



Replacement of framework and approach 2019–24

NSW, ACT and TAS electricity distribution businesses and TAS electricity transmission business

December 2016

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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 Ausgrid, Endeavour Energy, Essential Energy, ActewAGL and TasNetworks (as distribution businesses) and TasNetworks as a transmission business, are required to submit to us by 31 January 2018.

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.

¹ AER, *Ring-fencing guideline electricity distribution*, November 2016. See: <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/electricity-ring-fencing-guideline-2016>.

- whether incentive schemes will apply to distribution and transmission businesses, for example, to service quality, improvements in network reliability or capital and operating 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 NSW, ACT and TAS reset process for the regulatory control period of 1 July 2019 to 30 June 2024. Stakeholder consultation occurs throughout the process.

Diagram 1: Reset process



1.2 Our decision

For the 2019–24 regulatory control period we consider it prudent to undertake a more comprehensive review of the NSW, ACT and Tasmanian 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 are currently developing a new demand management incentive scheme (DMIS)⁴ and have recently 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*, November 2016. See: <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/electricity-ring-fencing-guideline-2016>.

⁶ NER, cl. 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 NSW and ACT distributors were published in two stages on 25 March 2013 and 31 January 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.

TasNetworks electricity distribution F&A paper was published on 9 July 2015⁸ and TasNetworks electricity transmission was published on 23 January 2014.⁹ While these are relatively recent F&A papers, again the changes to metering contestability, introduction of our national ring-fencing guideline and review of a DMIS prompt us to revisit the F&A papers for TasNetworks in full.

In accordance with the Rules, we intend to publish replacement F&A papers by 31 July 2017.¹⁰ Consultation on the replacement F&A papers will commence with publication of a discussion paper for the NSW and ACT distributors and TasNetworks respectively in early 2017.

Before reaching this decision to replace the NSW and ACT distributors and TasNetworks' F&A papers, we issued a notice under the Rules,¹¹ 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 2 December 2016 and we received two responses.¹² AGL's submission covered service classification, form of control and incentive schemes for all distributors. The Southern Sydney Regional Organisation of Councils (SSOR) also made a submission in relation to public lighting in Ausgrid's distribution area. We have had regard to these submissions in reaching our decision.¹³

Ausgrid, Endeavour Energy, Essential Energy, ActewAGL and TasNetworks each submitted requests to us to address a number of issues in their respective F&A papers that we are required to consider.¹⁴ 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.¹⁵ A copy of

⁷ See <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/ausgrid-determination-2014-19/aer-position> and <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/actewagl-determination-2014-19/aer-position>.

⁸ See <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/tasnetworks-formerly-aurora-energy-2017-2019/initiation>.

⁹ See <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/tasnetworks-transend-determination-2014-2019/aer-position>.

¹⁰ NER, cl. 6.8.1(e) and 6A.101A(e).

¹¹ NER, cl. 6.8.1(c)(2) and 6A.10.1A(c)(2). We issued this notice on 8 November 2016.

¹² Responses to our notice are available at <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/ausgrid-determination-2019-24/initiation>.

¹³ NER, cl. 6.8.1(c)(3), 6.8.1(d) , 6A.10.1A(c)(3) and 6A.10.A(d) .

¹⁴ Ausgrid, *Request to replace framework and approach paper*, 25 October 2016; Endeavour Energy, *Request to update framework and approach*, 25 October 2016; Essential Energy, *Update to framework and approach for the 2019–24 regulatory control period*, 25 October 2016; ActewAGL, *Request to AER to made, or make an amended or replacement framework and approach*, 28 October 2016; TasNetworks, *Framework and approach for the 2019–24 determinations*, 27 October 2016.

¹⁵ Service provider written requests were submitted in accordance with NER, cl. 6.8.1(c)(1) and 6A.10.1A(c)(1).

each service providers' request is published on our website alongside this decision¹⁶ together with AGL and SSROCs' submissions.

Reasons for our decision follow.

¹⁶ As required under NER, cl. 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 NSW, ACT and Tasmanian F&A papers for the next regulatory control period of 1 July 2019 to 30 June 2024. The sections below correspond to the various components of the F&A.

2.1 Distribution service classification

We consider it necessary to replace the NSW, ACT and Tasmanian F&A papers with respect to the classification of distribution services.¹⁷ 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.¹⁸ 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 NSW, ACT and Tasmania. The classification process for these jurisdictions coincides with a range of services, like metering services becoming contestable. Additionally, the Australian Energy Market Commission will likely consider several rule change requests relating to service classification.¹⁹ These changes provide an opportunity for interested parties to convey views on possible options to allow for competition of electricity services to develop.²⁰

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.²¹

SSROC submitted that in reviewing service classification, we should continue to regulate public lighting services in NSW. SSROC stated that the NSW distributors continue to hold an effective monopoly of public lighting services and prospects for meaningful contestability and any subsequent competition are limited.²²

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.

¹⁷ NER, cl. 6.8.1(b)(2)(i).

¹⁸ NER, cll. 6.2.1 and 6.2.2

¹⁹ See <http://www.aemc.gov.au/Rule-Changes?topicId=1&status=3>.

²⁰ AGL, *Consultation to amend or replace F&A for NSW, ACT and TAS distributors*, 2 December 2016, pp. 1–2.

²¹ Ausgrid, *Request to replace framework and approach paper*, 25 October 2016, p. 3; Endeavour Energy, *Request to update framework and approach*, 25 October 2016, p. 1; Essential Energy, *Update to framework and approach for the 2019–24 regulatory control period*, 25 October 2016, p. 1; ActewAGL, *Request to AER to made, or make an amended or replacement framework and approach*, 28 October 2016, p. 3; TasNetworks, *Framework and approach for the 2019–24 determinations*, 27 October 2016, p. 4; AER, *Ring-fencing guideline electricity distribution*, November 2016.

²² SSROC, *SLI Program submission on 2019–24 NSW F&A public lighting*, 2 December 2016.

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.²³ We may also apply additional criteria in considering the form of control we will apply (as we have done elsewhere).²⁴ Our assessment is particularly important as we have limited discretion to amend the form of control in our final determination.²⁵

At present, NSW and Tasmania operate under a revenue cap for standard control services and a price cap for alternative control services. AGL submitted that in light of uncertainty around future rates of network demand and utilisation, we should review the form of control. Specifically, AGL submitted that a price cap on standard control services would better align prudent expenditure and cost minimisation.²⁶

ActewAGL (ACT) currently operates under a revenue yield cap (average revenue cap) for standard control services and a price cap for alternative control services. ActewAGL requests a review of the form of control in the overall context of the changing business environment for electricity distribution and the potential volatility of electricity consumption forecasts.²⁷

For these reasons, we will review the form of control applicable to each of the NSW, ACT and Tasmanian service providers in our F&A.

The Rules also require us to set out the control mechanism we will apply.²⁸ The control mechanism is the formulae we will use to calculate service prices. We expect to classify some services differently and remove adjustments that were relevant only to the 2014–15 transitional year for NSW and ACT. Again, we have limited discretion to alter control mechanism listed in the F&A at the time of the determination unless we consider unforeseen circumstances have arisen.²⁹

2.3 Dual-function assets

Dual-function assets are high voltage transmission assets forming part of the distribution network. Transmission network service providers usually operate these assets. Considering transmission assets as part of a distribution determination avoids the need for a separate transmission proposal. Where a network service provider notifies us that it owns, controls or operates dual-function assets, we assess how material the value of the dual-function asset is as a proportion of the total regulatory asset base values of standard control services. Based

²³ NER, cl. 6.2.5.

²⁴ In the current NSW and ACT F&A processes, we applied three additional criteria in our form of control mechanism assessment. For consistency, we applied the same criteria to Queensland and South Australia in 2015–20. We consider it prudent to continue applying these criteria to NSW/ACT and Tasmania for 2019–24.

²⁵ NER, cl. 6.8.1(b)(1)(i) and 6.12.3(c) and (c1).

²⁶ AGL, *Consultation to amend or replace F&A for NSW, ACT and TAS distributors*, 2 December 2016, pp. 1–2.

²⁷ ActewAGL, *Request for AER to make, or make an amended or replacement, Framework and approach paper*, 28 October 2016, p. 3.

²⁸ NER, cl. 6.8.1(b)(2)(ii).

²⁹ NER, cl. 6.12.3(c1).

on this materiality, we will then decide whether the revenue attributed to dual-function assets are to be recovered according to the transmission or distribution pricing principles.³⁰

Ausgrid and ActewAGL have advised us that they currently own, control or operate dual function assets.³¹ We will review and decide how to price these assets as set out above in our F&A.

The treatment of dual-function assets is not a feature of the current Endeavour Energy, Essential Energy or Tasmanian electricity determinations or F&A papers. This is because these service providers did not own, control or operate dual-function assets at the time of the last determination. Further, these service providers do not currently own, control or operate any dual-function assets.³² For these reasons, the Rules do not require us to make a decision in regard to dual-function assets in the F&A papers for Endeavour Energy, Essential Energy or TasNetworks.³³

2.4 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:³⁴

- 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. Additionally, we are currently reviewing the demand management incentive scheme (DMIS). The service providers' preference is for any new DMIS to apply to them for the 2019–24 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,

³⁰ NER, cl. 6.8.1(b)(1)(ii) and 6.25(b)-(d).

³¹ Ausgrid, *Request to replace framework and approach paper*, 25 October 2016, p. 9; ActewAGL, *Advice to the AER on the value of dual function assets under cl. 6.25(a) of the NER*, 28 October 2016, p. 1.

³² Essential Energy, *Update to framework and approach paper for 2019–24 regulatory control period*, 25 October 2016, p. 2; Endeavour Energy, *Request to update framework and approach paper for the next regulatory control period*, 25 October 2016, Attachment A, p. 1.

³³ NER, cl. 6.8.1(b)(2) and 6.25.

³⁴ AER, *Electricity distribution network service providers, Service target performance incentive schemes*, June 2008, p. 2; AER, *Better Regulation, Draft expenditure incentives*, 9 August 2013.

some of the parameters of the service target performance incentive scheme (STPIS) and the capital expenditure sharing schemes (CESS).³⁵

AGL also submitted that we should revisit the operation and application of incentive schemes given the broadening scope of contestable services.³⁶

In light of the issues raised above, we consider that the application of all incentive schemes should be reviewed in the NSW, ACT and Tasmanian F&A papers.³⁷

2.5 Other matters

TasNetworks requested that we prepare a combined F&A covering its transmission and distribution networks to reflect the merged nature of its business. TasNetworks also requested that when considering incentive schemes, we explore whether its reporting requirements can be aligned to create improved efficiencies.

AGL submitted that we should review our Cost allocation guideline with a view to greater prescription regarding the basis for allocating shared costs.³⁸

The NSW, ACT and Tasmanian service providers have expressed concerns with the application of the current Expenditure forecast assessment guideline. They seek consultation on whether we will amend the guideline or to engage with us 'improve our methodology'.

The Rules require us to consider these matters in developing the F&As for NSW, ACT and Tasmanian 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&A for NSW, ACT and Tasmania for the next regulatory control period of 1 July 2019 to 30 June 2024. We expect to issue a discussion paper in early 2017 outlining preliminary views on the matters outlined in this decision. We must then publish final F&A papers by 31 July 2017.

³⁵ Ausgrid, *Request to replace framework and approach paper*, 25 October 2016, pp. 2, 5–8; Endeavour Energy, *Request to update framework and approach*, 25 October 2016, pp.4–5; Essential Energy, *Update to framework and approach for the 2019–24 regulatory control period*, 25 October 2016, p. 2; ActewAGL, *Request to AER to made, or make an amended or replacement framework and approach*, 28 October 2016, pp. 4–5; TasNetworks, *Framework and approach for the 2019–24 determinations*, 27 October 2016, pp. 5–7.

³⁶ AGL, *Consultation to amend or replace F&A for NSW, ACT and TAS distributors*, 2 December 2016, pp. 1–2.

³⁷ NER, cl. 6.8.1(b)(2)(iii)-(viii).

³⁸ AGL, *Consultation to amend or replace F&A for NSW, ACT and TAS distributors*, 2 December 2016, pp. 1–2.

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

The replacement NSW, ACT and Tasmanian electricity distribution 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 2024–2029 regulatory control period is to be based on actual or forecast capital expenditure.

The replacement Tasmanian electricity transmission F&A³⁹ 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 2024–2029 regulatory control period is to be based on actual or forecast capital expenditure.

³⁹ We note TasNetworks' preference for a single F&A to capture our regulatory approach to reviewing its merged transmission and distribution business. The AER will consider this request and liaise with TasNetworks in due course. See TasNetworks, *Letter to AER on TasNetworks' Framework and Approach for 2019-24 determination*, 27 October 2016, p. 2.