Replacement of framework and approach 2020−25

Energex, Ergon Energy, SA Power Networks and Directlink

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AUSTRALIAN ENERGY REGULATOR

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1 Introduction

The Framework and approach (F&A) is the first step in a process to determine efficient prices for electricity distribution and transmission services. The F&A determines, amongst other things, which distribution services the Australian Energy Regulator (AER) will regulate and certain aspects of a regulatory determination set out under the National Electricity Rules (the Rules). It facilitates early public consultation on the pricing mechanism for regulated services (for distribution businesses) and the incentive schemes that will encourage efficient network expenditure (for distribution and transmission businesses).

These are important aspects of the regulatory process and have a significant bearing on the regulatory proposals that Energex, Ergon Energy, SA Power Networks and Directlink are required to submit to us by 31 January 2019.

1.1 Why is the F&A important for consumers?

The F&A is important because it provides an opportunity for interested parties, including consumers, to have a say in which distribution services we should regulate and how much control we have over determining the prices for network services. Our intended approach on service classification will settle the ring-fencing obligations for particular services for a regulatory control period.[1]

The F&A also sets out information around incentive schemes that will apply to network service providers to encourage efficient investment and performance.

The sorts of issues we will consider in the F&A include:

- whether there is the possibility of increased competition in the provision of some distribution services traditionally provided only by network service providers. This might happen if, for example, we were satisfied there were no significant barriers to competitive provision of a particular service. In this event, we may decide not to regulate that service, leaving prices to be set by the market.
- whether the provision of distribution services should take place on a fee for service basis or perhaps as a service for which there is minimal oversight by us. For example, we may determine that a distribution business may bundle the costs for a particular service into a generic electricity supply service (standard control service). Alternatively, we may decide that charging for a service on a user-pays basis is more appropriate (alternative control service). Finally, we may allow consumers and network service providers negotiate the price of a service (negotiated distribution service) and only intervene if the parties cannot reach an agreement.
- whether incentive schemes will apply to distribution and transmission businesses, for example, to service quality, improvements in network reliability or capital and operating

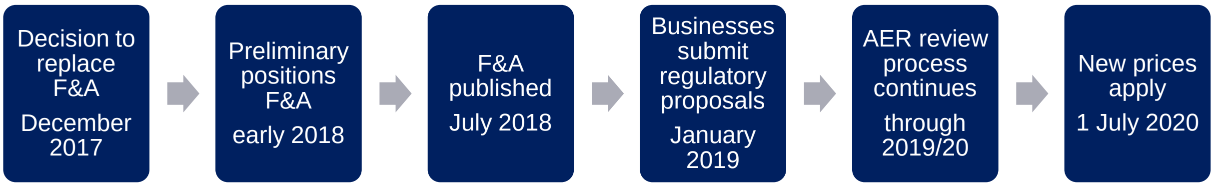
1 AER, *Ring-fencing guideline electricity distribution*, October 2017. See: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/electricity-ring-fencing-guideline-october-2017.

expenditure. The purpose of incentive schemes is to encourage network service providers to manage their business in a safe, reliable manner that serves the long term interests of consumers. The schemes provide network service providers with incentives to only incur efficient costs and to meet or exceed service quality targets. In some instances, network service providers may incur a financial penalty if they fail to meet set targets.

We consider that consumers should be actively involved in the F&A process as the decisions made, particularly relating to classification of distribution services and pricing, will apply for a five year period before they are reviewed.

Diagram 1 provides an overview of where the F&A sits in the Queensland and South Australia (Qld and SA) reset processes for the regulatory control period of 1 July 2020 to 30 June 2025. Stakeholder consultation occurs throughout the process.

Diagram 1: Reset process



1.2 Our decision

For the 2020–25 regulatory control period we consider it prudent to undertake a more comprehensive review of the Qld/SA F&A papers. Changes to the Rules in November 2012 introduced new incentive schemes and make it possible for us to adopt improved approaches to the assessment of the expenditure forecast by the network service providers.[2] The Power of Choice reform also introduced changes to metering contestability.[3] Further, we developed a new demand management incentive scheme (DMIS) [4] and have published a national ring-fencing guideline.[5]

This decision sets out our reasons to replace the current F&A papers for the next regulatory control period. Appendix A lists the specific matters we will include in the F&A papers. We will also consider any other relevant matters appropriate or convenient for us to address in the F&A papers.[6]

2 Which we outline in our published guidelines. These guidelines are available at www.aer.gov.au/Better-regulation-reform-program.

3 See: http://www.aemc.gov.au/Major-Pages/Power-of-choice.

4 See: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/demand-management-incentive-scheme-and-innovation-allowance-mechanism.

5 AER, *Ring-fencing guideline electricity distribution*, October 2017. See: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/ electricity-ring-fencing-guideline-october-2017.

6 NER, cll. 6.8.1(g) and 6A.10.1A(g). The AER would consult appropriately on any additional matters it wishes to include in the F&A.

The F&A papers for the Qld and SA distributors were published on 30 April 2014.[7] As Rule changes were introduced during the F&A process, there were a range of transitional provisions in effect that are not relevant to the next regulatory control period.

In accordance with the Rules, we intend to publish replacement F&A papers by 31 July 2018.[8] Consultation on the replacement F&A papers will commence with publication of a discussion paper for the Qld and SA distributors respectively in early 2018.

Before reaching this decision to replace Qld and SA F&A papers, we issued a notice under the Rules,[9] inviting submissions on whether it is necessary or desirable to amend or replace the current F&A papers for network service providers. Submissions closed on 30 November 2017 and we received one response, from the Renewable Energy Policy Group SA (REPG).[10] REPG's submission covered incentive schemes, trials, forecasting, cost allocation and consumer protection for SA Power Networks. We have had regard to this submission in reaching our decision.[11]

Directlink, Energex, Ergon Energy and SA Power Networks each submitted requests to us to address a number of issues in their respective F&A papers that we are required to consider.[12] This is because the Rules include a provision that permits a network service provider to specify certain issues that must be addressed in its F&A.[13] A copy of each service providers' request is published on our website alongside this decision[14] together with REPG's submission.

Reasons for our decision follow.

7 See https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/energex-determination-2015-2020/aer-position and https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/sa-power-networks-determination-2015-2020/aer-position.

8 NER, cll. 6.8.1(e) and 6A.101A(e).

9 NER, cll. 6.8.1(c)(2) and 6A.10.1A(c)(2). We issued this notice on 1 November 2017.

10 Responses to our notice are available at https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/sa-power-networks-determination-2020-25/initiation.

11 NER, cll. 6.8.1(c)(3), 6.8.1(d) , 6A.10.1A(c)(3) and 6A.10.A(d) .

12 SA Power Networks, *Request to replace framework and approach*, 31 October 2017; Energex, *Request to amend the framework and approach*, 31 October 2017; Ergon Energy, *Request to amend the framework and approach*, 31 October 2017; Directlink, *Re: framework and approach paper for Directlink*, 31 October 2017.

13 Service provider written requests were submitted in accordance with NER, cll. 6.8.1(c)(1) and 6A.10.1A(c)(1).

14 As required under NER, cll. 6.8.1(c)(3)(ii) and 6A.10.1A(c)(3)(ii).

2 Our reasons

This section sets out our reasons for deciding to replace the Qld and SA F&A papers for the next regulatory control period of 1 July 2020 to 30 June 2025. The sections below correspond to the various components of the F&A.

2.1 Distribution service classification

We consider it necessary to replace the Qld and SA F&A papers with respect to the classification of distribution services.[15] The Rules require us to determine which services provided by network businesses will be subject to regulation as well as the manner in which we will regulate those services.[16] That is, whether we will directly control prices through to deciding not to regulate a particular service. We make these decisions by assessing a range of factors to determine whether there is competition or potential for competition for the provision of that service.

We consider it timely to consider distribution service classification in Qld and SA. The classification process for these jurisdictions coincides with a range of services, like metering services, becoming contestable. Additionally, we have recently released our electricity distribution Ring-fencing Guideline, which requires DNSPs to separate their services based on the classification. The Australian Energy Market Commission has also recently issued a rule change relating to service classification, which applies to all distribution businesses. The rule change requires us to develop and publish a service classification guideline in 2018.[17] These changes provide an opportunity for interested parties to convey views on possible options to allow for competition of electricity services to develop.

The service providers also requested a review of service classifications to ensure the service descriptions better reflect the services offered. This review will also provide improved clarity given that service classification will set ring-fencing obligations for the regulatory control period.[18]

2.2 Form of control

For distribution services classified as direct control services, we must determine the price or revenue controls (or some other hybrid arrangement) for each service or group of services. The form of control may be, for example, a cap on revenue or a cap on prices charged by the network service providers. The Rules set out assessment criteria we must consider.[19] We may also apply additional criteria in considering the form of control we will apply (as we have done elsewhere).[20] Our assessment is particularly important as we have limited

15 NER, cl. 6.8.1(b)(2)(i).

16 NER, cll. 6.2.1 and 6.2.2

17 See http://www.aemc.gov.au/Rule-Changes/Contestability-of-energy-services.

18 SA Power Networks, *Request to replace framework and approach*, 31 October 2017, p.5; Energex, *Request to amend the framework and approach*, 31 October 2017, p. 1; Ergon Energy, *Request to amend the framework and approach*, 31 October 2017, p. 1; AER, *Ring-fencing guideline electricity distribution*, October 2017.

19 NER, cl. 6.2.5.

20 In the current Queensland and South Australia F&A processes, we applied three additional criteria in our form of control

discretion to amend the form of control in our final determination.[21] For these reasons, we will review the form of control applicable to each of the Qld and SA providers in our F&A.

The Rules also require us to set out the formulae that give effect to the control mechanisms we will apply.[22] The control mechanisms are the formulae we will use to calculate service prices. We expect to classify some services differently. Again, we have limited discretion to alter the control mechanism formulae listed in the F&A at the time of the determination unless we consider a material change in circumstances justifies departing from those formulae.[23]

2.3 Application of incentive schemes

We have developed several mechanisms that provide incentives for network service providers to invest efficiently and therefore be more likely to operate in the long term interests of consumers. These schemes include the service target performance incentive scheme, efficiency benefit sharing scheme, capital expenditure sharing scheme and demand management and embedded generation connection incentive scheme. The overall objectives of the schemes are to:[24]

- incentivise network service providers to spend more efficiently on capital and operating expenditure
- reduce the risk of consumers paying for unnecessary capital expenditure
- share efficient improvements and losses between network service providers and consumers
- encourage appropriate levels of service quality
- maintain network reliability as appropriate.

A number of incentive schemes already apply to the network service providers. However, since our last determination, there have been updated versions of some schemes released. We now have a new demand management incentive scheme (DMIS), which network service providers would prefer applied to them for the 2020-2025 regulatory control period. The network service providers have also suggested that there may be some modifications that could be made to the design of some schemes. For example, some of the parameters of the service target performance incentive scheme (STPIS) and the capital expenditure sharing schemes (CESS).[25]

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mechanism assessment. We consider it prudent to continue applying these criteria to Queensland and South Australia for 2020−25.

21 NER, cll. 6.8.1(b)(1)(i) and 6.12.3(c) and (c1).

22 NER, cl. 6.8.1(b)(2)(ii).

23 NER, cl. 6.12.3(c1).

24 AER, *Electricity distribution network service providers, Service target performance incentive schemes*, June 2008, p. 2; AER, *Better Regulation, Draft expenditure incentives*, 9 August 2013.

25 SA Power Networks, *Request to replace framework and approach*, 31 October 2017, p.3; Energex, *Request to amend the framework and approach*, 31 October 2017, p. 1; Ergon Energy, *Request to amend the framework and approach*, 31 October 2017, p. 1; Directlink, *Re: framework and approach paper for Directlink*, 31 October 2017, p.2.

In light of the issues raised above, we consider that the application of all incentive schemes should be reviewed in the Qld and SA F&A papers.[26]

2.4 Other matters

SA Power Networks has submitted that we should continue to apply the Expenditure Forecast Assessment Guideline consistently and should outline our intended approach to depreciation. It submitted there is no reason to depart from our current approach to both. In relation to the Expenditure Forecast Assessment Guideline, Directlink submitted that its F&A should be update to reflect that the base step trend approach may not be as suitable for Directlink as it may be for other network service providers.

The Rules require us to consider these matters in developing the F&As for Qld, SA and Directlink for the next regulatory control period. However, we may consider it unsuitable to state a specific position on these matters in the F&A. This may be because, for example, our position may be dependent on information that will only become available once a network service provider submits its regulatory proposal.

For the above reasons and having regard to the submissions, we consider it necessary to replace the F&As for Qld, SA and Directlink for the next regulatory control period of 1 July 2020 to 30 June 2025. We expect to issue a discussion paper in early 2018 outlining preliminary views on the matters outlined in this decision. We must then publish final F&A papers by 31 July 2018.

26 NER, cll. 6.8.1(b)(2)(iii)-(viii).

Appendix A – Matters to be addressed in the F&A

The replacement Qld and SA F&A will address the following matters:

- classification of distribution services (which services we will regulate)
- form of control mechanisms (how we will determine prices for regulated services) and the control mechanism formulae that give effect to the form of control mechanisms
- application of a range of incentive schemes that encourage things like service quality, improvements in network reliability or efficient capital and operating expenditure. This includes application of the:
    - service target performance incentive scheme
    - efficiency benefit sharing scheme
    - capital expenditure sharing scheme
    - demand management and embedded generation connection incentive scheme
    - small-scale incentive scheme
    - expenditure forecast assessment guidelines
    - whether depreciation for establishing the regulatory asset base the network service providers opening regulatory asset base for the 2025–2030 regulatory control period is to be based on actual or forecast capital expenditure.

The replacement Directlink F&A will address the following matters:

- application of a range of incentive schemes that encourage things like service quality, improvements in network reliability or efficient capital and operating expenditure. This includes application of the:
    - service target performance incentive scheme
    - efficiency benefit sharing scheme
    - capital expenditure sharing scheme
    - demand management and embedded generation connection incentive scheme
    - small-scale incentive scheme
    - expenditure forecast assessment guidelines
    - whether depreciation for establishing the regulatory asset base the network service providers opening regulatory asset base for the 2025–2030 regulatory control period is to be based on actual or forecast capital expenditure.