includes the unders and overs adjustment.</p>
<p>Side Constraints</p> <p>Side Constraints apply to price movements for each tariff class must be consistent with formula in Figure 14-2.</p>	<p>Essential Energy disagrees with the formula in Figure 14-2 on the grounds that it is inconsistent with 6.18.6(c) of the Rules which requires the side constraint be the greater of CPI-X plus 2% or CPI plus 2%.</p> <p>Essential Energy has proposed an alternative formula that addresses our concerns and corrects for this error in the formula in Figure 14-2.</p>	<p>Essential Energy objects to the formula and proposes that the permissible percentage in the formula be expressed as the greater of a CPI-X plus 2% or CPI plus 2%.</p> <p>Essential Energy also notes that there is an unintended error in formula in Figure 14-2 where the AER has expressed the price change as being both less than or equal to (\leq) and equal to ($=$).</p>
<p>Unders and Overs Accounts</p> <p>Essential Energy must demonstrate compliance with the control mechanism for standard control services in accordance with Appendices A, B and C of the AER’s draft decision.</p>	<p>Essential Energy disagrees with aspects of Appendix A which addresses the DUOS unders and overs account.</p> <p>Appendix B addresses “TUOS” unders and overs account but should address “Designated Pricing Proposal Charges Unders and Overs Account”.</p>	<p>Essential Energy objects to the AER’s decision not to apply interest to the opening balance in year “t” of the unders and overs accounts in Appendices A, B and C of the AER’s draft decision.</p> <p>Essential Energy request the AER use the same interest calculations as currently in use for TUOS under and overs.</p>
<p>“TUOS” Under/ Over Recovery</p> <p>Essential Energy must submit as part of its annual pricing proposal, a record of the amount of revenue recovered from TUOS charges and associated payments in accordance with Appendix B.</p>	<p>Same issue as raised above, the reference should be to “Designated Pricing Proposal Charges” not TUOS.</p>	<p>Essential Energy objects to the AER’s draft decision not to apply interest to the opening balance in year “t” and request the AER use the same interest calculations as currently in use for TUOS under and overs.</p>

AER Decision	Essential Energy Response	Brief Description of Response
Jurisdictional Schemes Reporting Essential Energy must report to us its jurisdiction scheme amounts recover in accordance with Appendices C.	Accepted Essential Energy's proposed approach, except in respect to the inclusion of interest in year t.	Essential Energy objects to the AER's draft decision not to apply interest to the opening balance in year "t" and request the AER use the same interest calculations as currently in use for TUOS under and overs.
Application of Tolerance Limit	Essential Energy disagrees with the AER's approach to tolerance limits	Essential Energy seeks reconsideration of the AER's rejection of our proposed approach to tolerance, particularly in respect to imposing a limit on the recoupment of residual metering asset costs.

2. Application of control mechanism formula

The AER draft decision requires Essential Energy to submit to the AER proposed DUOS tariffs as part of its annual pricing process that comply with the following control mechanism formula¹:

$$1. \quad ARR_t = \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij} \quad i=1,\dots,n \text{ and } j=1,\dots,m \text{ and } t=2,\dots,5$$

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

$$2. \quad DUOS_t \leq R_t$$

$$3. \quad DUOS_t = \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij}$$

$$4. \quad R_t = ARR_t \pm U \& O_t$$

$$5. \quad ARR_t = AR_t \pm B_t$$

$$6. \quad AR_t = AR_{t-1}(1 + \Delta CPI_t)(1 - X_t)(1 - S_t)$$

$$7. \quad B_t = MC_t \pm PT_t$$

Where:

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

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

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

R_t is the total DUOS revenue entitlement in year t.

¹ Note that Essential Energy is also required to demonstrate that its proposed DUOS tariffs comply with the side constraint mechanism

ARR_t is annual distribution revenue requirement in year t.

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

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

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

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

MC_t is the residual metering costs in year t.

$$\Delta CPI_t = \frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} - 1$$

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

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

S_t is the STPIS factor sum of the raw s-factors for all reliability of supply and customer service parameters (as applicable) to be applied in year t.

3. STPIS Incentive and Transitional Adjustment

Essential Energy notes and accepts the AER's position that adjustments be included in the control mechanism for STPIS and Approved Pass Through Amounts, and that a transitional adjustment is no longer required to account for the difference in the notional revenue for the 2014-15 regulatory year and the placeholder revenue in the transitional decision as the AER has taken into account this difference as part of the true-up in establishing the smoothed total revenues over the 2015-19 period.

4. Annual Adjustment (B-Factor)

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

Essential Energy also notes that the AER have applied tolerance limits to the recovery of residual metering asset costs. Essential Energy does not agree with the AER and believes that the tolerance limit should be applied to the DUOS overs and unders account, rather than the recoupment of residual metering asset costs. Essential Energy's approach will ensure that customers are protected for potential price shocks without unnecessarily restricting Essential Energy's recoupment of residual metering asset costs in a given year. This issue is explained in more detail below.

5. Treatment of Under and Over Recovery mechanism for DUOS

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

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

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

We do not approve this proposal because we consider that Essential Energy can smooth prices by working with its customers to smooth its revenue i.e. by having a pricing strategy that would smooth out price shocks. Furthermore, a tolerance limit will allow Essential Energy to bank revenues that may result in greater price shocks in the future when they are ultimately recovered from customers. Our decision in applying a tolerance limit for Energex in 2010 has had this undesirable result.²

Essential Energy strongly disagrees with the AER on this matter and believes it is inappropriate for the AER to dictate pricing strategy in their draft decision to compensate for any shortcomings in their proposed control mechanism. The AER opted for the revenue cap control mechanism in the full knowledge that to move away from the weighted average price cap would pass volume risk from the distributor to the customer in the form of price volatility.

Essential Energy's proposed tolerance limit is a reasoned approach to limit the price shocks that are inherent in the AER's revenue cap control mechanism without adversely impacting Essential Energy's ability to implement efficient pricing strategy decisions.

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

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

In proposing variations to the amount and structure of DUOS charges, Essential Energy must attempt to achieve an expected zero balance on their DUOS unders and overs accounts in each forecast year in its annual pricing proposals in the 2015-19 regulatory control period, unless it can demonstrate for a given year that such an adjustment exceeds the agreed tolerance limits set out in this decision. In such circumstances, the balance at the end of the regulatory control period will reflect the amount by which the adjustment exceeded the first tolerance limit (that is, the amount by which the under/over adjustment exceeded two per cent of Essential Energy's ARR for year t.)³

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

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

² AER 2014, Draft Decision, Essential Energy distribution determination 2015-16 to 2018-19 Attachment 14: Control Mechanisms, Attachment A, p.14-11.

³ AER 2014, Draft Decision, Essential Energy distribution determination 2015-16 to 2018-19 Attachment 14: Control Mechanisms, Attachment A, p.14-17.

Table 6-2: AER's draft tolerance limits and actions – general requirement

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

Essential Energy is concerned that the AER's approach may only be effective in managing this risk in the situation where the under/over adjustment each year is immaterial. This is because it does not impose an obligation on Essential Energy to actively manage a material under or over recovery of DUOS revenue on behalf of customers.

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

To address the AER's concerns with the tolerance limit, we have reduced our proposed upper tolerance limit from 10% to 5% as part of our revised proposal and we encourage the AER to adopt the approach to tolerance limits proposed by Essential Energy, as shown in the table below:

Table 6-3: Essential Energy's proposed tolerance limits and actions

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

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

Table 6-4: AER's draft tolerance limits and actions – specific requirement

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

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

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

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

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

$$8. \quad PV \text{ of } \sum_{t=1}^z ARR_t = PV \text{ of } \sum_{t=1}^z DUOS_t$$

Where:

$DUOS_t$ is the expected DUOS revenue in year t (calculated in accordance with formula 3 above)

ARR_t is annual revenue requirement in year t (calculated in accordance with formula 4 above)

The AER approach of excluding interest in year t does not fully compensate the DNBP for the opportunity costs associated with the under-recovery of DUOS revenue in year t-2 given that the DNBP receives its DUOS revenue (cash inflow) during the course of year t, rather than the first day of the year t.

Essential Energy encourages the AER to reconsider its position on this issue and adjust their final decision to include an interest calculation for any under or over recovery of revenue in year t of DUOS, designated pricing proposal charges (TUOS) and jurisdictional scheme under and over amounts. This will be in line with the current treatment of the TUoS unders and overs account.

8. Side constraint

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

$$9. \quad \frac{(\sum_{t=1}^m d_t^j q_t^j)}{(\sum_{t=1}^m d_{t-1}^j q_t^j)} \leq (1 + \Delta CPI_t)(1 - X_t)(1 + 2\%)(1 + S_t) \pm PT_t \pm DUOS_t$$

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

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

d_{t-1}^j is the price charged by the Essential Energy for component 'j' of the tariff class in year t-1

q_t^j is the forecast quantity of component 'j' of the tariff class in year t

$$\Delta CPI_t = \frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} - 1$$

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

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

S_t is the STPIS factor sum of the raw s-factors for all reliability of supply and customer service parameters (as applicable) to be applied in year t.

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

$DUOS_t$ is an annual adjustment factor related to the balance of the DUOS unders and overs account with respect to regulatory year t.

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

- > the permissible percentage is expressed on the basis of a CPI-X limitation plus 2%. This approach is inconsistent with section 6.18.6(c) of the NER and will prevent Essential Energy from undertaking efficient tariff reform in an environment of declining allowed revenues and prices' and
- > the AER side constraint formula requires that the proposed % increase in Essential Energy's expected weighted average revenue in year t is both " \leq " and " $=$ " to the permissible percentage.⁴

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

$$10. \frac{(\sum_{t=1}^m d_t^j q_t^j)}{(\sum_{t=1}^m d_{t-1}^j q_t^j)} \leq \text{Permissible Percentage}$$

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

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

d_{t-1}^j is the price charged by the Essential Energy for component 'j' of the tariff class in year t-1

q_t^j is the forecast quantity of component 'j' of the tariff class in year t

The Permissible Percentage is the greater of:

11. $(1 + \Delta CPI_t)(1 - X_t)(1 + 2\%)(1 + S_t) \pm PT_t \pm U \ \& \ O_t$, or

12. $(CPI_t + 2\%)$

⁴Note: Essential Energy has assumed that the inclusion of " $=$ " is an error given the compliance issues that this contradiction would cause.

Where

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

S_t is the STPIS factor sum of the raw s-factors for all reliability of supply and customer service parameters (as applicable) to be applied in year t .

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

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

$$\Delta CPI_t = \frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} - 1$$

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

9. Recovery of d factor amounts

Essential Energy notes that the AER's transitional decision allows distributors to recover the costs and foregone revenues of applicable demand management projects in the 2009-14 regulatory control period in the transitional and subsequent regulatory control periods⁵

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

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

- > X-factor approach: to set the X-factor under the revenue cap for distribution standard control services on the basis that an estimate of our entitlement under the D-factor in FY 2014/15 and FY 2015/16 is including in the building block revenue requirement, and
- > annual pricing proposal approach: allow Essential Energy to include a proposed D-factor amount in its annual pricing proposal for the forthcoming year and to account for this amount in the B-factor under the revenue cap.

⁵ AER 2014, Transitional Distribution Decision 2014-15, page 47