



L-factor additions

**PAL RRP APP08 - L-factor additions - Dec2020 -
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Revised regulatory proposal 2021–2026

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1 Summary

In response to the draft determination regarding our proposed step change for the increase in Energy Safe Victoria (**ESV**) levies in the next regulatory period, we are proposing to provide for the recovery of ESV levy costs through the B-factor adjustment in the standard control services price control formula, rather than a step change.

In addition, as the Australian Energy Market Operator (**AEMO**) has indicated it may seek to impose participant fees on distributors from 1 July 2021, we are also proposing to provide for the recovery of AEMO fees through the B-factor adjustment.

Our proposed approach is consistent with the regulatory treatment of license fees payable to the Essential Services Commission of Victoria (**ESCV**). The approach delivers appropriate regulatory outcomes because:

- we have no control over the cost of ESV levies and AEMO fees; they are determined unilaterally by the Minister and AEMO respectively. We therefore cannot respond to incentives to reduce these costs and, in circumstances where we are already likely to face significant pressures on our operating expenditure in the next regulatory period, we should not also be required to absorb increases in unavoidable costs that are outside of our control
- we are not provided with an opportunity to recover these costs through base operating expenditure given:
 - ESV levies are expected to increase substantially above historic levels in the next regulatory period
 - we have not paid AEMO fees historically and thus no AEMO fees are reflected in our base year expenditure
- we are not provided with an opportunity to recover these costs through the rate of change because:
 - in applying a productivity growth rate of 0.5 per cent, which was set prior to the onset of the COVID-19 pandemic, the AER cannot maintain that it is applying a lower productivity estimate that accounts for higher costs resulting from changed obligations
 - the ESV levies we incur move independently of input prices and output growth
 - neither the level or, nor basis on which AEMO fees will be imposed, is known and thus the AER cannot conclude that these costs are recovered through the rate of change
- our proposed approach will ensure we do not under-recover our prudent and efficient costs, and at the same time will ensure customers are not required to pay for levies and fees not ultimately incurred.

There is no basis for the AER to refuse to provide us with an opportunity to recover the higher ESV levies and AEMO fees we will incur in the next regulatory period on the basis the increases in these costs are not 'material'. There is no express materiality threshold under the National Electricity Law (**Law**) or National Electricity Rules (**Rules**) for the purposes of assessing whether particular operating expenditure should be provided for in a determination. Further, there is no basis in the Law or Rules for applying such a threshold in circumstances where we are an efficient distributor facing a range of other pressures on our operating expenditure in the next regulatory period, including:

- a negative productivity adjustment, which reduces our total operating expenditure allowance
- real non-labour price growth of zero, which means that the non-labour component of price growth is equal only to the consumer price index (**CPI**)
- the enduring impact of COVID-19, which (all other things being equal) increases our costs of providing network services
- the rejection by the AER of a number of the step changes we proposed, which costs will thus need to be absorbed.

2 Background

2.1 Original proposal

Section 8 of the *Electricity Safety Act 1998* (Vic) provides that a distribution company must pay to ESV at such time or times as the Minister determines such annual amount (if any) as the Minister determines to be payable by that distribution company in respect of the reasonable costs and expenses of ESV.

In our original proposal, we proposed a step change of \$4 million (\$2020-21) in response to the forecast incremental increase in the ESV levy over the next regulatory period.

At the time of our original proposal, AEMO had not yet published its Consultation Paper on electricity participant fee structures and thus AEMO fees were not addressed.

2.2 AER's draft determination

In spite of ESV confirming the proposed step change was consistent with expected increases in their levies, the AER rejected our proposed step change.¹

The AER reasons that, in the absence of exceptional circumstances, fluctuations in the ESV levy should be managed within base operating expenditure and the rate of change because:²

- base operating expenditure already reflects the cost of meeting existing regulatory obligations, including the obligation to pay the ESV levy
- the rate of change formula escalates base operating expenditure by the forecast change in prices, output and productivity
- the incremental cost of the ESV levy is immaterial relative to total forecast operating expenditure and thus movements in the levy costs can be funded as the cost of other programs and projects in the base year decline.

While the draft determination in respect of the ESV levy step change refers to the rate of change more broadly, in describing the approach to forecasting operating expenditure generally, the AER suggests the productivity component of the rate of change is the relevant component. The AER indicates that 'incremental changes in obligations are likely to be compensated through a lower productivity estimate that accounts for higher costs resulting from changed obligations'.³

The AER also determined that annual ESV levies should not be recovered through the B-factor adjustment in the standard control services price control formula, referring to the draft determination regarding AusNet Services.⁴ In that draft determination the AER stated only that:⁵

- while the licence fees payable to the ESCV are included in the B-factor, this reflects historical treatment
- the AER's preference going forward is to avoid the use of the annual adjustments in the price control formula to recover annual licence fees
- the AER's approach is consistent with the approach adopted in respect of the other Victorian distributors.

¹ AER, Draft decision, Powercor Distribution Determination 2021–2026, Attachment 6: Operating expenditure, pp. 60-61.

² AER, Draft decision, Powercor Distribution Determination 2021–2026, Attachment 6: Operating expenditure, pp. 60-61.

³ AER, Draft decision, Powercor Distribution Determination 2021–2026, Attachment 6: Operating expenditure, p. 17.

⁴ AER, Draft decision, Powercor Distribution Determination 2021–2026, Attachment 14: Control mechanisms, p. 21.

⁵ AER, Draft decision, AusNet Services Distribution Determination 2021–2026, Attachment 6: Operating expenditure, p. 42.

3 Revised proposal

In response to the draft determination, we are proposing to remove the costs associated with the ESV levy from the base year operating expenditure and include an annual adjustment for ESV levy payments in the B-factor of the standard control services price control formula, rather than proposing a step change to base year operating expenditure.

In addition, we are proposing to provide for the recovery of AEMO fees expected to be incurred in the next regulatory period through the B-factor adjustment. In August 2020, after our original proposal was submitted, AEMO published a consultation paper on a revised structure to apply for participant fees payable under the Rules from 1 July 2021, which identifies the potential for fees to be imposed on distributors.⁶

The AER has erred in failing to make any allowance for the expected increases in ESV levies in the next regulatory period and should allow for recovery of these costs through the B-factor in the standard control price control formula. The AER should also now allow for the possibility of AEMO fees through the B-factor. This is because:

- ESV levies and AEMO fees are not like other categories of operating expenditure in respect of which it is desirable to have the incentive properties of the building block methodology and the efficiency benefit sharing scheme apply. They are unavoidable costs over which we have no control, determined unilaterally by the Minister and AEMO respectively
- the AER's approach of failing to allow for the recovery of increased operating expenditure that is not 'material' has no basis in the Law or Rules
- the increases in the ESV levy are not compensated for through the rate of change.

These matters are discussed in turn below.

Our proposed approach delivers appropriate regulatory outcomes for each of these reasons. In addition, our proposed approach of recovering ESV levies and AEMO fees will ensure that changes to fees and levies imposed by regulatory bodies are economically neutral. That is, it will ensure that we do not under-recover our prudent and efficient costs, and our customers are not required to pay for levies and fees not ultimately incurred.

3.1 ESV levy and AEMO fee costs are unavoidable and outside of our control

The draft determination fails to take into account that, like our licence fees paid to the ESCV, ESV levies and AEMO fees are unavoidable costs that are outside of our control:

- we are required to pay the ESV levy under section 8 of the *Electricity Safety Act 1998* (Vic). The ESV levy costs are the subject of a Ministerial determination
- we are required to pay AEMO fees under clause 2.11.2(c) of the Rules. These fees are charged by AEMO in accordance with the structure of participant fees it has developed and published under the Rules.⁷
- As a result, these are costs that will and must be incurred as a necessary consequence of owning and operating an electricity distribution network and we cannot respond to the incentives properties of the building block methodology and the efficient benefit sharing scheme to reduce these costs.

The rationale for an annual adjustment for these regulatory costs outside of our control is even stronger in light of the pressures we will face in recovering our operating expenditure in the next regulatory period (discussed in

⁶ AEMO, Electricity Fee Structures, Consultation Paper, August 2020, available at https://aemo.com.au/-/media/files/stakeholder_consultation/consultations/nem-consultations/2020/electricity-market-participant-fee-structure-review/final-aemo-electricity-fee-structure-consultation-paper_aug-2020.pdf?la=en.

⁷ Rules, clauses 2.11.1 and 2.11.2(a).

section 3.2 below). Given these pressures, we should not be required to absorb increases in unavoidable costs that are outside of our control.

The AER accepts that licence fees payable to the ESCV will be recovered through the B-factor on the basis they have historically been recovered by way of an annual adjustment. The reason the ESCV provided for ESCV licence fees (as well as fees associated with the AER and the Australian Energy Market Commission (AEMC)) to be recovered in this way under the prior regulatory regime was 'because of the uncertainty regarding the value of these over the period given the proposed changes to the Federal and jurisdictional regulatory frameworks governing distribution networks'.⁸ The ESV levy was excluded from the annual adjustment on the basis that it had been confirmed that ESV levies were to increase in line with CPI and thus the ESCV did not consider it necessary or appropriate to include these fees as an annual adjustment.⁹

Given there is no basis for concluding that ESV levies or AEMO fees are expected to increase in line with CPI, the ESCV's rationale for making an annual adjustment for ESCV licence fees historically holds true today for ESV levies and AEMO fees, in addition to ESCV licence fees.

The AER has previously accepted that a broader range of regulatory costs than just licence fees can be recovered on the basis of actual costs incurred through use of an annual adjustment. For example, Jemena Gas Networks' approved access arrangement for 1 July 2020 - 1 July 2025 includes an annual adjustment for a range of regulatory fees, including AEMO fees (through a true up of the difference between actual fees and the forecast provided for in the regulatory allowance).¹⁰ Regarding AEMO fees, the AER stated (references excluded):¹¹

We agree with JGN that, although it currently does not incur AEMO fees, AEMO's evolving role in the gas market means such fees cannot be ruled out in the future. Historically, AEMO fees were allocated to market participants and not controllable by JGN. Hence, based on information provided by JGN in its revised proposal, we consider it is reasonable to include such fees in the licence fee factor should they arise again in the future.

There is no reasonable basis for rejecting a similar regulatory treatment to uncontrollable costs in our determination.

3.2 There is no basis in the Law or Rules for a 'materiality' threshold

In the draft determination, the AER rejected step changes that do not arise from a change in regulatory obligations or an efficient substitution of capital expenditure for operating expenditure, including the ESV levy step change included in our original proposal, on the basis that the expenditure is not 'material'. To the extent the AER seeks to apply the same rationale in considering our proposal to recover ESV levies and AEMO fees through the B-factor, the AER's approach has no basis in the Law or Rules.

The flaws in the AER's approach are discussed in detail in the other step changes business case 9.06 submitted with this revised proposal. By way of summary:

⁸ ESCV, *Electricity Distribution Price Review 2006-10, October 2005 Price Determination as amended in accordance with a decision of the Appeal Panel dated 17 February 2006, Final Decision Volume 1, Statement of Purpose and Reasons*, October 2006, p. 471.

⁹ ESCV, *Electricity Distribution Price Review 2006-10, October 2005 Price Determination as amended in accordance with a decision of the Appeal Panel dated 17 February 2006, Final Decision Volume 1, Statement of Purpose and Reasons*, October 2006, p. 471.

¹⁰ Jemena Gas Networks (NSW) Ltd, Access Arrangement 1 July 2020 - 30 June 2025, clause 3.2 and Schedule 3, available at <https://www.aer.gov.au/system/files/AER%20-%20Final%20decision%20-%20JGN%20access%20arrangement%202020-25%20-%20Approved%20Access%20Arrangement%20for%20JGN%20%28NSW%29%20Ltd%202020-25%20-%20June%202020%20-%20Clean.pdf>.

¹¹ AER, Final Decision Jemena Gas Networks (NSW) Ltd Access Arrangement, 2020 to 2025, Overview, June 2020, p. 22, available at https://www.aer.gov.au/system/files/AER%20-%20Final%20decision%20-%20JGN%20access%20arrangement%202020-25%20-%20Overview%20-%20June%202020_0.pdf.

- in contrast to other provisions of the Rules, there is no express materiality threshold under the Law or Rules for the purposes of assessing whether operating expenditure should be included in a forecast or otherwise provided for in the distribution determination
- there is no basis in the Law or Rules for applying a materiality threshold to the recovery of operating expenditure in circumstances where we will face significant pressures on our operating expenditure in the next regulatory period as a result of a range of matters, including:
 - we are an efficient distributor, and thus the base year operating expenditure can be assumed to reflect the prudent and efficient costs of meeting the operating expenditure criteria, having regard to the operating expenditure factors
 - the AER is proposing to assume productivity growth of 0.5 per cent, which has the effect of reducing real expenditure allowances in the next regulatory period
 - the AER is proposing to apply real non-labour price growth of zero (i.e. non-labour price growth equal to the CPI)
 - the enduring impact of COVID-19 will result in higher costs for our operations due to changed work practices beyond the next few years and will be difficult to unwind in future as expectations regarding social distancing have changed
 - we are already being required by the draft determination to absorb a number of step changes, in addition to further step changes we chose not to include in our original proposal, to maintain affordability for our customers in what are challenging times
- the AER makes a further fundamental error in rejecting a number of step changes on the basis they are, individually, not 'material'. This is not consistent with the requirements of the Rules or Law. It is the cumulative impact of expected changes on future total operating expenditure that is the relevant consideration. Taken to the extreme, a distributor's expenditure could be expected to double on the basis of step changes or other costs proposed to be recovered through the control mechanism that are, on their own, not 'material' but which cumulatively have a significant impact such that a failure to include those step changes or cost recovery mechanism in the determination would deprive the distributor of the opportunity to recover their prudent and efficient costs.

3.3 The increases in ESV levies and AEMO fees are not captured by the rate of change

As noted in section 2.1 above, the AER appears to contemplate that increases in ESV levies are captured by the productivity adjustment, and may seek to apply the same reasoning to the expected imposition of AEMO fees during the next regulatory period.

Productivity measures the change in output for a given amount of input. The draft determination applies a productivity growth forecast of 0.5 per cent per year, notwithstanding the impact of COVID-19 pandemic on our productivity. The productivity growth of 0.5 per cent per year was forecast in March 2019.¹² This was over 12 months prior to the impact of the COVID-19 pandemic. The health and safety measures we are required to uphold to stop the spread of the virus reduce our output for a given amount of input and are not expected to be significantly relaxed over the next regulatory period. Social distancing norms, for example, will persist.

¹² AER, Draft decision, Powercor Distribution Determination 2021–2026, Attachment 6: Operating expenditure, p. 17.

In these circumstances, the AER cannot maintain that it is applying a lower productivity estimate that accounts for higher costs resulting from changed obligations such as higher ESV levies and AEMO fees.

Neither are the increases in ESV levies or AEMO fees captured by the other elements of the rate of change. For instance:

- the ESV levy moves independently of input prices. Expected changes in labour costs and CPI are not adequate to capture the expected increases in the ESV levy in the next regulatory period
- while we understand that ESV levies are spread across service providers based on the proportion of customers on each distributors network, the total costs to be distributed do not move in line with customer numbers or any of the other measures of output growth reflected in the output growth forecast (circuit length, ratcheted maximum demand or energy throughput). This means that there is no connection between output growth and the amount payable in of ESV levies
- given the details of the AEMO fees are not yet known, it is not reasonable for the AER to conclude that the increases in these fees (from zero) are captured by the rate of change.

3.4 Revised proposal

In order to give effect to our revised proposal, we have removed the costs associated with the ESV levy from base year operating expenditure and propose the following amendments to the B factor of the revenue cap formula for standard control services set out in the draft determination:

B_t is the sum of annual adjustment factors for year t. It includes:

- the true-up for any under or over recovery of actual revenue collected through DUoS charges calculated using the following method:
- $DUoS\ Under\ and\ Overs\ True - Up_t = -(Opening\ Balance_t)(1 + WACC_t)^{0.5}$
- where:
- $DUoS\ Under\ and\ Overs\ True - Up_t$ is the true-up for the balance of the DUoS unders and overs account in year t.
- $Opening\ Balance_t$ is the opening balance of the DUoS unders and overs account in year t as calculated by the method in appendix A.
- $WACC_t$ is the approved weighted average cost of capital (WACC) used in regulatory year t in the DUoS unders and overs account in Appendix A. This WACC figure will be a nominal WACC figure that reflects actual inflation rather than forecast inflation. To calculate this nominal WACC, the real vanilla WACC from the annual update PTRM will be escalated for actual inflation.
- the license fee, annual levy and participant fee charges incurred by the Victorian businesses, ~~charged by payable to~~ the Victorian Essential Service Commission, Energy Safe Victoria and the Australian Energy Market Operator respectively. The recovery of license fee, annual levy and participant fee charges will occur on a two-year lag, and will therefore be indexed by two years interest, calculated using the following method:
- $L_{t-2} \times (1 + WACC_t) \times (1 + WACC_{t-1})$
- where:
- L_{t-2} is the sum of: the license fees paid by the distributor to the Victorian Essential Services Commission; the annual levy paid by the distributor to Energy Safe Victoria; and the participant fees paid by the distributor to the Australian Energy Market Operator, relating to regulatory year t-2.