Final

Framework and approach paper for Victorian electricity distribution regulation

Citipower, Powercor, Jemena, SP AusNet and United Energy

Regulatory control period commencing 1 January 2011

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AUSTRALIAN ENERGY REGULATOR

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Summary

Citipower, Powercor, Jemena (formerly Alinta / AGL), SP AusNet and United Energy operate as distribution network service providers (DNSPs) in Victoria (collectively the Victorian DNSPs).

The process that the AER must follow in making a distribution determination for the next regulatory control period, commencing on 1 January 2011, will take place over the final two years of the current regulatory period. This process commenced in December 2008 with the release of the AER's preliminary positions paper on the framework and approach.

The AER held a public stakeholder forum in Melbourne on 20 February 2009 to discuss the preliminary positions paper. Submissions to the paper closed on 6 March 2009 and 11 submissions were received. Stakeholders that provided submissions on the preliminary positions paper are listed at Appendix G of this paper.

This final framework and approach paper for the Victorian DNSPs sets out the AER's consideration of issues raised in response to the preliminary positions paper. It also sets out the framework and approach for the AER's distribution determination for the Victorian DNSPs for the regulatory control period commencing 1 January 2011.

The AER's functions and powers are set out in the National Electricity Law (NEL) and the National Electricity Rules (NER).

In anticipation of every distribution determination, the AER is required to prepare and publish a framework and approach paper. The framework and approach paper assists the DNSPs in preparing their regulatory proposal to the AER by:

- stating the form (or forms) of the control mechanisms to be applied by the distribution determination and the AER's reasons for deciding on control mechanisms of the relevant form (or forms)
- setting out the AER's likely approach (and its reasons for that likely approach) in the distribution determination to:
    1. the classification of distribution services
    2. the application of a service target performance incentive scheme (STPIS) or schemes
    3. the application of an efficiency benefit sharing scheme (EBSS) or schemes
    4. the application of a demand management incentive scheme (DMIS) or schemes, and
    5. any other matters on which the AER thinks fit to give an indication of its likely approach.
- providing a statement of the AER's likely approach to cost allocation based on the guidelines currently in force.

The control mechanisms applied by the distribution determination must be as set out in the framework and approach paper. In all other respects, the framework and approach paper is not binding on the AER or a DNSP, however:

- the classification of services in the distribution determination must be as set out in the framework and approach paper unless the AER considers that, in light of the DNSP's regulatory proposal and any submissions received in the determination process, there are good reasons for departing from the classification proposed in the framework and approach paper, and
- where, in respect to classification of services or any other matter, a DNSP's regulatory proposal puts forward an approach different to that set out in the framework and approach paper, the AER will expect to see a fully supported argument explaining the difference in approach, and detailing how circumstances have changed such that a different approach would be appropriate and necessary to satisfy the requirements of the NEL and NER.

Each element of the AER's framework and approach paper is summarised in the sections below and discussed in detail in the chapters that follow.

Current Victorian distribution determination and Advanced meter infrastructure program

The AER assumed responsibility for the economic regulation of the Victorian DNSPs on 1 January 2009. The AER is also responsible for administering, to 31 December 2010, the Electricity Distribution Price Review (EDPR) that was issued by Essential Services Commission of Victoria (ESCV) for the economic regulation of the Victorian DNSPs in 2005.

The AER's existing economic regulation of the Victorian DNSPs also includes specific responsibilities under the Victorian *Advanced Metering Infrastructure Order in Council, dated 25 November 2008* (November 2008 AMI Order in Council). Under the arrangements provided for by the Order, DNSPs were required to provide an Advanced Metering Infrastructure (AMI) budget application to the AER in February 2009 for expenditure on AMI services. The DNSPs must, by 1 June 2009, also make an application to the AER which sets out their proposed initial AMI charges for 2010 and 2011. The AER is required to review the budget application and charges application and make a determination on charges for 2010 and 2011 by 31 October 2009. Prior to making this determination the AER must release a draft determination.

In 2006, the Victorian Government announced a decision to rollout advanced interval meters to all Victorian electricity customers. The regulatory arrangements relating to the rollout were initially set out in an August 2007 Order in Council made by the Victorian Governor in Council. These arrangements have been revised and are now set out in the November 2008 AMI Order in Council. Under these arrangements, AMI will be regulated under the November 2008 AMI Order in Council and will not be subject to the regulatory arrangements under chapter 6 of the NER for the next regulatory period, including the framework and approach discussed in this paper.

The November 2008 AMI Order in Council provides the arrangements for the regulation of charges for the following AMI services:

- regulated services comprising:
  - metering services supplied to first tier customers or second tier customers with annual electricity consumption of 160 MWh or less where the electricity consumption of that customer is (or is to be) measured using a revenue meter that is either an accumulation meter, a manually read interval meter, or a remotely read interval meter
- other fees and charges:
  - exit fees where the retailer becomes the responsible person for a relevant customer's metering services
  - restoration fees where a retailer ceases to be the responsible person for a relevant customer's metering services and the distributor becomes the responsible person
  - unmetered supplies (until 31 December 2010)[1], and
  - customer requested services — which are services provided to a retailer in respect of a customer that requests a service to a standard in excess of that normally provided.

Consequently, these AMI services, except for unmetered supplies, are not classified in this framework and approach paper. The AMI services are expected to be regulated under chapter 6 of the NER in the 2016 to 2020 regulatory control period.

On 30 January 2009, the AER released its final decision on the framework and approach applying to distributors' budget applications for AMI expenditure for 2009 – 2011 and charges applications for 2010 and 2011. A copy of this paper is available on the AER's website, at www.aer.gov.au.

Classification of services

In classifying distribution services the NER require the AER to act on the basis that:

- there should be no departure from a previous classification (if the services have been previously classified), or
- the classification should be consistent with the previously applicable regulatory approach (if there has been no previous classification),[2]

unless a different classification is clearly more appropriate.

The AER's likely approach is to classify:

- certain prescribed distribution services currently provided by the Victorian DNSPs as standard control services, with all of these services being grouped as network services. This includes distribution use of system (DUOS) services

[1] From 1 January 2011 unmetered supplies will be regulated under chapter 6 of the NER.

[2] NER, cll. 6.2.1(d) and 6.2.2(d).

- certain excluded distribution services and prescribed metering services (unmetered supplies) currently provided by the Victorian DNSPs, as alternative control services, with these services being grouped in the following way:
  - connection services
  - metering services
  - public lighting services
  - fee based services, and
  - quoted services.
- connection and augmentation works for new customer connections, alteration and relocation of existing DNSP public lighting assets, and new public lighting, which are currently excluded distribution services, as negotiated distribution services.

The AER's likely approach is not to classify certain other distribution services for the purposes of chapter 6 of the NER. This includes AMI services, which will be regulated under the November 2008 AMI Order in Council, metering provision services and metering data provision services for type 1 to 4 metering installations, metering services provided to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters, and the installation and maintenance of watchman (security) lights.

Control mechanisms

The AER has decided that the:

- form of control applied by the ESCV to prescribed distribution services in the current regulatory control period is available under the NER for standard control services in the next regulatory control period. On this basis, the AER will apply a weighted average price cap to these services, and
- forms of control applied to excluded distribution services in the current regulatory control period are also available under the NER for alternative control services in the next regulatory control period. On this basis, the AER will apply price caps to the:
  - unit costs for the quoted services grouping of alternative control services, and
  - individual prices for all of the other alternative control services, including metering services (unmetered supplies).

This paper does not deal with the form of control for negotiated distribution services that are regulated under the negotiate/arbitrate framework set out in Part D of chapter 6 of the NER. That is, under the NER negotiated distribution services are not subject to a specified form of control such as a price or revenue cap. DNSPs will negotiate with users in accordance with a negotiating framework approved by the AER, and negotiated distribution service criteria determined by the AER.[3] In the

[3] NER, cl. 6.7.2.

event of a dispute, the AER will arbitrate in accordance with the same criteria and with regard to the approved framework.[4]

Application of service target performance incentive scheme

The AER's revised STPIS (version 1.1) was released in May 2009. The AER's likely approach is that it will apply the reliability of supply and customer service components for the s-factor and also the guaranteed service level component of the STPIS to the Victorian DNSPs in the next regulatory control period.

Targets for the reliability of supply component will be attached to SAIDI, SAIFI and MAIFI, with separate targets for each segment of the network, in accordance with the SCONRRR feeder categories identified in the STPIS. Targets will reflect available data on historical performance over the previous five years, with adjustments as necessary under the STPIS. The AER's likely approach is to apply the 5 per cent cap on revenue at risk under the STPIS. DNSPs can propose a different cap on revenue at risk as part of their regulatory proposals.

There will be no quality of supply component under the STPIS for the next regulatory control period.

For the customer service component, the AER's likely approach is that the telephone answering parameter (as defined in Appendix A of the STPIS) will apply to the Victorian DNSPs for the next regulatory control period. Other parameters under this component may be proposed by the Victorian DNSPs in their regulatory proposal.

The AER's likely approach is that it will apply the GSL component of its STPIS to the Victorian DNSPs in the next regulatory control period. The AER understands that the Victorian GSL scheme that currently applies to the Victorian DNSPs, which is provided for under the ESCV's Electricity Distribution Code and the Public Lighting Code, will not apply in the next regulatory control period. This is based on advice from the Victorian Department of Primary Industries (DPI).

Application of efficiency benefit sharing scheme

The AER's distribution EBSS was released in June 2008 and is available on the AER's website. The AER's likely approach is that the AER's EBSS will be applied to the Victorian DNSPs in the next regulatory control period.

The EBSS has been designed to provide an incentive for a DNSP to reveal its efficient level of expenditure through the retention of efficiency gains for five years after the year in which the gain is made. The scheme calculates revenue increments or decrements derived from the difference between a DNSP's actual operating expenditure and the forecast operating expenditure approved in its building block determination. It is these increments or decrements that provide for the fair sharing of gains and losses between a DNSP and network users.

[4] NER, cl. 6.22.2(c).

The EBSS is symmetrical in nature, which allows a DNSP to retain the benefits of an efficiency gain (or bear the costs of an efficiency loss) for the length of the carryover period, regardless of the year of the regulatory control period in which the gain/loss was realised.

The nominal five-year carryover period assumed in the AER's EBSS results in a benefit-sharing ratio of approximately 30:70 between DNSPs and their customers.[5] This means that a DNSP will retain 30 per cent of the benefits of efficiency gains and customers will retain 70 per cent of the benefits over time.

Carryover amounts are included as a building block element in the calculation of allowed revenue for the regulatory control period following the period in which the EBSS was applied.

Application of demand management incentive scheme

The AER's DMIS to apply to Victorian DNSPs was released in April 2009 and is available on the AER's website. The AER's likely approach is to apply the DMIS' demand management innovation allowance (DMIA) to the Victorian DNSPs. The AER's likely approach is to provide the Victorian DNSPs with the following DMIA amounts on an *annual* basis:

- Powercor: $600 000
- SP AusNet: $600 000
- United Energy: $400 000
- Jemena: $200 000, and
- Citipower: $200 000.

The AER considers that these allowances will enable each of the Victorian DNSPs to carry out a number of small-scale demand management projects, or a single larger-scale demand management project during the regulatory control period. Under these arrangements, a total of $10 million would be allowed as DMIA expenditure by the Victorian DNSPs over the next regulatory control period.

The AER will apply a weighted average price cap to the Victorian DNSPs' standard control services, which will result in its recovery of the annual revenue requirement being at least partially dependent on the amount of electricity sold, potentially creating disincentives for the Victorian DNSPs to undertake demand management initiatives. To counter this, the AER's likely approach is to allow the Victorian DNSPs to recover any forgone revenue directly attributable to a reduction in the quantity of electricity sold due to the implementation of a non-tariff demand management program approved under the DMIA.

[5] The EBSS assumes a nominal carryover period of five years, but allows a longer carryover period where the regulatory control period covered by the relevant distribution determination is longer than five years. The carryover period will not exceed 10 years. A 10-year carryover period results in a sharing ratio of approximately 50:50.

Other matters

The AER must include in its framework and approach paper for the Victorian DNSPs a statement of its likely approach to cost allocation based on the guidelines then in force[6].

In accordance with the transitional provisions in chapter 11 of the NER, the AER released Victorian specific cost allocation guidelines on 26 June 2008.[7]

Under clause 11.17.5(a) of the NER, Victorian DNSPs must submit their proposed Cost Allocation Method at, or by, the time their building block proposal is submitted.

The AER's likely approach is that:

- the Victorian DNSPs prepare and submit a Cost Allocation Method to the AER in accordance with the NER and section 3 of the AER's Victorian Cost Allocation Guidelines
- it will approve, or reject, a Victorian DNSP's proposed Cost Allocation Method in accordance with section 4 of the Victorian Cost Allocation Guidelines, and
- the Victorian DNSPs apply their approved Cost Allocation Method in accordance with section 5 of the Victorian Cost Allocation Guidelines.

Also, clause 6.8.1(ca) of the NER requires that the framework and approach paper must include the AER's determination[8] as to whether or not Part J of Chapter 6A is to be applied to determine the pricing of any transmission standard control services provided by any dual function assets owned, controlled or operated by the DNSPs. The Victorian DNSPs have advised the AER that they do not own, control or operate any dual function assets.

[6] NER cll. 11.17.5(c).

[7] AER, *Victorian electricity distribution network service providers - Cost allocation guidelines*, June 2008.

[8] Under NER cl. 6.25(b).

Next steps

This framework and approach paper completes the first stage of consultation on the distribution determination for Victorian DNSPs for the next regulatory control period.

The next steps in the determination process are summarised in the table below:

Victorian DNSPs to submit regulatory proposals to the AER	**30 November 2009**
AER to publish draft decision on distribution determination for Victorian DNSPs	May 2010*
AER to publish final decision and distribution determination for Victorian DNSPs	31 October 2010
Victorian DNSPs to submit initial pricing proposals for AER approval	Mid November 2010
AER to publish approved pricing proposal	Mid December 2010
Distribution determination and approved pricing proposal to commence	1 January 2011

* The NER do not provide specific timeframes in relation to publishing the draft decision. Accordingly, this date is indicative only.

1 Introduction

The AER is responsible for the economic regulation of monopoly electricity distribution services in the National Electricity Market (NEM). The AER's functions and powers are set out in the NEL and the NER.

Under chapter 6 of the NER, the AER is able to make a decision to classify or not classify distribution services to be provided by a distribution network service provider (DNSP) and how they should be regulated, and must make distribution determinations for each DNSP.

Citipower, Powercor, SP AusNet, United Energy and Jemena operate as DNSPs in Victoria (Victorian DNSPs). The provision of distribution services by these DNSPs is currently regulated by the ESCV, in accordance with the EDPR issued by the ESCV in October 2005 for the regulatory control period 1 January 2006 to 31 December 2010, and subsequently amended[9] in accordance with a decision of the Appeal Panel dated 17 February 2006.

The AER assumed responsibility for the economic regulation of the Victorian DNSPs on 1 January 2009 and is responsible for administering the EDPR to 31 December 2010. The AER will also be responsible for the next distribution determination in accordance with the NER, which will apply from 1 January 2011.

The procedure to be followed by the AER in making a distribution determination is set out in Part E of chapter 6 of the NER. The first step in making a distribution determination is the preparation and publication of a framework and approach paper. For the Victorian DNSPs, this step in the process commenced on 19 December 2008 with the publication of the AER's preliminary positions paper on the framework and approach and is completed with the publication of this paper.

The AER held a public stakeholder forum in Melbourne on 20 February 2009 to discuss the preliminary positions paper. Submissions to the paper closed on 6 March 2009 and 11 submissions were received. Stakeholders that provided submissions on the preliminary positions paper are listed at Appendix G of this paper.

1.1 Nature of framework and approach paper

In anticipation of every distribution determination, the AER is required to prepare and publish a framework and approach paper. The framework and approach paper assists DNSPs in preparing their regulatory proposals to the AER by:

- stating the form (or forms) of the control mechanisms to be applied in the distribution determination and the AER's reasons for deciding on the form of control[10]
- setting out the AER's likely approach (and its reasons for that likely approach) in the distribution determination to:

[9] ESCV, *EDPR, Final Decision Volume 1*, October 2006 and ESCV, *EDPR, Final Decision Volume 2*, October 2006.

[10] NER, cl. 6.8.1(c).

1. the classification of distribution services
2. the application of a service target performance incentive scheme (STPIS) or schemes
3. the application of an efficiency benefit sharing scheme (EBSS) or schemes
4. the application of a demand management incentive scheme (DMIS) or schemes, and
5. any other matters on which the AER thinks fit to give an indication of its likely approach[11]

- providing a statement of the AER's likely approach to cost allocation based on the guidelines currently in force.[12]

The control mechanisms applied in the distribution determination must be as set out in the framework and approach paper.

In all other respects, the framework and approach paper is not binding on the AER or DNSPs, however:

- the classification of services in a distribution determination must be as set out in the framework and approach paper unless the AER considers that, in light of a DNSP's regulatory proposal and any submissions received in the determination process, there are good reasons for departing from the classification proposed in that paper, and
- where, in respect to classification of services or any other matter, a DNSP's regulatory proposal puts forward an approach different to that set out in the framework and approach paper, the AER will expect to see a fully supported argument explaining the difference in approach, and detailing how circumstances have changed such that a different approach would be more appropriate and necessary to satisfy the requirements of the NEL and NER.

The framework and approach paper must also include the AER's determination as to whether or not Part J of chapter 6A of the NER is to be applied to determine the pricing of transmission standard control services provided by any dual function assets owned, controlled or operated by the DNSP.[13] If a DNSP owns, controls or operates dual functions assets, it must advise the AER of the value of those assets 24 months prior to the end of the current regulatory control period to enable such a determination.[14] The Victorian DNSPs have advised the AER that they do not own, control or operate any dual function assets.

[11] NER, cl. 6.8.1(b).

[12] NER, cl. 11.17.5(c).

[13] NER, cl. 6.8.1(ca). A dual function asset means any part of a network owned, operated or controlled by a Distribution Network Service Provider which operates between 66 kV and 220 kV and which operates in parallel, and provides support, to the higher voltage transmission network which is deemed by clause 6.24.2(a) to be a dual function asset. For the avoidance of doubt:

(a) a dual function asset can only be an asset which forms part of a network that is predominantly a distribution network; and

(b) an asset which forms part of a network which is predominantly a transmission network cannot be characterised as a dual function asset, through the operation of clause 6.24.2(a).

[14] NER, cl. 6.25.

The procedure to be followed by the AER in making a distribution determination is set out in chapter 6, Part E of the NER, and summarised in table 1.1.

Table 1.1 Procedures for making a distribution determination

1	**AER's framework and approach paper**	
	AER published preliminary positions paper for its framework and approach paper for Victorian DNSPs	19 December 2008
	AER to publish framework and approach paper for Victorian DNSPs	30 May 2009
2	**Regulatory proposal and distribution determination**	
	Victorian DNSPs to submit regulatory proposals to the AER	30 November 2009
	AER to publish draft decision on distribution determination for Victorian DNSPs	May 2010*
	AER to publish final decision and distribution determination for Victorian DNSPs	31 October 2010
	Victorian DNSPs to submit initial pricing proposals for AER approval	Mid November 2010
	AER to publish approved pricing proposal	Mid December 2010
	Distribution determination and approved pricing proposal to commence	1 January 2011

* The NER do not provide specific timeframes in relation to publishing the draft decision. Accordingly, this date is indicative only.

On 19 December 2008, the AER published a preliminary positions paper on its framework and approach for the Victorian DNSPs for the next regulatory control period.

This final framework and approach paper for the Victorian DNSPs sets out the AER's consideration of issues raised in response to the preliminary positions paper, and sets out the framework and approach for the AER's distribution determination for the Victorian DNSPs for the regulatory control period commencing 1 January 2011.

1.2 Components of framework and approach paper

The AER has decided that it will publish one framework and approach paper to apply to all Victorian DNSPs for the next regulatory control period. This is consistent with the AER's approach in other jurisdictions.

The detailed requirements guiding the AER's decision on each component of the framework and approach paper are discussed in the chapters that follow. To provide context to those chapters, this section outlines the relationships between the various components of the framework and approach paper.

The first issues to be addressed in the framework and approach paper are the AER's likely approach to classification of distribution services provided by DNSPs, and the control mechanism(s) that will apply to each class of services.

Service classification occurs at two levels:

1. the AER may choose to:
   i. classify a distribution service as a direct control service, or
   ii. classify a distribution service as a negotiated distribution service.

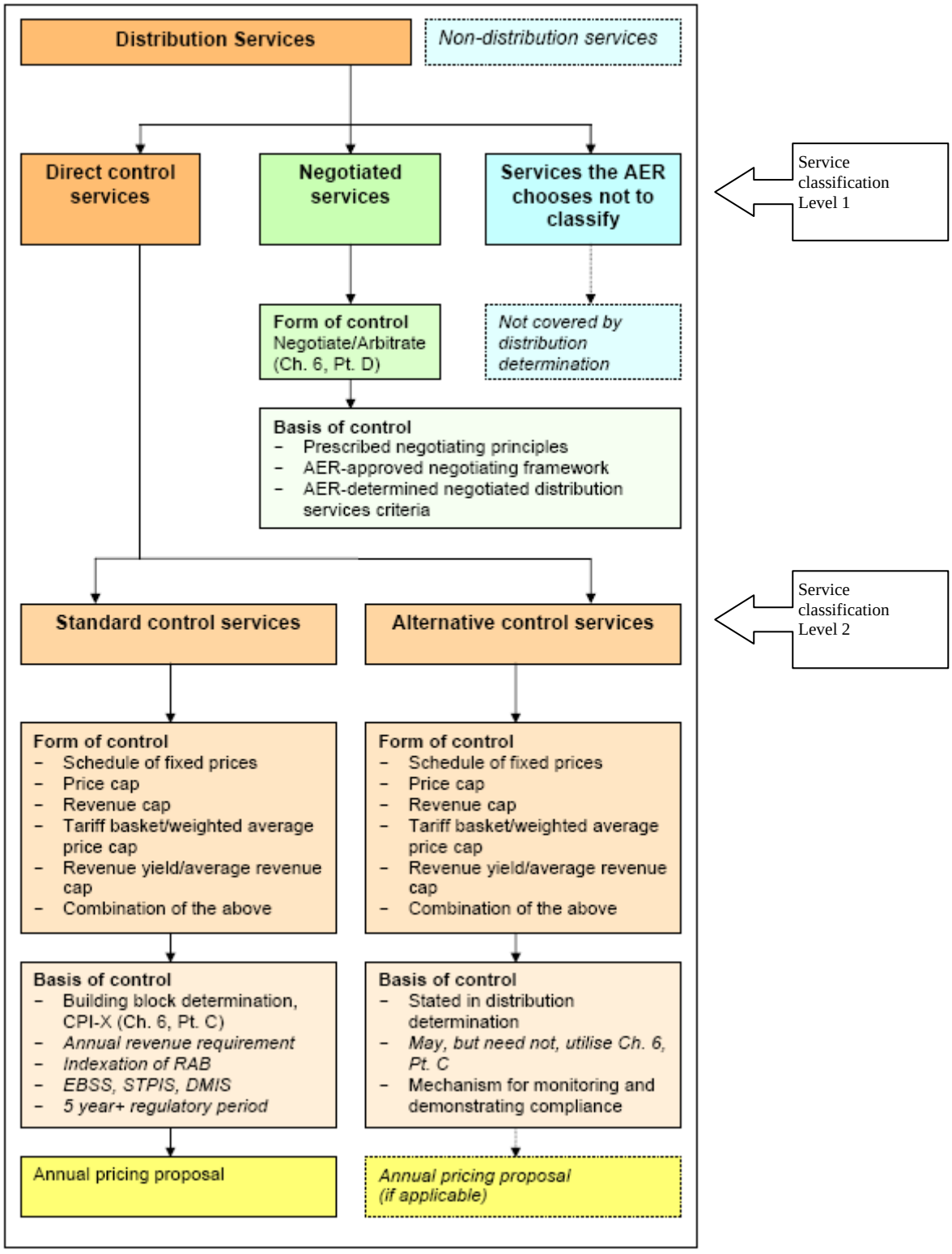
   If the AER decides against classifying a distribution service, the service is not regulated under the NER.
2. where the AER classifies a distribution service as a direct control service it must further classify it as either:
   i. a standard control service, or
   ii. an alternative control service.[15]

The classification to which a service is assigned determines what control mechanism(s) can be applied to that service and what the basis for that control mechanism will be, and therefore how the service and costs associated with providing it are treated in a distribution determination.

This is illustrated in figure 1.1 below.

[15] NER, cl. 6.2.2(a).

Figure 1.1 Service classification and control mechanisms



Source: NER, chapter 6.

Distribution services not classified will not be subject to the framework for economic regulation of distribution services in chapter 6 of the NER.[16] Also, non-distribution services cannot be regulated under the NER.

Terms and conditions of access to negotiated distribution services, including the price of those services, will be determined under the negotiate/arbitrate framework set out in Part D of chapter 6 of the NER. DNSPs will negotiate with users in accordance with a negotiating framework approved by the AER, and negotiated distribution service criteria determined by the AER.[17] In the event of a dispute, the AER will arbitrate in accordance with these criteria and with regard to the approved framework.[18]

The distribution determination must impose a control on the price of, and/or revenue derived from, direct control services.[19] The control mechanism may consist of:

1. a schedule of fixed prices
2. caps on the prices of individual services
3. caps on the revenue to be derived from a particular combination of services
4. tariff basket price control
5. revenue yield control, or
6. a combination of any of the above.[20]

For standard control services, the control mechanism must be of the prospective CPI minus X (CPI−X) form or an incentive-based variant. The basis of the control mechanism must be a building block determination made in accordance with Part C of chapter 6 of the NER.[21] The AER's distribution determination must include a decision on how compliance with the relevant control mechanism is to be demonstrated.[22]

The basis of the control mechanism for alternative control services may, but need not, be a building block determination, and can utilise elements of Part C of chapter 6 of the NER with or without modification.[23] The distribution determination must state the basis for the control mechanism applied to any alternative control services,[24] and must include a decision on how compliance with the control mechanism is to be demonstrated.[25]

For all direct control services, an annual pricing proposal must be submitted to, and approved by, the AER under Part I of chapter 6 of the NER.[26]

[16] NER, cl. 6.2.1(a).
[17] NER, cl. 6.7.2.
[18] NER, cl. 6.22.2(c).
[19] NER, cl. 6.2.5(a).
[20] NER, cl. 6.2.5(b).
[21] NER, cl. 6.2.5(a).
[22] NER, cl. 6.12.1(13).
[23] NER, cl. 6.2.6(c).
[24] NER, cl. 6.2.6(b).
[25] NER, cl. 6.12.1(13).
[26] NER, cl. 6.18.2(a).

The incentive schemes developed by the AER under chapter 6 of the NER apply only to standard control services.[27]

As noted previously, the framework and approach paper for the Victorian DNSPs must also include a statement of the AER's likely approach to cost allocation based on the guidelines then in force and a determination in relation to any dual function assets owned, controlled or operated by the DNSPs.[28]

1.3 Continuity between regulatory control periods

The AER recognises that the transition to the new national framework for the economic regulation of distribution services has the potential to impose administrative costs on DNSPs, and to create short-term uncertainty, for DNSPs, their customers and end-users. This is recognised in transitional provisions in the NER and in the jurisdictional legislation that applies, as well as in jurisdictional derogations in chapter 9 of the NER.

The AER's has sought to minimise the impact of the transition to the new economic regulatory framework, both in regards to changes to current arrangements necessitated by the new requirements of the NEL and the NER, and in coordinating the AER's regulatory functions with those retained by jurisdictional regulators. The framework and approach paper is a key means by which greater certainty can be provided on how the new regulatory framework will apply to DNSPs.

1.4 Structure of this paper

This paper sets out the AER's framework and approach for the Victorian DNSPs for the regulatory control period commencing 1 January 2011:

- chapter 2 sets out the likely approach to the classification of distribution services
- chapter 3 states the form (or forms) of the control mechanisms to be applied to each class of services by the distribution determination
- chapter 4 sets out the likely approach to the application of the STPIS
- chapter 5 sets out the likely approach to the application of the EBSS
- chapter 6 sets out the likely approach to the application of the DMIS, and
- chapter 7 sets out the likely approach to a range of other issues, including cost allocation based on the guidelines currently in force.

Appendices to this paper provide details of distribution services provided by the Victorian DNSPs and information about regulatory arrangements that apply to the Victorian DNSPs in the current regulatory control period.

[27] NER, cll. 6.5.8, 6.6.2 and 6.6.3.

[28] The Victorian DNSPs have advised the AER that they do not own, control or operate any dual function assets relevant under clause 6.8.1 (ca) of the NER.

2 Classification of distribution services

2.1 Introduction

This chapter sets out the AER's likely approach to the classification of the Victorian DNSPs' distribution services for the next regulatory control period. The AER may classify the distribution services as either direct control services or negotiated distribution services. The AER must further classify direct control services as either standard control services or alternative control services. Services not classified by the AER are not regulated under the NER.

Service classification effectively determines two key aspects of the distribution determination:

- whether the service should be under a direct price or revenue control, a 'negotiate-arbitrate' framework, or no price or revenue control — that is, the form of control that will apply to the service,[29] and
- whether the costs of providing the service should be recovered by the Victorian DNSPs through distribution use of system (DUOS) tariffs paid by most customers, or through separate tariffs paid by the individual customer requesting the service.[30]

The AER's role in service classification only determines the manner in which a DNSP recovers the costs associated with the distribution services it provides — it does not determine the contestability of these services.[31] For example, the AER's classification of a distribution service as a direct control service does not make any of the Victorian DNSPs the exclusive monopoly providers of the service. Likewise, the AER's classification of a distribution service as a negotiated distribution service does not, of itself, make the service contestable and open to supply by providers other than the Victorian DNSPs. Contestability is determined by legislation, the NER, or other regulatory instruments, and is beyond the control of the AER. Contestability is, however, one of the factors that the AER must consider in classifying services[32].

[29] The forms of control available for each service depend on the classification. The forms of control available for direct control services are listed under clause 6.2.5(b) of the NER and include revenue caps, average revenue caps, price caps, weighted average price caps, a schedule of fixed prices or a combination of the specified forms of control. Negotiated distribution services are regulated under the 'negotiate-arbitrate' framework set out in Part D of chapter 6 of the NER. The forms of control are discussed in greater detail in chapter 3 of this paper.

[30] In general, the costs of providing standard control services would be expected to be recovered through DUOS tariffs paid by all or most customers, whereas the costs of providing alternative control or negotiated distribution services would be expected to be recovered from the individual customers who are the recipients of such services.

[31] Contestability concerns whether or not a service is permitted by the laws or other regulatory instruments of the relevant jurisdiction to be provided by a party other than the DNSP.

[32] NER, cl. 6.2.1(c).

2.2 Requirements of the NEL and NER

A distribution determination must include a decision on the classification of the distribution services to be provided by the DNSP during the course of the relevant regulatory control period.[33] Only services within the definition of "distribution services" in chapter 10 of the NER can be classified. The classification forms part of the distribution determination and operates only for the period for which the determination is made.[34] In this framework and approach paper, the AER must set out its likely approach to the classification of distribution services in a DNSP's forthcoming distribution determination, and its reasons for that approach.[35] If the AER decides against classifying a distribution service, the service is not regulated under the NER.[36]

The classification of services in the distribution determination must be as set out in this framework and approach paper unless the AER considers that, in light of the DNSP's regulatory proposal and submissions received, there are good reasons for departing from the classification.[37]

Distribution services can also be grouped together for the purpose of classification, so that a single classification applies to each service in the group.[38]

Where the NER require that a particular classification be assigned to a specified kind of distribution service, the service is to be classified in accordance with that requirement.[39] In all other cases, the factors that will guide the AER's decision on service classification are discussed in the sections that follow. In classifying services that have previously been subject to regulation under the present or earlier legislation, the AER must act on the basis that:

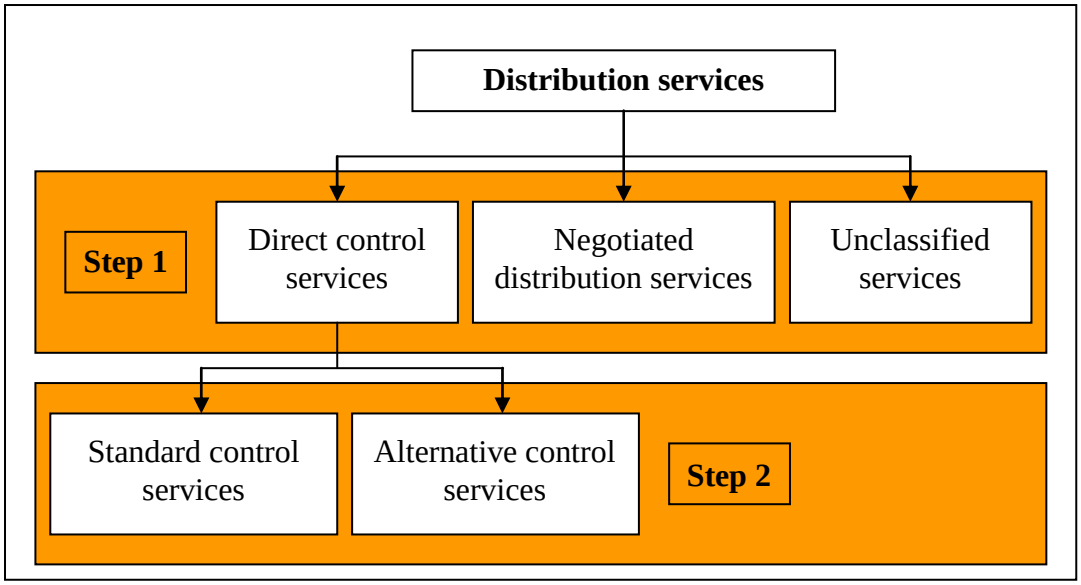
- there should be no departure from a previous classification (if the services have been previously classified under the NER), or
- (if there has been no classification under the NER) the classification should be consistent with the previously applicable regulatory approach,[40]

unless a different classification is clearly more appropriate. The Victorian DNSPs' current service classifications are listed in table 2.1 of this paper.

Figure 2.1 below outlines the steps in the distribution service classification process.

[33] NER, cl. 6.12.1(1).
[34] NER, cl. 6.2.3.
[35] NER, cl. 6.8.1(b)(1).
[36] Refer note at NER, cl. 6.2.1.
[37] NER, cl. 6.12.3(b).
[38] NER, cll. 6.2.1(b) and 6.2.2(b).
[39] NER, cll. 6.2.1(e) and 6.2.2(e).
[40] NER, cl. 6.2.1(d).

Figure 2.1 Distribution service classification process



Source: NER[41]

2.2.1 Step 1 — Division of distribution services into direct control, negotiated distribution and unregulated services

When classifying distribution services as either direct control services or negotiated distribution services, the AER must have regard to all of the four factors in clause 6.2.1(c) of the NER:

(1) the form of regulation factors in section 2F of the NEL:

- the presence and extent of any barriers to entry in a market for electricity network services
- the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other electricity network service provided by the network service provider
- the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other service provided by the network service provider in any other market
- the extent to which any market power possessed by a network service provider is, or is likely to be, mitigated by any countervailing market power possessed by a network service user or prospective network service user
- the presence and extent of any substitute, and the elasticity of demand, in a market for an electricity network service in which a network service provider provides that service
- the presence and extent of any substitute for, and the elasticity of demand in a market for, elasticity or gas (as the case may be), and
- the extent to which there is information available to a prospective network service user or network service user, and whether that information is adequate,

[41] NER, chapter 6, Part B.

> to enable the prospective network service user or network service user to negotiate on an informed basis with a network service provider for the provision of an electricity network service to them by the network service provider.[42]

(2) the form of regulation (if any) previously applicable to the relevant service or services and, in particular, any previous classification under the present system of classification or under the present regulatory system (as the case requires)

(3) the desirability of consistency in the form of regulation for similar services (both within and beyond the relevant jurisdiction), and

(4) any other relevant factor.[43]

2.2.2 Step 2 — Division of direct control services into standard control and alternative control services

In classifying direct control services as either standard control services or alternative control services, the AER must have regard to all of the six factors in clause 6.2.2(c) of the NER:

(1) the potential for development of competition in the relevant market and how the classification might influence that potential

(2) the possible effects of the classification on administrative costs of the AER, the DNSP and users or potential users

(3) the regulatory approach (if any) applicable to the relevant service immediately before the commencement of the distribution determination for which the classification is made

(4) the desirability of a consistent regulatory approach to similar services (both within and beyond the relevant jurisdiction)

(5) the extent that costs of providing the relevant service are directly attributable to the customer to whom the service is provided, and

(6) any other relevant factor.[44]

2.3 Overview of current service classification arrangements in Victoria

This section provides an overview of the classification of distribution services that currently applies to the Victorian DNSPs for the regulatory control period, 1 January 2006 to 31 December 2010.

The EDPR was prepared by the ESCV under Version 1 of the NER, which defined 'distribution services' as:

> The services provided by a distribution system which are associated with the conveyance of electricity through the distribution system. Distribution services include entry services, distribution network use of system services and exit services which are provided by part of a distribution system.

[42] NEL, s. 2F.

[43] NER, cl. 6.2.1(c).

[44] NER, cl. 6.2.2(c).

Under the EDPR, services are classified as either prescribed distribution services or excluded distribution services. A distinction was, in turn, made between prescribed distribution services and prescribed metering services. These categories are discussed below.

2.3.1.1 Prescribed distribution services

The EDPR defines prescribed distribution services as the 'services of connection to, and use of, the distribution system (except those that are specifically designated to be excluded services)'.[45] It also provides that the services specified in clause 2.2(f) of the *Victorian Electricity Supply Industry Tariff Order 2005* (2005 Tariff Order) will be treated as prescribed distribution services.[46]

The prescribed distribution services referred to in clause 2.2(f) of the 2005 Tariff Order are set out in Appendix B of this paper. These services include the transportation of electricity, distribution of electricity at public transport points, maintenance and repair to enable electricity distribution and 'standard' aspects of meter provision.

2.3.1.2 Prescribed metering services

The EDPR defines prescribed metering services as those services provided to:

- a distribution customer who consumes less than 160 MWh per annum and does not have an interval meter that is remotely read, and
- a distribution business who provides its standard metering service to that distribution customer, or
- a distribution customer who has an unmetered supply.[47]

Certain prescribed metering services, that relate to the rollout of advanced metering infrastructure (AMI) in Victoria, were subsequently made excluded distribution services under clause 3 of the *Victorian Order in Council 2007*[48] (2007 AMI Order in Council). These services are discussed further in section 2.4 below.

2.3.1.3 Excluded distribution services

The list of excluded distribution services is set out in the EDPR, the 2005 Tariff Order and the 2007 AMI Order in Council. This list is reproduced in appendices C, D and E of this paper. In addition, for the purpose of the current applicable control mechanism, excluded distribution services are distinguished between:

- non-contestable excluded distribution services, and
- contestable excluded distribution services.

[45] ESCV, *EDPR, Final Decision Volume 2*, October 2006, p. 72.
[46] Ibid, cl. 6.1.6.
[47] Ibid, p. 43 and cl. 4.1.3.
[48] *Order Under Section 15A and Section 46D of the Electricity Industry Act 2000* (Vic), 28 August 2007.

This distinction is given effect in the EDPR, which provides that prices for excluded distribution services must be set in accordance with the ESCV's *Electricity Industry Guideline 14 — Provision of Services by Electricity Distributors, April 2004* (Guideline 14). Under the EDPR and Guideline 14, a DNSP must submit a statement of a proposed charge and terms and conditions for approval for all non-contestable excluded distribution services. For those services determined to be contestable by the ESCV no pricing statement is required.

Table 2.1 below shows the current arrangements for the regulation of distribution services in Victoria.

Table 2.1 Victorian DNSPs' current services and regulatory arrangements

Service category	Prescribed distribution or metering service	Excluded distribution service	Unregulated service
Network services	All "standard" network services	Above standard network services	N.A
Connection services	Connection - energisation	Connection and augmentation works	N.A
Metering services	Standard metering services for types 5-7 Metering services for unmetered supplies	Above-standard metering services Metering services provided to existing first tier customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters	Metering services for type 1-4 remotely read meters
Public lighting services	N.A	Operation, repair, replacement and maintenance of DNSP public lighting assets Alteration and relocation of DNSP public lighting assets New public lighting	

Service category	Prescribed distribution or metering service	Excluded distribution service	Unregulated service
Other Services	N.A	Above standard services including: o the movement of mains, services or meters forming part of the Distributor's Distribution System to accommodate extension, re-design or re-development of any premises o the provision of electric plant for the specific purpose of enabling the provision of top-up or standby supplies or sales of electricity, and o the provision of pre-payment meters to customers. Relocation of electric lines plant and the carrying out of associated works pursuant to any statutory obligation imposed on the Distributor. Specific services for identified customers Temporary supplies Network services for connection points where customers operate parallel generation requiring a stand-by supply Reserve (duplicate) supply Distribution services and system augmentation required to receive energy from: o an embedded generator, as defined in a licence issued under Division 3 of Part 2 of the EIA to distribute electricity, or o another Distributor. Provision of services as a result of customer non compliance with the Electricity Distribution Code or Electricity Retail Code including but not limited to reactive power, line losses in excess of deemed distribution losses due to customer's poor power factor, harmonics, voltage dips and test supplies. Provision of reactive power and energy to a connection point or the receipt of reactive power and energy from a connection point.	N.A

Source: AER analysis of EDPR, 2005 Tariff Order and 2007 AMI Order in Council and various ESCV Guidelines.

2.4 Future regulation of metering services

The Victorian DNSPs currently provide a variety of metering services which are either:

- regulated as prescribed metering services
- regulated as excluded distribution services, or
- are unregulated.

As explained below, this framework and approach paper does not classify metering services that will be regulated under the November 2008 AMI Order in Council, applicable to the introduction of advanced interval meters in Victoria.

In 2006, the Victorian Government announced a decision to rollout advanced interval meters to all Victorian electricity customers. The regulatory arrangements relating to the rollout were initially set out in a 2007 Victorian Order in Council and were subsequently revised in November 2008 (November 2008 AMI Order in Council).[49] These arrangements specify that 'regulated services', as defined in the November 2008 AMI Order in Council, will not be subject to the regulatory arrangements under chapter 6 of the NER for the 2011–15 regulatory control period.

The November 2008 AMI Order in Council provides the arrangements for regulation of charges for the following AMI services:

- metering services supplied to first tier customers or second tier customers with annual electricity consumption of 160 MWh or less where the electricity consumption of that customer is (or is to be) measured using a revenue meter that is either an accumulation meter or a manually read interval meter
- metering services supplied to first tier customers or second tier customers with annual electricity consumption of 160 MWh or less where the electricity consumption of that customer is (or is to be) measured using a revenue meter that is a remotely read interval meter, and
- other fees and charges:
  - exit fees where the retailer becomes the responsible person for a relevant customer's metering services
  - restoration fees where a retailer ceases to be the responsible person for a relevant customer's metering services and the distributor becomes the responsible person
  - prices for unmetered supplies,[50] and
  - customer requested services—which are services provided to a retailer in respect of a customer that requests services to a standard in excess of that normally provided.

[49] *Advanced Metering Infrastructure Order in Council 2008*, 25 November 2008.

[50] Unmetered supplies are to be regulated under the November 2008 AMI Order in Council until 31 December 2010, after which time these services will be regulated under chapter 6 of the NER.

The AER understands that all metering services, including 'above standard services' provided by the Victorian DNSPs to customers with annual consumption of less than 160 MWh, regardless of whether they have a revenue meter that is either an accumulation meter or a manually read interval meter, will be regulated under the November 2008 AMI Order in Council. As a result, these regulated services, with the exception of 'unmetered supplies', will not be classified in the AER's framework and approach paper or the DNSPs' distribution determinations for the 2011–15 regulatory control period.

However, there are several metering services that the Victorian DNSPs provide, or could potentially provide, to other classes of customers that are not covered by the November 2008 AMI Order in Council.

First, there are customers with annual consumption of 160 MWh or more that are serviced by type 1 to 4 remotely read interval meters. Meter provision services and metering data provision services (provided by metering data agents) for these customers are currently provided on a fully contestable basis. Victorian DNSPs are only one of many potential providers of these services that can be chosen by the relevant 'responsible person', as defined in chapter 10 of the NER. The AER understands that none of the Victorian DNSPs is currently accredited by NEMMCO as a metering data agent. These services are not currently regulated by the ESCV and will not be classified in the AER's framework and approach paper, or in its distribution determination, for the 2011–15 regulatory control period.

Second, there are unmetered supplies where the customer does not have a meter. These metering services (type 7 - unmetered connection points) are currently regulated by the ESCV as prescribed metering services and will be regulated under the November 2008 AMI Order in Council until 31 December 2010. These services are classified in this framework and approach paper as alternative control services and will be regulated in accordance with chapter 6 of the NER from the commencement of the 2011–15 regulatory control period.

Third, there are existing customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters. There is a finite number of these customers because, under NEMMCO's *National Metrology Procedures*, new large customers in Victoria with annual consumption greater than 160 MWh must be serviced by type 1 to 4 remotely read interval meters.[51] Type 5 and type 6 meter services are currently regulated as excluded distribution services. Importantly, metering services provided to customers using type 5 or type 6 meters with annual consumption greater than 160 MWh that have manually read meters are:

- not covered by the November 2008 AMI Order in Council, because they have annual consumption of more than 160 MWh

[51] See NEMMCO, *National Metrology Procedures (parts A and B), schedule 2*, available at www.nemmco.com.au.

- supplied exclusively by the Victorian DNSPs who are the metering providers and metering data providers for these customers under the NER,[52]and
- currently regulated by the ESCV, which sets maximum fair and reasonable charges for meter provision as non-contestable excluded distribution services.[53]

In summary, these arrangements mean that for:

- all metering services provided to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters, and
- metering services for unmetered connection points,

the AER is required to make a classification decision for the purposes of the 2011–15 regulatory control period.

2.5 AER's preliminary position on service classification

Having regard to the regulatory approach applicable to distribution services provided by the Victorian DNSPs in the current regulatory control period,[54] and the requirements of clauses 6.2.1 and 6.2.2 of the NER, the AER's preliminary position was that, in the next regulatory control period, the distribution services currently classified as:

- prescribed distribution services should be classified as direct control services, and further classified as standard control services
- excluded distribution services and prescribed metering services that are unmetered supplies should be classified as alternative control services, and
- connection and augmentation works for new customer connections and new public lighting should be classified as negotiated distribution services.

The preliminary position paper provided the following summary of the AER's proposed classification of distribution services provided by the Victorian DNSPs.

[52] Clause 7.2.3(a)(2) of the NER states that the 'Local Network Services Provider is the responsible person for … a type 5, 6 or 7 metering installation connected to, or proposed to be connected to, the Local Network Service Provider's network'.

[53] ESCV, *EDPR, Final Decision Volume 1*, October 2006, Table 15.1.

[54] NER, cll. 6.2.1(c)(2) and 6.2.2(c)(3).

Table 2.2 AER's preliminary position – classification of Victorian DNSPs' distribution services

Service grouping	Negotiated distribution services	Direct control Services - standard control services	Direct control services - alternative control services
Network services		All "standard" network services	
Connection services	Connection and augmentation works for new customer connections		Connection - energisation
Metering services			Metering services provided to existing first tier customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters Metering services for unmetered supplies
Public lighting services	New public lighting		Operation, repair, replacement and maintenance of DNSP's public lighting assets Alteration and relocation of existing DNSP public lighting assets
Fee based services			All fee based services
Quoted services			All quoted services

Source: AER analysis.

In its preliminary positions paper, the AER considered that these classifications were likely to cover the full spectrum of the DNSP's distribution services, other than:

- meter provision services and metering data provision services for customers with annual consumption of 160 MWh or more that are serviced by type 1 to 4 remotely read interval meters, and
- the metering services that will be regulated under the November 2008 AMI Order in Council,

which are not to be classified in the framework and approach paper.

2.6 Summary of submissions

The AER received a number of submissions from stakeholders in response to its preliminary positions paper in relation to the classification of the DNSPs' distribution services, including from:

- Citipower
- Jemena
- Powercor
- SP AusNet
- United Energy
- the Victorian Department of Primary and Industries (DPI)
- Origin Energy
- the Trans Tasman Energy Group, and
- the Streetlight Group of Councils.

The submissions were generally supportive of the broad service groupings proposed by the AER. However, stakeholders considered that certain services should be moved between different service groupings and that other services should not be classified at all.

One submission was received in relation to network services. SP AusNet considers that the public transport connection points do not require specific identification as they are currently treated the same as other network services.[55]

Several submissions supported the AER's proposed classification of connection and augmentation works as negotiated distribution services. However, the DPI submits that this should be reconsidered if the Victorian DNSPs' tendering obligations detailed in the ESCV's Guideline 14 do not continue, [56] while SP AusNet submits that this classification should still apply even in the absence of Guideline 14.[57] Citipower and Powercor jointly submit that connection services where only a service cable and a meter are required should be classified as alternative control services.[58]

One submission was received in relation to metering services. SP AusNet considers that metering provider services to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters should be unclassified, as customers can choose to have a type 4 remotely read interval meter installed instead of retaining a type 5 or type 6 meter.[59]

Several submissions were received in relation to public lighting.

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[55] SP AusNet, *Electricity Distribution Price Review (EDPR) – SP AusNet Response to Framework and Approach Position Paper,* 6 March 2009, p. 6.

[56] Department of Primary Industries, *Submission: Framework and Approach Paper for Victorian Electricity Distribution Businesses,* 10 March 2009, p. 1.

[57] SP AusNet, op cit, p. 7.

[58] Citipower and Powercor, *Submission to Australian Energy Regulator's Preliminary Positions Framework and Approach Paper*, 6 March 2009, p. 10.

[59] SP AusNet, op cit, p. 8-9.

The Trans Tasman Energy Group's and Streetlight Group of Councils' submissions on the preliminary positions paper suggest that all public lighting services should be classified as negotiated distribution services.[60]

United Energy[61], SP AusNet[62] and Jemena[63] all submit that the alteration and relocation of existing public lighting assets should be classified as a negotiated distribution service, rather than as an alternative control service. They considered that this would better reflect the current contestability arrangements under the ESCV's Public Lighting Code and Guideline 14.

SP AusNet submit that the competitive market for new public lighting assets means that these services should be unclassified, rather than being treated as negotiated distribution services as proposed by the AER.[64]

A number of stakeholders suggested various changes to the types of services that the AER proposed classifying as fee based services:

- "Elective underground service where an existing overhead service exists" — Citipower, Powercor[65] and SP AusNet[66] submit that this should be classified as a quoted service, while United Energy[67] and Jemena[68] submit that it should be classified as a negotiated distribution service
- "Charge for damage to overhead service cables caused by high vehicles" — SP AusNet submit that this should be classified as a quoted service[69]
- "Service supply abolishment" — United Energy submit that this should be classified as a quoted service[70]
- "High load escorts" — United Energy[71] and Jemena[72] submit that this should be classified as a quoted service
- "Location of underground cables" and large scale "supply abolishments" — Jemena submit that these services should be classified as quoted services,[73] and
- "Watchman lights" — United Energy[74] and Jemena[75] submit that this service should not be classified.

[60] Streetlight Group of Councils / Trans Tasman Energy Group, *Framework and approach paper: Preliminary Positions*, March 2009, p. 3.

[61] United Energy, *AER's Framework and Approach Paper – Regulatory control period commencing 1 January 2011*, 6 March 2009, p. 8.

[62] SP AusNet, op cit, p. 9.

[63] Jemena, *Preliminary positions: Framework and approach paper – Citipower, Powercor, Jemena, SP AusNet and United Energy: Regulatory control period commencing 1 January 2011*, 13 March 2009, p. 6-7.

[64] SP AusNet, op cit, p. 10.

[65] Citipower and Powercor, op cit, p. 10.

[66] SP AusNet, op cit, p. 10.

[67] United Energy, op cit, p. 9.

[68] Jemena, op cit, p. 11.

[69] SP AusNet, op cit, p. 10.

[70] United Energy, op cit, p. 9.

[71] Ibid.

[72] Jemena, op cit, p. 11.

[73] Ibid, p. 10.

[74] United Energy, op cit, p. 9.

Several stakeholders also suggested various changes to the types of services that the AER proposed classifying as quoted services:

- "Non-emergency recoverable works" — Citipower and Powercor jointly propose that this should be included as an additional quoted service or classified as a negotiated service[76]
- SP AusNet submits that a number of services that are currently included in the 2005 Tariff Order do not appear to have been classified in the preliminary positions paper and should be treated as quoted services[77]
- "Customer requested rearrangement of network assets or supply enhancement" — Jemena suggests that this service should be split, with large-scale works being classified as negotiated services and small-scale works being classified as quoted services[78]
- "Auditing of design and construction" and "specification and design enquiry fees" — Jemena submits that these services should be classified as negotiated services,[79] and
- "The alternation and relocation of existing DNSP network assets" — United Energy submits that these services should be treated as negotiated services.[80]

Section 2.7 of this chapter sets out the AER's consideration of these submissions.

2.7 Issues and AER's considerations

2.7.1 Distribution services[81]

Under the NER, the AER must make a positive decision to classify a service as a direct control or negotiated distribution service, and, in relation to direct control services, as a standard control or alternative control service. This requires the AER, taking into account the matters contained in clauses 6.2.1 and 6.2.2 of the NER, to proceed on the basis that the service classification it adopts should be the same as that applying previously, unless another classification is clearly more appropriate.

First, it is necessary to understand what a distribution service is. The definition of a 'distribution service' in the NER has changed since the ESCV issued its EDPR. The NER now defines a 'distribution service' as 'a service provided by means of, or in connection with, a distribution system'.[82]

'Distribution system' is also defined in the NER as a 'distribution network, together with the connection assets associated with the distribution network, which is

[75] Jemena, op cit, p. 12.
[76] Citipower and Powercor, op cit, p. 10.
[77] SP AusNet, op cit, p. 11.
[78] Jemena, op cit, p. 8.
[79] Ibid, p. 9.
[80] United Energy, op cit, p. 10.
[81] The definition of distribution services in this section paraphrases that contained in the chapter 10 of the NER. In the case of any inconsistency between the definition in this section and that in the NER, the definition in the NER prevails.
[82] NER, chapter 10.

connected to another transmission or distribution system. Connection assets on their own do not constitute a distribution system'.[83]

As provided for by the NER, distribution services include services provided by means of, or in connection with, the apparatus, equipment, plant or buildings used to convey, and control the conveyance of, electricity to customers (whether wholesale or retail), where these assets are owned, controlled or operated by the DNSP, excluding services provided over a transmission network.

Distribution services therefore include network services, connection services, metering services, public lighting services, fee based services, quoted services and unregulated services.

2.7.2 Considerations relevant to classification of services

2.7.2.1 Requirement to classify a service of a specified kind in a particular way

As noted above, where the NER require a service of a specified kind to be classified as a direct control or negotiated distribution service, or as a standard control or alternative control service (as the case may be), then that service is to be classified in accordance with that requirement.[84] The AER is not aware of any requirement in the NER to this effect in relation to distribution services provided by any of the Victorian DNSPs.

2.7.2.2 Presumption in favour of prior classification or classification consistent with previously applicable regulatory approach (as the case may be)

Where the NER do not require a service to be classified in a particular way, the classification process begins with a presumption in favour of the prior classification, or classification consistent with the previously applicable regulatory approach (as the case may be).[85] In practice, this suggests that for the 2011–15 regulatory control period:

- the prescribed distribution services provided by the Victorian DNSPs should be classified as direct control services and further classified as standard control services, and
- the excluded distribution services provided by the Victorian DNSPs should be classified as either alternative control services or negotiated distribution services, having regard to the factors in clause 6.2.1 and 6.2.2 of the NER.

With this in mind, the AER must assess whether a different classification is clearly more appropriate, having regard to the factors it is required to consider in the NER. The AER considers that there is only one service where a different classification is clearly more appropriate. The AER's likely approach on the classification of unmetered supplies (type 7 meters) is to deviate from the current regulatory approach. The reasons why the AER considers that a different classification is clearly more appropriate are set out later in this chapter.

[83] Ibid.

[84] NER, cll. 6.2.1(e) and 6.2.2(e).

[85] NER, cll. 6.2.1(d) and 6.2.2(d).

The AER acknowledges the need to classify services in such a way as to allow flexibility to DNSPs to alter the exact specification (but not the nature) of a service during the regulatory control period. At the same time, the AER needs to provide certainty as to how specific services, particularly new services that may arise during a regulatory control period, are classified. This balance can be achieved by grouping services for the purpose of classification as provided for by the NER.[86] This approach has the advantage of classifying a class of activities, rather than the specific activities performed as part of the service, allowing the specific definition or magnitude of services to change whilst maintaining the desired classification. Such broad classifications may be combined with a list of specific services that are included (but not limited to) that classification grouping.

2.7.3 Classification of distribution services

Having regard to the presumption in favour of the previous regulatory approach for prescribed distribution services and excluded distribution services discussed above, this section considers whether a different classification in each instance is clearly more appropriate. The following service groupings are discussed in turn:

- network services
- connection services
- metering services
- public lighting services
- fee based services, and
- quoted services.

2.7.3.1 Network services

The AER considers network services to predominantly relate to services provided over the shared network used to service all network users connected to it. Such services may include the construction, maintenance, operation, planning and design of the shared network. Network services are delivered through the provision and operation of apparatus, equipment, plant and / or buildings (excluding connection assets) used to convey, and control the conveyance of, electricity to customers.[87] Network services also include the provision of emergency response and administrative support for other network services.

The term ‘network services’ therefore encompasses a significant proportion of a DNSP’s distribution services. The AER considers this view is consistent with how the NER defines a ‘network service’.[88]

[86] NER, cll. 6.2.1(b) and 6.2.2(b).

[87] Such assets include poles, lines, cables, substations, communication and control systems, and involve activities such as inspection, testing, repairs, maintenance, vegetation clearing, asset replacement, asset refurbishment and asset construction services that are not connection services.

[88] NER, chapter 10. “Distribution service associated with the conveyance, and controlling the conveyance, of electricity through the network.”

Current classifications

The Victorian regulatory framework does not currently have a group of services called 'network services'. However, the AER is of the view that the following prescribed distribution services referred to in clause 2.2(f) (and set out in Part B of the Attachment) to the 2005 Tariff Order meet the NER definition of network services:

1. the transportation of electricity, except as contemplated in paragraph 1 of Part A of this Attachment;[89]

2. the Distribution of electricity to customers connected at the following existing connection points:

   (a) Public Transport Corporation - Caulfield;

   (b) Public Transport Corporation - Cremorne;

   (c) Public Transport Corporation - Burnley;

   (d) Public Transport Corporation - North Melbourne;

   (e) Public Transport Corporation - Rushall;

   (f) Public Transport Corporation - Victoria Park.

3. the carrying out of works or the provision of maintenance or repair for the purpose of carrying out Distribution of electricity.

Network services are characteristically provided on a 'standard' basis, with the 'above standard' supply of these services generally dealt with as a fee based, or quoted, service. The AER refers to an above standard network supply as being the provision of a higher standard of reliability or quality of supply, which would be provided by a DNSP by providing assets which enable greater reliability or quality of supply at a customer's premises. These assets would be supplied as either a fee based service (if the cost of works can be gauged in advance and therefore a single price can be set) or as a quoted service. This is further discussed in sections 2.7.3.5 and 2.7.3.6 of this chapter.

AER's preliminary position

The AER's preliminary position was that the Victorian DNSPs' network services should be classified in a manner consistent with the previously applicable regulatory approach, as no other classification was clearly more appropriate. This was supported by the AER's assessment against the factors in clause 6.2.1 and 6.2.2 of the NER.

On this basis, the AER considered 'standard' network services should be classified as direct control services and, in turn, as standard control services. The AER considered that above standard network services, which are currently treated as excluded distribution services, should be classified as quoted services.

Issues and the AER's considerations

The AER received one submission in relation to network services. SP AusNet considers that the public transport connection points do not require specific

[89] Paragraph 1 of Part A of the 2005 Tariff Order classifies the transportation of electricity between DNSPs as an excluded service.

identification as they are currently treated the same as other network services.[90] The AER has identified these services in the discussion above because they are cited in the 2005 Tariff Order and it considers that they meet the broader definition of network services.

In determining the appropriate classification for the Victorian DNSPs' distribution services, the AER has first had regard to all of the four factors in clause 6.2.1(c) of the NER, including the form of regulation factors contained in section 2F of the NEL.

The Victorian DNSPs each hold an electricity distribution licence that has been issued by the ESCV. Each licence prevents the DNSP from distributing or supplying electricity outside of its designated distribution area. Similarly, under the *Electricity Industry Act 2000* (Vic), a person is prevented from distributing and supplying electricity unless they hold a licence authorising them to do so.

The AER considers these arrangements together effectively amount to a regulatory barrier to entry for the purposes of section 2F(a) of the NEL. This is because the Victorian DNSPs, as the only holders of electricity distribution licences in their designated distribution areas, are the only parties that can provide these network services within these areas. Also, users of these services do not have an option to source these services from other providers.

Furthermore, the significant capital costs of entry, and the economies of scale and scope available to the Victorian DNSPs as incumbent service providers, are highly likely to make duplication of the Victorian DNSPs' shared network by an alternative service provider commercially unviable and economically inefficient. For the purposes of sections 2F(b) and 2F(c) of the NEL, the economies of scale and scope available to Victorian DNSPs are also likely to prevent augmentation of the network being competitively provided by an alternative service provider.

For the purposes of section 2F(e) of the NEL, substitutes for using these shared network services are few, and are likely to be limited to embedded generation, switching to an alternative energy source, such as natural gas, or switching the connection point to the transmission network. These are unlikely to be viable commercial options in most instances for most existing large and small customers. There is also likely to be low asset stranding risk associated with a DNSP's shared network assets, as the elasticity of demand for the service is likely to be low, such that demand will not fall significantly as the price increases.

These factors contribute to the view that the Victorian DNSPs possess significant market power in the provision of network services, and that it is appropriate to subject these services to a direct form of control. In particular, having regard to the purpose of section 2F(g) of the NEL, even a high degree of information available to users, would not neutralise the lack of countervailing market power caused by these other form of regulation factors.

The AER has also had regard to clauses 6.2.1(c)(2) and 6.2.1(c)(3) and notes that network services are currently subject to a control form of regulation in Victoria — this is also the case in the other NEM jurisdictions.

[90] SP AusNet, op cit, p. 6.

Having regard for the requirements of clause 6.2.1 of the NER, the AER considers that network services should be classified as direct control services.

Once a service is classified as a direct control service, the AER must then have regard to the six factors in clause 6.2.2(c) to determine whether it should be classified as a standard or alternative control service.

Network services are currently regulated as prescribed distribution services under a weighted average price cap form of control, which creates a presumption that they should be classified as standard control services unless a different classification is clearly more appropriate. Having regard to the factors in clause 6.2.2(c), the AER considers that there is no basis to move away from this presumption, for the following reasons:

- as discussed above, there is little if any potential for the development of competition in the market for network services. The AER considers that its classification will not influence the potential for competition — rather, the absence of competition is determined by the requirements of the DNSPs' licences and the *Electricity Industry Act 2000* (Vic)

- there would be no material effect on administrative costs of the AER, DNSP or any other party. This is because classifying network services as standard control services would involve a broadly similar regulatory approach to that which has been applied by the ESCV for the current regulatory control period

- network services are currently regulated in Victoria, and all of the other jurisdictions in the NEM, under a control mechanism that incorporates a CPI−X framework (or variant thereof), where the X-factor is determined according to a building block approach. Network tariffs are subject to the annual approval of the regulator

- the nature of network services is that they are provided by a shared network and their costs cannot be directly attributed to individual customers, and

- there are no other relevant factors that change the AER's proposed classification.

AER's likely approach

The AER's likely approach is to classify the Victorian DNSPs' network services in a manner which is consistent with the previously applicable regulatory approach, as no other classification is clearly more appropriate. This is supported by the AER's assessment against the factors in clause 6.2.1 and 6.2.2 of the NER.

On this basis, the AER considers 'standard' network services should be classified as direct control services and, in turn, as standard control services.

Above standard network services, which are currently treated as excluded distribution services, are discussed in section 2.7.3.6 of this chapter under the quoted services grouping.

2.7.3.2 Connection services

Chapter 10 of the NER defines connection services as consisting of entry services and exit services. An entry service is a service provided to serve a generator or group of generators, or a network service provider or group of network service providers, at a single connection point. An exit service is a service provided to serve a distribution customer or a group of distribution customers, or a network service provider or group of network service providers, at a single connection point.

Current classifications

The Victorian DNSPs' electricity distribution licences define 'connection service' as:

> the service of establishing connection between the Licensee's distribution system and another electrical system (including, without limitation, an electrical installation).

The electricity distribution licences include an obligation on licensees to provide an offer to connect a customer or an embedded generator upon request. This obligation distinguishes between:

- connection and augmentation works involving the *construction* of assets that are required to establish the connection, and
- the energisation of the connection point once the assets have been constructed.

Connection and augmentation works

This section addresses connection and augmentation works that are being undertaken by a DNSP. It does not cover works that are undertaken by other parties — for example, developer constructed works in the case of sub-divisions — and gifted to the DNSP.

In Victoria, connection and augmentation works are made contestable under the ESCV's Guideline 14. The contestability arises from the requirement in Guideline 14 for a DNSP to call for tenders to construct the works from at least two other people who otherwise compete for such work.[91]

Guideline 14 also sets out under its capital contribution provisions (see clause 3.3), arrangements for customer contributions to the capital cost of new works and augmentations. These arrangements are separate to the tendering provisions in Guideline 14 discussed above. While the tendering provisions deal with contestability arrangements, the capital contribution provisions deal with the regulatory approach to up-front contributions by customers to the cost of new works and augmentations, which is a pricing matter. These capital contribution arrangements were developed by the ESCV to ensure that capital contributions for new connections and augmentations are consistent with providing efficient price signals to customers and DNSPs have sufficient flexibility to estimate the incremental cost of servicing a customer. [92]

Given that the scope of connection and augmentation works are not generally known before the customer has requested a connection, these services are not provided for a

[91] See in particular clause 4.2.1 of Guideline 14; also see clauses 4.1.1, 4.3.2 and 4.4.1 of Guideline 14.

[92] Refer ESCV, *Review of Augmentation and Customer Connection Guideline – Final Decision*, April 2004.

fixed fee. Connection and augmentation works are currently treated as a contestable excluded distribution service under the ESCV's regulatory arrangements and fees for such services are generally quoted because a 'standard' service fee cannot be predetermined. Having regard to this, the AER has classified *standard* and *above standard* connection and augmentation works together for the purposes of service classification. The AER's consideration of the classification of connection and augmentation works is discussed below.

Connection — energisation

This section does not address above standard connection (energisation) services. These are dealt with as quoted services in section 2.7.3.6 of this chapter.

Once connection and augmentation works have been completed, a customer's connection point is then energised by a DNSP. This 'connection service' is generally undertaken by the DNSP for a retailer acting on behalf of a customer. This is a 'new connection' service within the meaning of NEMMCO's *B2B Procedure — Service Order Process*, which means that this service is charged on a fixed fee basis under those procedures. The scope of the service is also uniform across customers.

The energisation component of connection services is currently treated as an excluded distribution service under the ESCV's regulatory framework.

AER's preliminary position

The AER's preliminary position was that:

- standard connection and augmentation works should be classified as negotiated distribution services, because:
  - the market for these services is contestable and characterised by several participants in the market
  - the AER has assumed that the regulatory obligations applicable to DNSPs outlined above for the tendering of construction works (currently under the DNSPs' licences and ESCV Guideline 14) will continue in some form after 2010, and
  - there is no economic need for direct control regulation
- non-standard connection and augmentation works should also be classified as negotiated distribution services, for the same reasons, and
- the 'standard' energisation of a connection point should be classified as a direct control service, and then classified as an alternative control service, because the Victorian DNSPs are the monopoly providers of these services in their respective distribution areas and because the costs of providing these services can be attributed to a particular customer.

Issues and AER's considerations

Connection and augmentation works

On the basis of advice from the DPI, the AER has assumed that the nature of the current obligations under the DNSP's licences and Guideline 14 for DNSPs to tender connection and augmentation works will continue in some form after 2010. This

assumption also has regard to Guideline 14 having been in place since 2004 and similar obligations for DNSPs to tender connection and augmentation works having been in place since 1994. On this basis, it follows that there is not likely to be a material change after 2010 in the way these services are provided by DNSPs or the potential for competition in the delivery of these services.

This assumption implies that, for the purposes of section 2F(a) of the NEL, there is not likely to be a regulatory barrier to parties other than the Victorian DNSPs providing connection and augmentation works after 2010.

The AER understands that:

- the market for the provision of connection and augmentation works is currently contestable in Victoria and there are alternative providers of these services
- there is a mixture of customers accepting quotations directly from the Victorian DNSPs and those going to tender, and
- alternative providers of connection and augmentation works are being successful in tender processes and are undertaking works.

However, the AER notes:

- the assumption that the requirement to tender works will continue beyond the transfer of regulatory responsibility to the AER is important
- the network services that the Victorian DNSPs offer through the shared network may give them the ability to exploit operational and economic efficiencies in the provision of connection and augmentation works, and thereby create barriers to other parties providing these works on a cost competitive basis, and
- individual customers may not, in the absence of the regulatory requirements applicable to DNSPs outlined above for tendering of construction works (currently under the DNSPs' licences and ESCV Guideline 14), have countervailing market power sufficient to provide incentives to the Victorian DNSPs to price efficiently.

This suggests that the tender provisions under Guideline 14 and the DNSPs' licences:

- largely mitigate the kinds of network externalities contemplated under sections 2F(b) and 2F(c) of the NEL
- balance the market power of the DNSP and the network service user, or prospective network user, for the purposes of section 2F(d) of the NEL, and
- provide information to enable a network service user, or a prospective network user, to negotiate on an informed basis for the purposes of section 2F(g) of the NEL.

However, the AER considers that, for the purposes of section 2F(e) of the NEL, substitutes for these connection and augmentation works are few, and are likely to be limited to embedded generation, switching to an alternative energy source, such as natural gas, or switching the connection point to the transmission network. These are unlikely to be viable commercial options for most large and small customers.

On balance, the AER considers that if the kind of regulatory obligations under the DNSPs' licences and ESCV Guideline 14 regarding *contestability* continue in some

form, these factors contribute to the circumstances under which there is countervailing market power held by customers in the provision of all (standard and above standard) connection and augmentation works, and these services consequently do not require a direct form of control. On this basis, and provided that the regulatory obligations regarding contestability are continued, the AER considers that these services should be classified as negotiated distribution services.

It is noted however that DNSPs need to operate and maintain connection and augmentation assets that they own, irrespective of whether the assets have been built and funded by the DNSP or gifted by a customer or another party. This operation and maintenance activity is to be treated as a network service, and the associated operating and maintenance expenditure is to be included in a DNSP's standard control services' operating expenditure building block (albeit that the DNSP would not earn a regulated return under the building block model on, and of, a new asset that has been constructed for and classified as a negotiated distribution service).

The AER considers that classifying connection and augmentation works as negotiated services will result in the current form of regulation for these services being broadly retained.

Terms and conditions for negotiated distribution services, including the price of those services, will be determined under the negotiate/arbitrate framework set out in chapter 6 of the NER. DNSPs will negotiate with customers in accordance with a negotiating framework approved by the AER, and negotiated distribution service criteria determined by the AER.

As noted above, connection and augmentation works are currently treated as a contestable excluded distribution service under the ESCV's regulatory arrangements. ESCV Guideline 14 also sets out current arrangements for up-front customer contributions to the capital cost of new works and augmentations undertaken by DNSPs (see Guideline 14, in particular clauses 3.2 to 3.5). Classifying connection and augmentation works as negotiated services under the NER will result in the *capital* cost of those services being recovered under the negotiate/arbitrate framework set out in chapter 6 of the NER, rather than through DUOS charges for network services under the building block model. The AER notes that the NER do not provide a derogation to allow the existing Victorian (ESCV Guideline 14) capital contribution arrangements to continue in their current form. As these arrangements deal with service pricing, which in Victoria will be regulated under chapter 6 of the NER from 1 January 2011, they would not apply to new works and augmentations in the 2011-15 regulatory control period.

It is noted that clause 6.7.1 of the NER outlines the pricing principles relating to negotiated distribution services and requires, among other things, that terms and conditions be fair and reasonable.

The AER also notes that the negotiate/arbitrate framework provides an opportunity for an economically efficient outcome where the parties can agree to the price and terms and conditions for a service, and in this context is most effective where a customer has a choice of providers or some form of countervailing power when negotiating with a DNSP. However, in the event of a dispute, the AER will arbitrate

in accordance with Part D and Part L of chapter 6 of the NER, thereby maintaining regulatory oversight given the potential for DNSPs to take advantage of the market power they possess.

The AER considers that it may not be appropriate to classify these services as negotiated distribution services if the existing regulatory obligations regarding contestability do not continue in some broadly equivalent form. This view was supported in several submissions received in response to the AER's preliminary positions paper.[93] In its submission, the DPI notes that consideration should be given to reclassifying connection and augmentation services as direct control services if the obligations detailed in Guideline 14 do not continue.[94] Similarly, SP AusNet supports the classification of connection and augmentation services as negotiated distribution services, however it submits that this classification should even apply in the absence of Guideline 14, as it considers that a mature market now exists for these services.[95]

For the reasons noted above, the AER considers that it is appropriate to assume for the purposes of this framework and approach paper that the nature of the current obligations under Guideline 14 and the DNSPs' licences to tender connection and augmentation works will continue in some form after 2010. The AER agrees that it would need to reassess its classifications if this assumption did not hold. This could be done at the time of the AER's distribution determination, on the basis of the regulatory proposal and submissions received.

Citipower and Powercor jointly submit that connection services where only a service cable and a meter are required should be classified as alternative control services.[96] The AER considers that retaining the regulatory obligations for tendering under the DNSPs' licences and Guideline 14 means that it is not necessary to subject these connection services to a direct form of control and that it is more appropriate to classify these services as negotiated distribution services. However, if they choose, Citipower and Powercor can propose a different classification in their regulatory proposals, which would need to be considered on its merits under the NER.

Connection — energisation

The AER understands that only the Victorian DNSPs can energise a connection point in their respective distribution areas as provided for by section 16 of the *Electricity Industry Act 2000* (Vic), which restricts the provision of this service to licensed distributors. The Victorian DNSPs' electricity distribution licences oblige them to make an offer to provide this service upon a retailer's or customer's request.

On this basis, and having regard to the factors in section 2F of the NEL, the AER considers that there is a regulatory barrier to any party other than the Victorian DNSPs providing this service. Furthermore, the economies of scale and scope available to Victorian DNSPs, in particular in relation to its network services, are likely to prevent connection services being competitively provided by an alternative

[93] For example, see Origin Energy, *AER Preliminary Framework and Approach Paper for Victorian Distribution Businesses in Regulatory Period 2011*, 6 March 2009, p. 2.
[94] DPI, op cit, p. 1.
[95] SP AusNet, op cit, p. 7.
[96] Citipower and Powercor, op cit, p. 10

service provider. The AER also considers that there are no real substitutes for this service once the connection and augmentation works have been completed and a connection point is ready to be energised.

These factors contribute to the view that the Victorian DNSPs possess significant market power in the provision of connection (energisation) services and that it is appropriate to apply a direct form of control to these services.

Having regard to the factors in clauses 6.2.1(c)(2) and 6.2.1(c)(3) of the NER, the AER notes that connection (energisation) services are currently subject to a control form of regulation in Victoria as well as in all other jurisdictions in the NEM.

For these reasons, the AER considers that connection (energisation) services should be classified as direct control services.

Once a service is classified as a direct control service, the AER must then have regard to the six factors in clause 6.2.2(c) to determine whether it should be classified as a standard or alternative control service.

Connection (energisation) services are currently excluded distribution services, which creates the presumption that they should be classified as alternative control services unless a different classification is clearly more appropriate. The AER considers that there is no basis to move away from this presumption, having regard to all of the factors in clause 6.2.2(c). This is because:

- for the reasons noted above, there is little if any potential for the development of competition in the market for connection (energisation) services. The AER considers that its classification will not influence the potential for competition — rather, the absence of competition is determined by the requirements of the DNSPs' licences and the *Electricity Industry Act 2000* (Vic)

- there would be no material effect on administrative costs of the AER, DNSP or any other party. This is because classifying connection (energisation) services as alternative control services would involve a broadly similar regulatory approach to that which has been applied by the ESCV for the current regulatory control period

- connection (energisation) services are currently regulated in Victoria, and in other NEM jurisdictions, on a fixed fee basis

- the nature of connection (energisation) services is that they do not involve building new assets and the costs of providing the services can be directly attributed to individual customers, and

- there are no other relevant factors that change the AER's proposed classification.

For these reasons, the AER considers that there is no basis to move away from the presumption that these services should be classified as alternative control services.

AER's likely approach

The AER's likely approach is that:

- standard connection and augmentation works be classified as negotiated distribution services, because:
  - the market for these services is contestable and characterised by several participants in the market
  - the AER has assumed that the regulatory obligations applicable to DNSPs outlined above for the tendering of construction works (currently under the ESCV Guideline 14 and the DNSPs' licences) will continue in some form after 2010, and
  - there is no economic need for direct control regulation
- non-standard connection and augmentation works also be classified as negotiated distribution services, for the same reasons, and
- the 'standard' energisation of a connection point be classified as a direct control service, and then classified as an alternative control service, because the Victorian DNSPs are the monopoly providers of these services in their respective distribution areas and because the costs of providing these services can be attributed to a particular customer.

2.7.3.3 Metering services

As discussed in section 2.4 of this paper, the Victorian DNSPs currently provide a range of metering services. However, in the 2011–15 regulatory control period:

- the AER intends not to classify meter provision services and metering data provision services for customers with annual consumption of 160 MWh or more that are serviced by type 1 to 4 remotely read interval meters
- metering services regulated separately under the November 2008 AMI Order in Council will also not be classified, and
- the AER is required to make a classification decision for all metering services provided to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters, and metering services for unmetered connection points.

Current classifications

As discussed in section 2.4 of this paper, metering services provided to existing first tier customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters are currently regulated as excluded distribution services.

Metering services for unmetered connection points are currently regulated as prescribed metering services.

AER's preliminary position

The AER's preliminary position was that:

- the Victorian DNSPs' metering services provided to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters should be classified in a

manner which is consistent with the previously applicable regulatory approach, as no other classification is clearly more appropriate, and

- unmetered supplies should be classified as direct control services, and then as alternative control services, on the basis that these services do not involve the provision of assets and that the costs of providing the service can be attributed to a particular customer.

On this basis, the AER's preliminary position was that these metering services should be classified as direct control services and in turn as alternative control services.

Issues and AER's considerations

The AER notes that clause 7.2.3(a)(2) of the NER provides that the DNSP, as the Local Network Service Provider, is the responsible person for all type 5, 6 and 7 (unmetered connection points) metering installations.

On this basis, and having regard to the factors in section 2F of the NEL, the AER considers there is a regulatory barrier to any party other than the Victorian DNSPs providing these types of metering services.

However, the AER also recognises that there are substitutes for type 5 and type 6 metering services, as customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters can choose to have a type 4 remotely read interval meter. SP AusNet raises this in its submission on the preliminary positions paper where it considers that type 5 and type 6 meter services should not be classified services (i.e. and should not be regulated) because customers could change to a type 4 meter service, which is a contestable service.[97]

As discussed in section 2.4 of this paper, meter provision services and metering data provision services (provided by metering data agents) for type 4 meters are currently provided on a fully contestable basis, with the Victorian DNSPs being only one of many potential providers of these services that can be chosen by the relevant 'responsible person', as defined in chapter 10 of the NER. These services are not currently regulated by the ESCV and will not be classified in the AER's distribution determination for the 2011–15 regulatory control period. The AER therefore acknowledges that type 4 meter services are contestable and notes that customers of type 5 and type 6 meter services[98] have a choice of service provider other than a DNSP given that a type 4 meter service is a substitute for a type 5 or type 6 metering service.

These factors contribute to the view that the Victorian DNSPs possess market power in the provision of metering services for unmetered connection points but not in the provision of metering services provided to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters.

[97] SP AusNet, op cit, p. 8-9.

[98] As discussed in section 2.4 of this chapter, there is a finite number of these customers because, under NEMMCO's *National Metrology Procedures*, new large customers in Victoria with annual consumption greater than 160 MWh must be serviced by type 1 to 4 remotely read interval meters.

Having regard for the requirements of clause 6.2.1 of the NER, the AER considers that metering services for unmetered connection points (type 7 metering) should be classified as direct control services and metering services provided to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters should not be classified.

Once a service is classified as a direct control service, the AER must then have regard to the six factors in clause 6.2.2(c) to determine whether it should be classified as a standard or alternative control service.

In relation to unmetered supplies,[99] which are currently classified as prescribed metering services, the AER considers that these services should also be regulated in the future as alternative control services. After taking into account the factors in clause 6.2.2(c), the AER considers:

- there is little if any potential for the development of competition in the market for unmetered supplies. The AER considers that its classification will not influence the potential for competition — rather, the absence of competition is determined by the requirements of clause 7.2.3(a)(2) of the NER

- there would be no material effect on administrative costs of the AER, DNSP or any other party. This is because classifying unmetered supplies as alternative control services would involve a broadly similar regulatory approach to that which has been applied by the ESCV for the current regulatory control period

- unmetered supplies are currently regulated in Victoria as part of a weighted average price cap for metering services, and none of the other services within this metering services 'basket' will be regulated under the AER's 2011–15 distribution determination.[100] The AER understands that the approach taken in most other NEM jurisdictions is to regulate unmetered supplies on a fixed fee basis

- the nature of unmetered supplies is that they do not involve the provision of assets and the costs of providing the service can be attributed to a particular customer, and

- there are no other relevant factors that change the AER's proposed classification.

For these reasons, the AER considers that unmetered supplies should be regulated as alternative control services, rather than as standard control services.

AER's likely approach

The AER's likely approach is that:

- the Victorian DNSPs' metering services provided to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters not be classified on the basis

[99] The AER understands that the only unmetered market loads in Victoria are for public lighting. Refer NEMMCO, *National Electricity Market Load Tables for Unmetered Connection Points*, September 2008.

[100] These other metering services will be regulated under the November 2008 AMI Order in Council, as discussed in section 2.4 of this paper.

that customers of these services have a choice of service provider other than a DNSP given that a type 4 meter service, which is fully contestable, is a substitute for a type 5 or type 6 metering service, and

- unmetered supplies be classified as direct control services, and then as alternative control services, on the basis that Victorian DNSPs are the only parties able to provide these services, they are likely to have market power in the provision of these services, and the costs of the services can be directly attributed to individual customers.

2.7.3.4 Public lighting services

The ESCV's Public Lighting Code defines "public lighting services" to mean:

> any of the following services provided for the purpose of lighting public places:
>
> (a) the operation of public lighting assets, including handling enquiries and complaints about public lighting, and dispatching crews to repair public lighting assets;
>
> (b) the maintenance, repair, alteration, relocation and replacement of public lighting assets; and
>
> (c) the installation of new public lighting assets.[101]

Public lighting assets are connected to the Victorian DNSPs' distribution systems. The conveyance of electricity to public lighting assets is therefore not considered to be a public lighting service, but rather is a network service, as discussed in section 2.7.3.1 of this chapter.

Public lighting in Victoria can be provided by the Victorian DNSPs or by other parties, such as VicRoads or local councils.

Current classifications

The ESCV currently classifies public lighting services into the following categories:

- the operation, repair, replacement and maintenance of public lighting as non-contestable excluded distribution services
- the alteration and relocation of existing public lighting assets as contestable excluded distribution services, by virtue of the ESCV's Public Lighting Code and Guideline 14, and
- the provision of new public lighting as contestable excluded distribution services.

The Victorian DNSPs' electricity distribution licences provide that:

- the Victorian DNSPs must make an offer to provide public lighting services to a public lighting customer (e.g. VicRoads, local councils and the Docklands Authority) if requested to do so
- if a public lighting customer accepts the DNSP's offer then the DNSP must provide public lighting services on the basis of the offer, and

[101] ESCV, *Public Lighting Code*, April 2005, section 8, p. 10.

- if the public lighting customer does not request, receive or accept an offer then the DNSP must provide public lighting services at a price, and on terms and conditions, which comply with the EDPR, a statement approved by the ESCV (such as the list of Standard Service Prices) and the Public Lighting Code.

Where public lighting assets are owned by the DNSP, no other party may undertake works on these assets unless they are authorised to do so by the DNSP.

Connection and augmentation works for new public lighting assets are dealt with under:

- section 3 of the Public Lighting Code, and
- the ESCV's Guideline 14, which applies the same tendering provisions to these services as those discussed in section 2.7.3.2 of this chapter.

The Public Lighting Code provides further guidance on the responsibilities of DNSPs. The Code only applies to the Victorian DNSPs and deals with the way in which they are required to provide all (standard and non-standard) public lighting services for assets that are owned by the Victorian DNSPs. It does not apply to assets owned by other parties. Importantly, under the Public Lighting Code, a Victorian DNSP is not required to construct new public lighting assets, or to alter, relocate or replace, existing public lighting assets, until it receives a design brief from a public lighting customer in accordance with the public lighting standards.

AER's preliminary position

The AER's preliminary position was that the Victorian DNSPs' public lighting services should be classified in the following manner:

- the operation, repair, replacement and maintenance of the Victorian DNSPs' existing public lighting assets should be classified as a direct control service and in turn as an alternative control service
- the alteration and relocation of the Victorian DNSPs' existing public lighting assets should be classified as a direct control service and in turn as an alternative control service, and
- new public lighting assets (standard and non-standard provision) should be classified as a negotiated distribution service.

Issues and AER's considerations

The AER received a number of submissions in response to its preliminary positions on service classification for public lighting.

The Trans Tasman Energy Group's and Streetlight Group of Councils' submissions argue that all public lighting services should be made contestable. [102] As noted in section 2.1 of this paper, the AER's role in classifying distribution services ultimately only determines the manner in which a DNSP recovers the costs associated with its distribution services — it does not determine the contestability of these services. For this reason, the Trans Tasman Energy Group's and Streetlight Group of Councils' proposals generally relate to policy positions that are beyond the AER's power to act upon.

[102] Streetlight Group of Councils / Trans Tasman Energy Group, op cit, p. 1-6.

Operation, repair, replacement and maintenance

This section refers only to the operation, repair, replacement and maintenance of public lighting owned by a DNSP that is providing a public lighting service. This service refers to the standard service as provided for under the ESCV's Public Lighting Code.

SP AusNet notes in its submission on the preliminary positions paper that the "repair" aspect of this service is a subset of the "maintenance" aspect of this service.[103] The AER agrees with this view but considers that the explicit reference to repair activities makes clear that these activities are included in this service.

As noted above, the AER understands that once public lighting has either been built by a DNSP, or built by another party and gifted to a DNSP, that only the DNSP can undertake or authorise works in relation to that public lighting asset. This means that the key characteristics of these services are that:

- they relate to a Victorian DNSP's own public lighting assets, and
- public lighting customers in Victoria cannot choose who operates, repairs, replaces and maintains the DNSP's public lighting assets.

Under the current regulatory framework, the ESCV approves a set of prices for the provision of these services although there is the potential for the DNSP and public lighting customers to negotiate on the price and the terms and conditions for the supply of 'above standard' services.

On this basis, and having regard to the factors in section 2F of the NEL, the AER considers there is a regulatory barrier to any party other than the Victorian DNSPs providing these services.

Notwithstanding the potential for DNSPs and public lighting customers to negotiate on the price and the terms and conditions for the supply of 'above standard' public lighting services under the ESCV's regulatory framework, the factors outlined above contribute to the view that the Victorian DNSPs possess significant market power in the provision of operation, repair, replacement and maintenance services for their public lighting assets.

The AER notes that these public lighting services are currently subject to a control form of regulation in Victoria and understands that this is generally also the case in other NEM jurisdictions.

Having regard for the requirements of clause 6.2.1 of the NER, the AER considers that these public lighting services should be classified as direct control services.

Once a service is classified as a direct control service, the AER must then have regard to the six factors in clause 6.2.2(c) of the NER to determine whether it should be classified as a standard or alternative control service.

These public lighting services are currently excluded distribution services, which creates the presumption that they should be classified as alternative control services unless a different classification is clearly more appropriate. The AER considers that

[103] SP AusNet, op cit, p. 9.

there is no basis to move away from this presumption. This is because the AER considers that:

- for the reasons noted above, there is little if any potential for the development of competition in the market for these public lighting services. The AER considers that its classification will not influence the potential for competition — rather, the absence of competition is determined by the requirements of the DNSPs' licences and the Public Lighting Code

- there would be no material effect on administrative costs of the AER, DNSP or any other party. This is because classifying these public lighting services as alternative control services would involve a broadly similar regulatory approach to that which has been applied by the ESCV for the current regulatory control period

- these public lighting services are currently regulated in Victoria, and in several other NEM jurisdictions, on a fixed fee basis

- the nature of these public lighting services is that they do not involve building new assets and the costs of providing these services can be directly attributed to a specific class of customers, and

- there are no other relevant factors that change the AER's proposed classification.

For these reasons, the AER considers that there is no basis to move away from the presumption that these public lighting (operation, repair, replacement and maintenance) services should be classified as alternative control services.

Alteration and Relocation of Existing Public Lighting Assets

The AER received several submissions, including from United Energy[104], SP AusNet[105] and Jemena[106] in response to its preliminary positions paper, noting specifically that:

- clause 4.4 of the Public Lighting Code allows a customer to request another party than the DNSP to alter, relocate or replace public lighting assets, and

- the contestability provisions in the ESCV's Guideline 14 extend to these types of works.

These three DNSPs, as well as Trans Tasman Energy Group[107], consider that the alteration and relocation of existing public lighting assets should be classified as negotiated distribution services, rather than as alternative control services as proposed by the AER in its preliminary positions paper.

[104] United Energy, *AER's Framework and Approach Paper – Regulatory control period commencing 1 January 2011*, 6 March 2009, p. 8.

[105] SP AusNet, op cit, p. 9.

[106] Jemena, *Preliminary positions: Framework and approach paper – Citipower, Powercor, Jemena, SP AusNet and United Energy: Regulatory control period commencing 1 January 2011*, 13 March 2009, p. 6-7.

[107] Streetlight Group of Councils / Trans Tasman Energy Group, op cit, p. 3.

The AER has had regard for the existing regulatory requirements and considers that, provided equivalent provisions to the current Public Lighting Code and Guideline 14 continue in some form, the key characteristics of these services in the future will be that:

- they relate to a Victorian DNSP's own public lighting assets, and
- customers can choose who alters or relocates the DNSP's public lighting assets.

The AER understands that the ESCV has not approved a set of prices for the provision of these services for the current regulatory control period. Rather, under the current regulatory framework, the DNSP and public lighting customers are left to determine the price, terms and conditions, for the supply of these services. These public lighting services are therefore currently regulated on a 'light handed' basis in Victoria.

On balance, having regard for the factors in section 2F of the NEL, the requirements of clause 6.2.1 of the NER and stakeholder submissions, the AER considers that these public lighting services should be classified as negotiated distribution services. The AER notes that the current absence of regulatory barriers means that parties other than the Victorian DNSPs can effectively alter or relocate existing public lighting assets. However, this classification assumes that equivalent provisions to the current Public Lighting Code and Guideline 14 continue to apply in the next regulatory control period.

The AER considers that the classification of these services as negotiated distribution services would result in continuing the existing classification of these services and form of regulation.

New public lighting assets

The AER understands that the provision of new public lighting assets is currently treated as a contestable excluded distribution services on the basis that that ESCV considered that:

> A public lighting customer may seek competitive tenders to install new public lighting assets. If the public lighting customer wishes the distributor to install new public lighting assets (using standard or non-standard fittings), then this would be a separate charge, which would be negotiated between the public lighting customer and the distributor. If the customer chooses to own the public lighting asset, then the excluded service charge does not apply unless the asset is vested with the distributor or such a charge is negotiated with the distributor.[108]

The Victorian DNSPs have an obligation to offer public lighting services, including new public lighting assets, by virtue of clause 10 of their Distribution Licences. Where they provide new public lighting services, the DNSPs must do so in accordance with section 3 of the Public Lighting Code and the provisions of the ESCV's Guideline 14 (i.e. the requirement to tender works discussed in section 2.7.3.2 of this chapter).

[108] ESCV, *Review of Public Lighting Excluded Service Charges – Final Decision,* August 2004, p. 39.

The AER understands that:

- the market for the provision of new public lighting assets is currently contestable in Victoria and there are alternative providers of these services
- there is a mixture of customers accepting quotations directly from the Victorian DNSPs and those going to tender, and
- alternative providers of new public lighting assets are being successful in tender processes and are undertaking works.

However, the AER also considers that:

- the assumption that the requirement to tender works will continue beyond the transfer of regulatory responsibility to the AER may be important, as discussed in section 2.7.3.2, and
- the network services that the Victorian DNSPs offer through the shared network may give them the ability to exploit operational and economic efficiencies in the provision of new public lighting assets. Despite this, the AER understands that there are potential alternative providers of new public lighting assets.

The AER considers that, having regard to the factors in section 2F of the NEL, there are no specific regulatory barriers to any party other than the Victorian DNSPs providing new public lighting assets and that customers seeking this service are likely to have some countervailing market power.

These factors contribute to the view that the Victorian DNSPs do not exercise significant market power in the provision of new public lighting assets.

SP AusNet's submission argues that the competitive market for new public lighting assets means that these services should be unclassified, rather than being treated as negotiated distribution services as the AER proposed in its preliminary positions paper. [109]

The AER considers that, despite the competitive nature of the market, it is not appropriate for new public lighting assets to be unclassified in the next regulatory control period and therefore subject to no regulatory oversight. This is because, although they do not currently exercise significant market power in the provision of these services, the DNSPs have the potential to do so by virtue of the economies of scale and scope provided by their shared network. Maintaining some regulatory oversight through the negotiate/arbitrate framework — where in the event of a dispute the AER will arbitrate in accordance with the framework in Part D and Part L of chapter 6 of the NER — is considered appropriate given the potential for DNSPs to exploit the market power they possess.

The AER considers that these factors, along with the ESCV's current classification of this service as a contestable excluded distribution service, indicate that new public lighting assets should be classified as negotiated distribution services.

The AER considers that this will result in the current form of regulation for these services being broadly retained.

[109] SP AusNet, op cit, p. 10.

AER's likely approach

The AER's likely approach is that the Victorian DNSPs' public lighting services should be classified in a manner which is consistent with the previously applicable regulatory approach, as no other classification is clearly more appropriate. On this basis, the AER proposes classifying:

- the operation, repair, replacement and maintenance of the Victorian DNSPs' public lighting assets as a direct control service and in turn as an alternative control service because of the DNSPs' monopoly position in the provision of these services, and the current classification of these services as excluded distribution services. There is no compelling reason to classify these services otherwise
- the alteration and relocation of the Victorian DNSPs' public lighting assets as a negotiated distribution service, on the basis that these services are currently provided on a competitive basis in accordance with the Public Lighting Code and the ESCV's Guideline 14, and
- new public lighting assets (standard and non-standard provision) as negotiated distribution services, on the basis that these services are currently provided on a competitive basis and are currently classified by the ESCV as contestable excluded distribution services.

2.7.3.5 Fee Based Services

The Victorian DNSPs provide a range of services on a fixed fee basis to retailers and customers. These services are generally homogenous in nature and scope and therefore their costs can be estimated with reasonable certainty. This means that a fixed fee can be set in advance for the provision of these services.

Current classifications

The AER understands that the Victorian DNSPs provide the following services on a fixed fee basis:

- the energisation of a new connection
- the de-energisation of an existing premises
- the re-energisation of an existing premises
- the provision of temporary supplies
- additional charges due to wasted attendance
- service truck visits
- the location of underground cables
- an elective underground service where an existing overhead service exists
- covering of low voltage mains for safety reasons
- a charge for damage to overhead service cables caused by high load vehicles, and
- attendance at site as a result of an emergency or fault call.

All of these services are classified as excluded distribution services in the current regulatory control period, in accordance with the EDPR and the 2005 Tariff Order.

The fixed fees for these services for the current regulatory control period are approved by the ESCV in accordance with the provisions of the DNSPs' electricity distribution licences and chapter 6, volume 2 of the EDPR.[110]

AER's preliminary position

The AER's preliminary position was that the Victorian DNSPs' fee based services should be classified in a manner consistent with the previously applicable regulatory approach, as no other classification was clearly more appropriate. On this basis, the AER's preliminary position was that these services should be classified as direct control services and then as alternative control services.

Issues and AER's considerations

The AER's presumption in relation to fee based services currently classified as excluded distribution services is that they should be classified as either alternative control services or negotiated distribution services for the next regulatory control period, having regard to the requirements in clause 6.2.1 of the NER.

In addition to certain distribution services currently classified as excluded services and provided on a fixed fee basis under the ESCV's regulatory framework, the AER proposed in its preliminary positions paper that several other distribution services be classified as fee based services (see Appendix A of that paper).

The AER received a number of submissions in response to its preliminary positions paper in relation to fee based services. While the submissions were supportive of establishing a grouping of fee based services, they proposed reclassifying certain services proposed by the AER for inclusion in this grouping. In particular:

- Citipower, Powercor[111] and SP AusNet[112] submit that an "elective underground service where an existing overhead service exists" should be classified as a quoted service given the variability in costs for this service. United Energy[113] and Jemena[114] submit that this service should be treated like other connections and augmentations and should therefore be classified as a negotiated distribution service. SP AusNet submits that it does not currently publish a fee for this service and considers that it should be classified as a quoted service.

  The AER understands that Citipower, Powercor and United Energy currently charge for this service on a fixed fee basis, albeit that they have different fees for different works. This was an important consideration for the AER in proposing that this service be classified as fee based. Although SP AusNet and Jemena do not publish a fee for this service, but rather apply their recoverable works rates, the fact that other DNSPs charge a fixed fee suggests that prices can be developed in advance for this service.

  On this basis, the AER's likely approach will be to classify this service as fee based. It is noted that DNSPs are able to propose, but must justify, alternative classifications in their regulatory proposals.

[110] ESCV, *EDPR, Final Decision Volume 2*, October 2006, chapter 6.

[111] Citipower and Powercor, op cit, p. 10.

[112] SP AusNet, op cit, p. 10.

[113] United Energy, op cit, p. 9.

[114] Jemena, op cit, p. 11.

- SP AusNet submits that it does not currently publish a fee for a "charge for damage to overhead service cables caused by high vehicles" and that this should be classified as a quoted service. [115]

  The AER understands that other DNSPs do charge for this service on a fixed fee basis. This was an important consideration for the AER in proposing that this service be classified as fee based.

  On this basis, the AER's likely approach will be to classify this service as fee based.

- SP AusNet also submits that its practice is not to distinguish between charges for wasted, and non-wasted, attendance at a customer's premises. [116]

  The AER understands that other DNSPs do make this distinction for these services and charge for them on a fixed fee basis. This was an important consideration for the AER in proposing that these services be classified as fee based.

  On this basis, the AER's likely approach will be to classify these services as fee based. As noted above, DNSPs are able to propose, but must justify, alternative classifications in their regulatory proposals. Alternatively, where appropriate, a DNSP could omit a particular service if it does not provide it or could structure its prices on the same basis for two different services that it considers should be charged the same amounts.

- United Energy submits that "service supply abolishment" should be treated as a quoted service, given that this service can vary in size and complexity.[117] United Energy[118] and Jemena[119] submit that "high load escorts" should be classified as a quoted service, given that this service can also vary in size and complexity. Jemena submits that "location of underground cables" and large scale "supply abolishments" should be classified as quoted services, given that these services can also vary in size and complexity.

  The AER considers that size and complexity differences for these services can be accommodated through the basis and structure of the prices for these services and that they should be classified as fee based services. The AER notes, for example, that Citipower currently has fixed fees in place for supply abolishment services.

- United Energy[120] and Jemena[121] submit that "watchman lights" should not be classified and should remain unregulated.

  The AER understands that these services are not currently regulated by the ESCV, that these lights are not part of the distribution system and that there are alternative providers of these services. Furthermore, these services are not regulated in several other jurisdictions, including Queensland.

  For these reasons, the AER agrees that "watchman lights" should remain unclassified, and therefore not regulated, in the next regulatory control period.

[115] SP AusNet, op cit, p. 10.
[116] SP AusNet, op cit, p. 10.
[117] United Energy, op cit, p. 9.
[118] Ibid.
[119] Jemena, op cit, p. 11.
[120] United Energy, op cit, p. 9.
[121] Jemena, op cit, p. 12.

The key characteristic of fee based services is that they involve undertaking works on, or in relation to, parts of the DNSPs' distribution network. Therefore, only the DNSP that owns the distribution network will be able to undertake these works and provide these distribution services, albeit that the DNSP may engage a third party to act on its behalf. In addition, the AER understands that:

- the network services provided by the Victorian DNSPs, discussed in section 2.7.3.1 of this chapter, provide positive externalities in the supply of fee based services, which could limit the prospect of effective competition in the market for fee based services. These network externalities may lead to barriers to entry, either in price or quality of service provided, which in turn may increase the market power of the DNSPs
- the fee based services are generally provided to individual customers on an infrequent 'as needs basis', which means that they would be unlikely to have substantial negotiating power in determining the price and other terms and conditions on which these services are provided
- customers generally do not have a credible ability to by-pass or avoid the provision of the services and their demand for the services is relatively price inelastic, and
- customers cannot source the services from a party other than a Victorian DNSP.

On this basis, and having regard to the factors in section 2F of the NEL, the AER considers there is a regulatory barrier to any party other than the Victorian DNSPs providing fee based services. Furthermore, the economies of scale and scope available to Victorian DNSPs, in particular in relation to its network services, are also likely to prevent fee based services being competitively provided by an alternative service provider. The AER also considers that there are no real substitutes for these services.

These factors contribute to the view that the Victorian DNSPs possess significant market power in the provision of fee based services.

The AER has had regard for clauses 6.2.1(c)(2) and (3) of the NER and notes that fee based services are currently subject to a control form of regulation in Victoria and that similar arrangements exist in several other jurisdictions in the NEM.

Having regard for the requirements of clause 6.2.1 of the NER, the AER considers that fee based services should be classified as direct control services.

Once a service is classified as a direct control service, the AER must then have regard to the six factors in clause 6.2.2(c) of the NER to determine whether it should be classified as a standard or alternative control service.

Fee based services are currently excluded distribution services, which creates the presumption that they should be classified as alternative control services unless there is a compelling reason otherwise. The AER considers that there is no basis to move away from this presumption. Having regard to the factors in clause 6.2.2, this is because:

- for the reasons noted above, there is little if any potential for the development of competition in the market for fee based services. The AER considers that its

classification will not influence the potential for competition — rather, the absence of competition reflects the fact that all of these services involve undertaking works on, or in relation to, parts of the DNSPs' distribution network

- there would be no material effect on administrative costs of the AER, DNSP or any other party. This is because classifying fee based services as alternative control services would involve a broadly similar regulatory approach to that which has been applied by the ESCV for the current regulatory control period
- fee based services are currently regulated in Victoria, and in other NEM jurisdictions such as Queensland, on a fixed fee basis
- the nature of fee based services is that they do not involve building new assets and the costs of providing the service can be directly attributed to individual customers, and
- there are no other relevant factors that change the AER's proposed classification.

For these reasons, the AER considers that there is no basis to move away from the presumption that fee based services should be classified as alternative control services.

AER's likely approach

The AER's likely approach is that the Victorian DNSPs' fee based services be classified in a manner consistent with the previously applicable regulatory approach, as no other classification is clearly more appropriate. On this basis, these services should be classified as direct control services and then as alternative control services.

2.7.3.6 Quoted services

The Victorian DNSPs provide a range of services on a quoted fee basis to retailers and customers. The nature and scope of these services are specific to individual retailers or customer's needs, and therefore the cost of providing the services cannot be estimated without first understanding the retailer's or customer's requirements. This means a DNSP must set individual prices for these services after they have been requested. It would not be appropriate to set a generic fixed fee in advance for the provision of these types of services.

Current classifications

The Victorian DNSPs provide the following services on a quoted fee basis:

- re-arrangement of network assets at customer request, including the alteration or relocation of existing public lighting assets
- supply enhancement at customer request, including undergrounding
- emergency recoverable works
- above standard connection and augmentation works — these have been proposed to be classified as negotiated distribution services by the AER in section 2.7.3.2 and are therefore not considered in this section
- auditing of design and construction, and

- specification and design enquiry fees.

All of these services are currently classified as excluded distribution services in the current regulatory control period in accordance with the EDPR and the 2005 Tariff Order.

In addition, the AER acknowledges it is possible that DNSPs could provide other above standard services on a quoted fee basis that are not specified above.

AER's preliminary position

The AER's preliminary position was that the Victorian DNSPs' quoted services should be classified in a manner which is consistent with the previously applicable regulatory approach, as no other classification was clearly more appropriate. On this basis, the AER's preliminary position was that these services should be classified as direct control services and in turn as alternative control services.

Issues and AER's considerations

The AER's presumption in relation to quoted services currently classified as excluded distribution services is that they should be classified as alternative control services or negotiated distribution services in the next regulatory control period, having regard for the requirements of clause 6.2.1 of the NER.

In addition to certain distribution services currently classified as excluded distribution services and provided on a quoted fee basis under the ESCV's regulatory framework, the AER proposed in its preliminary positions paper that several other distribution services be classified as quoted services (see Appendix A of that paper).

The AER received a number of submissions in response to its preliminary positions paper in relation to quoted services. While the submissions were supportive of establishing a grouping of quoted services, they proposed reclassifying certain services proposed by the AER for inclusion in this grouping. In particular:

- Citipower and Powercor jointly propose that "non-emergency recoverable works" should either be added as a quoted service or treated as a negotiated service.[122] The AER did not include this category of services in its preliminary positions paper, although it did include "emergency recoverable works" as a quoted service.

  It is not clear to the AER what types of recoverable works Citipower and Powercor consider should be included in this category of service, that would not otherwise be covered by other services that the AER has nominated. For this reason, the AER does not propose including this service in this framework and approach paper as an additional quoted service. However, DNSPs are able to nominate, but must justify, additional services for classification in their regulatory proposals.
- SP AusNet submits that a number of services that are currently included in the 2005 Tariff Order do not appear to have been classified in the preliminary positions paper, including inter network provider distribution, network services for connection where customers operate parallel generation and require a standby supply, provision of reserve (duplicate) supply, charges for higher quality and

[122] Citipower and Powercor, op cit, p. 10.

reliability, charges to operators of embedded generation units, charges for non-compliance with the distribution code, and charges for the provision or receipt of reactive power. [123]

The AER intended that these services would be covered by the service category of "supply enhancements at customer request". However, to the extent that DNSPs do not consider this appropriate, they are able to nominate, but must justify, additional services for classification in their regulatory proposals.

- Jemena proposes splitting the "customer requested rearrangement of network assets or supply enhancement" into large-scale works to be classified as negotiated distribution services and small-scale works to be classified as quoted services.[124]

  The AER does not agree that services should be classified on the basis of the size of the works being provided. Rather, they should be classified based on the requirements of clauses 6.2.1 and 6.2.2 of the NER. For this reason, the AER's likely approach will be to classify all works undertaken as part of supply enhancement at a customer's request as a quoted service. DNSPs are able to propose, but must justify, alternative classifications in their regulatory proposals.

- Jemena submits that "auditing of design and construction" and "specification and design enquiry fees" are currently offered under a negotiation framework under the ESCV's Guideline 14 and therefore should be classified as negotiated distribution services. [125]

  The AER agrees that the ESCV's Guideline 14 provides a form of negotiation framework for 'connection and augmentation works' and, on this basis, its likely approach is to classify these services as negotiated distribution services in the next regulatory control period.

  However, the AER considers that services relating to the "auditing of design and construction" and "specification and design enquiry fees" are different in nature because they can only be provided by or on behalf of the DNSP. For this reason, the AER's likely approach will be to classify these services as quoted services. Again, it is noted DNSPs are able to propose, but must justify, alternative classifications in their regulatory proposals.

- United Energy submits that "the alternation and relocation of existing DNSP network assets" was not classified in the AER's preliminary positions paper but should be treated as a negotiated service.[126]

  The AER intended that this service would be covered by the service "rearrangement of network assets at customer request". The AER classified this as a quoted service in its preliminary positions paper on the basis that these works could only be undertaken by a DNSP. For this reason, the AER's likely approach will be to classify these services as quoted services.

As with fee based services, the key characteristic of all the quoted services is that they involve undertaking works on, or in relation to, parts of a DNSP's distribution

[123] SP AusNet, op cit, p. 11.

[124] Jemena, op cit, p. 8.

[125] Ibid, p. 9.

[126] United Energy, op cit, p. 10.

network. Therefore, only the DNSP that owns the distribution network is able to undertake these works and provide these distribution services, albeit that the DNSP may engage a third party to act on its behalf.

On this basis, and having regard to the factors in section 2F of the NEL, the AER considers that there is a regulatory barrier to any party other than the Victorian DNSPs providing quoted services. Furthermore, the economies of scale and scope available to a Victorian DNSP, in particular in relation to its network services, are also likely to prevent quoted services being competitively provided by an alternative service provider.

The AER also considers that:

- for most quoted services, the network user has no genuine choice in the supply of the services, whereas
- for some quoted services, such as a supply enhancement, the customer's choices are likely to be limited to embedded generation, switching to an alternative energy source, such as natural gas, or switching the connection point to the transmission network. These are unlikely to be viable commercial options in most instances for most existing large and small customers.

These factors contribute to the view that the Victorian DNSPs possess significant market power in the provision of quoted services.

The AER has had regard for clauses 6.2.1(c)(2) and (3) of the NER and notes that quoted services are currently subject to a control form of regulation in Victoria. The AER understands that this is also the case in several other NEM jurisdictions.

Having regard for the requirements of clause 6.2.1 of the NER, the AER considers that quoted services should be classified as direct control services.

Once a service is classified as a direct control service, the AER must then have regard to the six factors in clause 6.2.2(c) of the NER to determine whether it should be classified as a standard or alternative control service.

Quoted services are currently classified as excluded distribution services, which creates the presumption that they should be classified as alternative control services in the next regulatory control period, unless a different classification is clearly more appropriate.

Having regard to the factors in clause 6.2.2 of the NER, the AER considers that all quoted services should be classified as alternative control services because:

- for the reasons noted above, there is little if any potential for the development of competition in the market for quoted services. The AER considers that its classification will not influence the potential for competition — rather, the absence of competition reflects the fact that all of these services involve undertaking works on, or in relation to, parts of the DNSPs' distribution network
- there would be no material effect on administrative costs of the AER, DNSP or any other party. This is because classifying quoted services as alternative control

services would involve a broadly similar regulatory approach to that which has been applied by the ESCV for the current regulatory control period

- quoted services are currently regulated in Victoria, and the AER understands in several other NEM jurisdictions, on quoted fee basis
- the nature of quoted services is that the costs of providing the service can be directly attributed to individual customers, and
- there are no other relevant factors that change the AER's proposed classification.

For these reasons, the AER considers that there is no basis to move away from the presumption that quoted services should be classified as alternative control services.

AER's likely approach

The AER's likely approach is that the Victorian DNSPs' quoted services should be classified in a manner which is consistent with the previously applicable regulatory approach, as no other classification is clearly more appropriate. On this basis, these services should be classified as direct control services and in turn as alternative control services.

2.8 AER's likely approach to service classification

Except where the NER require that a service of a specified kind be classified in a particular way, in classifying distribution services that have previously been subject to regulation under the present or earlier legislation, the NER require the AER to act on the basis that, unless a different classification is clearly more appropriate:

- there should be no departure from a previous classification (if the services have been previously classified), and
- if there has been no previous classification — the classification should be consistent with the previously applicable regulatory approach.[127]

Having regard to the regulatory approach applicable to distribution services provided by the Victorian DNSPs in the current regulatory control period and the requirements of clauses 6.2.1 and 6.2.2 of the NER, in the next regulatory control period, the AER's likely approach is that distribution services currently classified as:

- prescribed distribution services will be classified as direct control services, and further classified as standard control services
- excluded distribution services and prescribed metering services that are unmetered supplies will be classified as alternative control services, and
- connection and augmentation works for new customer connections, new public lighting assets and the alteration and relocation of the Victorian DNSPs' public lighting assets will be classified as negotiated distribution services.

The AER's likely approach is that, having considered and assessed the classifications currently in place for all services against the factors in clauses 6.2.1 and 6.2.2 of the

[127] NER, cll. 6.2.1(d) and 6.2.2(d).

NER, there is nothing to suggest that classifying the services differently to that detailed above is clearly more appropriate.

In reaching this position the AER also considers:

- the form of regulation factors in the NEL embody a market power assessment which underlies the reasons for classifying all services, with the exception of connection and augmentation works for new customer connections, new public lighting assets and the alteration and relocation of the Victorian DNSPs' public lighting assets, as direct control services

- it would not be appropriate, given the nature of the services currently classified as prescribed distribution services (except unmetered supplies), to classify these as other than standard control services, and

- it would not be appropriate, given the nature of the services currently classified as excluded distribution services (other than connection and augmentation works for new customer connections, new public lighting assets and the alteration and relocation of the Victorian DNSPs' public lighting assets, which are proposed to be classified as negotiated distribution services) and prescribed metering services for unmetered supplies, to classify these services in a manner other than alternative control services.

The NER also require the AER to have regard to the desirability of consistency in the regulatory approach and form of regulation within, and beyond, NEM jurisdictions. The AER's likely approaches set out in this paper achieve consistency in the treatment of like services within Victoria. However, this may not be possible between NEM jurisdictions in the first round of regulatory determinations given that the NER require the maintenance of consistency with previous regulatory approaches which may differ across jurisdictions. That said, the AER considers greater consistency in how similar services are classified across jurisdictions is a medium to longer term objective to the extent possible. The AER considers that different classifications for similar services may continue to be appropriate given differing circumstances (such as different legislative barriers to contestability that apply to similar services) between jurisdictions.

The AER has considered the cost implications of the transition to the new regulatory framework in chapter 6 of the NER, and the need to ensure that this transition does not impose unjustified costs on DNSPs and users. In the context of the presumption in favour of the previous classification, the AER is satisfied that the likely approaches set out in this paper provide for a smooth transition to the benefit of both the Victorian DNSPs and users, and does not impose unnecessary costs.

The AER's likely approaches to the classification of distribution services provided by the Victorian DNSPs are set out in the table below.

Table 2.3 AER's likely approaches – classification of Victorian DNSPs' distribution services

Service grouping	Negotiated distribution services	Direct control Services - standard control services	Direct control services - alternative control services
Network services		All "standard" network services	
Connection services	Connection and augmentation works for new customer connections		Connection - energisation
Metering services			Metering services for unmetered supplies
Public lighting services	New public lighting Alteration and relocation of DNSP public lighting assets		Operation, repair, replacement and maintenance of DNSP public lighting assets
Fee based services			All fee based services
Quoted services			All quoted services

Source: AER analysis.

The AER considers that these classifications are likely to cover the full spectrum of the DNSP's distribution services, other than:

- meter provision services and metering data provision services for customers with annual consumption of 160 MWh or more that are serviced by type 1 to 4 remotely read interval meters,
- metering services provided to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters,
- the metering services that will be regulated under the November 2008 AMI Order in Council, and
- the provision of watchman lights,

which are not classified in this framework and approach paper.

Table 1 of Appendix A of this paper includes general descriptions of the types of activities that fall within each proposed service group, although it does not purport to provide a complete listing of the underlying services provided by the Victorian DNSPs. It is also noted that:

- some DNSPs do not provide all of these services, and
- the DNSPs can nominate additional services or propose changes to the AER's likely approach in their regulatory proposals but must justify any changes or additional services proposed.

3 Control mechanisms

3.1 Introduction

This chapter states the forms of the control mechanisms to be applied to the Victorian DNSPs' direct control services for the next regulatory control period. Direct control services consist of standard control services and alternative control services. Different control mechanisms may apply to each of these classifications, or to services of the same classification.

This chapter does not deal with the form of control for negotiated distribution services, which are regulated under the negotiate/arbitrate framework set out in Part D of chapter 6 of the NER.

The AER's likely approach to the classification of the Victorian DNSPs' distribution services was discussed in chapter 2 of this paper.

3.2 Requirements of the NEL and NER

A distribution determination imposes controls over the prices of direct control services, and/or the revenue to be derived from direct control services.[128] The AER's framework and approach paper must state the form or forms of the control mechanisms to be applied by the distribution determination to direct control services and the AER's reasons for deciding on control mechanisms of the relevant form or forms.[129]

Unlike other elements of the framework and approach paper, the AER's statement of the form or forms of the control mechanisms in the framework and approach paper is binding on the AER and the DNSP for the relevant distribution determination — that is, the control mechanisms to apply in the distribution determination must be as set out in the framework and approach paper.[130]

3.2.1 Available control mechanisms

The NER limit the available control mechanisms that may be applied to direct control services. That is, these are the only available control mechanisms for both standard control and alternative control services. Control mechanisms in the NER comprise two parts:

- the form of control mechanism,[131] and
- the basis of the control mechanism.[132]

Clause 6.2.5(b) of the NER lists the available options for the *form* of control, which are:

[128] NER, cl. 6.2.5(a).
[129] NER, cl. 6.8.1(c).
[130] NER, cl. 6.12.3(c).
[131] NER, cl. 6.2.5(b).
[132] NER, cl. 6.2.6(a).

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

The forms of control mechanism available for standard and alternative control services are the same. The *basis* for the control mechanism, however, can differ depending on which class of services it is to apply to. This is discussed in turn below in relation to standard control and alternative control services.

3.2.2 Standard control services

In deciding on a control mechanism for standard control services, the factors in clause 6.2.5(c) of the NER that the AER must have regard to are:

- the need for efficient tariff structures
- the possible effects of the control mechanism on administrative costs of the AER, the DNSP and users or potential users
- the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination
- the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction), and
- any other relevant factor.

The basis of the control mechanism for standard control services must be the prospective CPI−X form or some incentive-based variant of the CPI−X form in accordance with Part C of chapter 6 of the NER.[133]

3.2.3 Alternative control services

The factors the AER must have regard to in deciding on a control mechanism for alternative control services are the same as those for standard control services in all but one respect. Whereas for standard control services the AER must have regard to the need for efficient tariff structures, for alternative control services the AER must instead have regard to the potential for development of competition in the relevant market, and how the control mechanism might influence that potential.[134]

The control mechanism must have a basis specified in the distribution determination.[135] This may, but need not, utilise elements of Part C of chapter 6 of the NER with or without modification. For example, the control mechanism may (but

[133] NER, cl. 6.2.6(a).
[134] NER, cl. 6.2.5(d)(1).
[135] NER, cl. 6.2.6(b).

need not) use a building block approach, and may (but need not) incorporate a pass-through mechanism.[136]

3.3 Overview of current forms of control for the Victorian DNSPs

3.3.1 Prescribed distribution services

The characteristics of the control mechanism for prescribed distribution services under the EDPR are summarised as follows:

- the revenue requirement for prescribed distribution services is developed using a building block approach
- once approved by the ESCV, the total revenue requirement is translated into a set of prescribed distribution charges by the Victorian DNSPs using forecasts of growth over the regulatory control period. Prescribed distribution services are then regulated under a CPI−X weighted average price cap control mechanism,[137] and
- the ESCV annually approves re-balancing mechanisms under the weighted average price cap, as well as network tariffs before the DNSPs issue their tariff schedules to take effect from 1 January each year in line with the EDPR. The distribution tariff re-balancing constraint is CPI+2 per cent during the 2006-10 regulatory control period.[138] Adjustments are applied by the ESCV to the constraint equation to take account of S factors and L factors (i.e. for the ESCV's service incentive scheme and licence fee arrangements).

This control mechanism is a weighted average price cap, otherwise known as a tariff basket.

3.3.2 Prescribed metering services

The ESCV set a separate control mechanism for the Victorian DNSPs' prescribed metering services in its EDPR, although it is in a similar form to that which applies to prescribed distribution services. The control mechanism which applies to prescribed metering services is also a weighted average price cap (or tariff basket) and its characteristics are similar to the control mechanism applied to prescribed distribution services, that is:

- the revenue requirement for prescribed metering services is developed using a building block approach
- once approved by the ESCV, the total revenue requirement is translated into a set of prescribed metering charges by the Victorian DNSPs using forecasts of growth over the regulatory control period. Prescribed metering services are then regulated under a CPI−X weighted average price cap control mechanism,[139] and

[136] NER, cl. 6.2.6(c).
[137] ESCV, *EDPR, Final Decision Volume 1*, October 2006, p. 467.
[138] Ibid, p. 478.
[139] Ibid, p. 565.

- the ESCV annually approves re-balancing mechanisms under the weighted average price cap as well as network tariffs before the DNSPs issue their tariff schedules to take effect from 1 January each year in line with the EDPR.

As noted in chapter 2 of this paper, only certain metering services are within the scope of the AER's framework and approach paper for the 2011–15 regulatory control period.

3.3.3 Excluded distribution services

The list of current excluded distribution services in Victoria is set out in the EDPR, the 2005 Tariff Order and the 2007 AMI Order in Council. There are three sub-categories of excluded distribution services in Victoria, being:

- non-contestable excluded distribution services — fee based services and public lighting services
- non-contestable excluded distribution services — recoverable works and "quoted" services, and
- contestable excluded distribution services.

3.3.3.1 Non-contestable excluded distribution services — fee based services and public lighting services

The control mechanism for excluded distribution services in Victoria is set out in the 2005 Tariff Order. The 2005 Tariff Order applies to all (contestable and non-contestable) excluded distribution services and does not distinguish between the three sub-categories of excluded distribution services.

Clause 2.2(h) of the 2005 Tariff Order requires that the:

> terms and charges for a Distributor's Excluded Services will be set in accordance with the provisions of the Distributors' Distribution licences issued under Division 3 of Part 2 of the EIA and any applicable guidelines published by the ESC and subject to oversight by the ESC Act.

Clause 12.1 of the Distribution Licences[140] provides that:

> The charge for and terms and conditions on which, in the conduct of its distribution business, the Licensee provides any excluded service other than an excluded service contemplated by clauses 6, 7, 8, 9 or 10 must be fair and reasonable and consistent with:
>
> (a) the Price Determination or any other applicable price determination made by the Commission; and
>
> (b) any applicable approved statement.

This means that the prices for excluded distribution services in Victoria must be fair and reasonable, and must be consistent with the EDPR for the current regulatory control period.

[140] Clause 12.1 is replicated in each DNSP business licence. For an example, see http://www.esc.vic.gov.au/NR/rdonlyres/8D3FC942-5316-4BB9-A592-DC169567C339/0/ElecDistributionLicenceUED_Jan05.pdf.

Attachment 15, of volume 2 of the EDPR defines the fee based services and associated charges provided by Victorian DNSPs.[141] The control mechanism for these services is a price cap, given effect by the approval of an up-front price for these services in the EDPR, with no automatic escalation applied to these prices over the regulatory control period. Where a DNSP wishes to amend its schedule of charges, it must submit an application in accordance with the relevant guideline.

The ESCV noted in volume 1 of the EDPR that the schedule of excluded distribution services' charges maintained by the DNSPs had remained largely unchanged since 1999.[142] The AER understands that no revisions have occurred to these charges since that time, although section 15.3 of the EDPR Volume 1 states that:

- distributors can apply for variations in excluded service charges at any time, although certain supporting information is required to be provided with any such application.

The process for adjusting the prices for which all excluded distribution services are offered is set out in section 15.3 of volume 1 of the EDPR, which also sets out the information that the ESCV requires for the escalation of the prices for excluded distribution services. This information includes:

- The charges (and associated terms and conditions) that the distributor proposes to charge for the excluded service.
- Information that demonstrates compliance of the proposed excluded service charge with the following requirements set out in clause 5.6.2 of Electricity Industry Guideline No. 14:
  - Costs of service provision: a distributor's charge and terms and conditions for an excluded service must be based on the costs incurred by the distributor in providing the excluded service.
  - Cost allocation: in respect of the costs incurred by a distributor in providing an excluded service:
    - those costs must not include costs in respect of which the distributor is remunerated under the distributor's distribution tariff; and
    - those costs must only include an appropriate allocation of any shared or common costs incurred by the distributor in providing the excluded service and in providing any other goods or services, whether in the conduct of the distributor's business as a distributor or any other business.
  - Cost differentials: a distributor's charge and terms and conditions for an excluded service must be the same for all customers unless there is a material difference in the costs of providing the excluded service to different customers or classes of customers. Different charges and terms and conditions for different customers or classes of customers must only be attributable to differences in:
    - the volume or quantity of the excluded service provided;
    - the places to or from which the excluded service is provided;
    - the time of day at which the excluded service is provided;

[141] ESCV, *EDPR, Final Decision Volume 2*, October 2006, Attachment 15.
[142] ESCV, *EDPR, Final Decision Volume 1*, October 2006, p. 600.

- the performance characteristics at which the excluded service is provided; or
- any other difference in the costs of providing the excluded service.
- simplicity: charges and terms and conditions for excluded services should be simple and easily comprehensible.

- Reported historic costs and the estimated costs of providing the excluded service.
- The reported historic and current demand for the excluded service, demand forecasts, and
- the method that was used to determine those forecasts, for the excluded service.
- Information on the allocation of costs between prescribed and excluded services, and within excluded services, and the method that was used to determine this allocation.

Under the EDPR, in the absence of submitting the above information, "the charges for excluded services will not be subject to automatic indexation".[143] The AER understands that the prices for these services have, to date, not been automatically indexed. The exception to this has been the operation, maintenance, repair and replacement charge for public lighting, which has been adjusted annually since 2008 at the request of DNSPs.

3.3.3.2 Non-contestable excluded distribution services — recoverable works and quoted services

While not explicitly differentiated in the EDPR or the 2005 Tariff Order, there is another sub-category of non-contestable excluded distribution services, the prices for which are not set in advance. These are the non-contestable services, which are quoted by the DNSP based on the application of unit rates. Section 15.2.1 of volume 1 of the EDPR states that:

> Where a distributor's existing schedule of excluded services includes excluded service charges that are recovered on a recoverable works basis, the distributor must provide standard labour recoverable works rates (applicable to business hours and after hours). These must be submitted to the Commission no later than 30 November 2005, in accordance with Electricity Industry Guideline No. 14. In the absence of such information, the charge for any services provided on a recoverable works basis will be zero from 1 January 2006.

This means that the ESCV approves "unit rates" for these types of non-contestable (quoted) excluded distribution services, where the nature and scope of the service cannot be known in advance of the service being requested. The control mechanism for these types of services is a variant of a price cap, where the components of the costs underpinning the price are capped, *although the total cost that the customer pays for the service is not itself capped.*

As these are excluded distribution services under the EDPR, the price caps on the unit costs that apply to these services are not automatically indexed each year. In accordance with section 15.3 of volume 1 of the EDPR, the Victorian DNSPs may make a submission to the ESCV to have these charges increased.

[143] Ibid, p. 603.

3.3.3.3 Contestable excluded distribution services

The final sub-category of the Victorian DNSPs' excluded distribution services are their contestable excluded distribution services. The distinction between contestable and non-contestable excluded distribution services is given effect by the EDPR which provides that prices for excluded distribution services must be set in accordance with the ESCV's Guideline 14. Clause 5.3.1 of Guideline 14 states that:

> If the Commission decides that an excluded service is a contestable excluded service, the Commission will not require any distributor to submit any statement of a proposed charge and terms and conditions for that excluded service for approval under clause 16 of the distributor's distribution licence.

Clause 5.3.2 of Guideline 14 sets out the matters that the ESCV will have regard to in considering whether to classify a distribution services as a contestable excluded distribution service.

If the ESCV classifies an excluded distribution service as a contestable excluded distribution service, the charge for that service does not need to be approved by the ESCV. There is therefore no control mechanism applied to these services.

3.3.3.4 Conclusion

The AER considers it is correct to characterise the current control mechanism in Victoria for fee based services, public lighting services, recoverable works and other quoted services as a price cap. Indexation is not automatically applied to the capped prices. The Victorian DNSPs must make a submission to the ESCV, and the ESCV must approve any such proposal, before any price increases can be implemented.

No control mechanism is currently applied to contestable excluded distribution services.

3.4 AER's preliminary position on the forms of control mechanisms

3.4.1 Standard control services

The AER's preliminary position was to apply a weighted average price cap to standard control services in the next regulatory control period. The AER's preliminary position was based on the following considerations, which it had regard to in accordance with clause 6.2.5(c) of the NER:

- a weighted average price cap is the current control mechanism for the Victorian DNSPs' prescribed distribution services and is one of the control mechanisms listed in clause 6.2.5(b) of the NER that can be applied in the next regulatory control period[144]
- the incentives and risks of this control mechanism are widely recognised. Importantly, this form of control allows the Victorian DNSPs to manage uncertainty in outturn volume by re-balancing their tariffs

[144] NER cl. 6.2.5(b)(4).

- there are provisions in place under clause 6.18 of the NER that require the AER to carefully examine tariff structures for efficiency as part of the pricing proposal process
- retaining the current form of control for standard control services maintains consistency in the regulation of those services across Victoria. The AER considered that consistency of regulatory approaches within jurisdictions was an important initial goal, while noting that achieving consistency across jurisdictions was a medium to longer term objective,[145] and
- transitioning to a completely new form of control mechanism would not guarantee a reduction in administrative costs, and may itself create undesirable administrative costs.[146]

3.4.2 Alternative control services

The AER's preliminary position was to apply price caps in the next regulatory control period to the:

- unit costs for the quoted services grouping of alternative control services (including the alteration and relocation of existing public lighting assets), and
- individual prices for all of the other alternative control services, with a limited building block approach being applied to the operation, repair, replacement and maintenance of public lighting assets.

The AER's preliminary position was based on the following considerations it had regard to in accordance with clause 6.2.5(d) of the NER:

- a price cap is the current control mechanism for the Victorian DNSPs' excluded distribution services and is one of the control mechanisms listed in 6.2.5(b) of the NER that can be applied in the next regulatory control period[147]
- it was considered unlikely that there would be any impact on the development of competition in the market for these services as a result of applying a price cap control mechanism
- retaining the current form of control for all alternative control services maintains consistency in regulation of those services across Victoria, and it was appropriate that this control mechanism be extended to the currently prescribed metering services (unmetered supplies) on the basis that it would not be appropriate to apply a weighted average price cap just to these services, and
- transitioning to a completely new form of control mechanism, other than in the case of the currently prescribed metering services (unmetered supplies), would not guarantee a reduction in administrative costs, and may itself create undesirable administrative costs.

[145] NER cl. 6.2.5(c)(4).
[146] NER cl. 6.2.5(c)(2).
[147] NER cl. 6.2.5(b)(4).

3.5 Summary of submissions

The AER received submissions from the following stakeholders in response to its preliminary positions paper in relation to the control mechanisms to apply to the DNSPs' distribution services:

- Citipower
- Jemena
- Powercor
- SP AusNet
- United Energy
- Origin Energy
- AGL
- The Victorian Council of Social Services (VCOSS)
- The Trans Tasman Energy Group, and
- The Streetlight Group of Councils.

All of the submissions that the AER received about the control mechanism to apply to standard control services support the retention of a weighted average price cap for the Victorian DNSPs for the next regulatory control period. However, submissions from AGL[148], Origin Energy[149] and VCOSS[150] express concern about the incentives that this form of control mechanism can create and the distribution pricing impacts that may result from its application. Citipower and Powercor's joint submission seeks clarification regarding:

- whether the L-factor will be retained in the weighted average price cap, and
- how foregone revenue arising from the application of the DMIS will be reflected into the weighted average price cap.[151]

United Energy's[152] and SP AusNet's[153] submissions support a simple and practical approach to setting prices for alternative control services.

Citipower, Powercor,[154] United Energy[155] and SP AusNet[156] all express concern in their submissions regarding their current excluded services prices not being annually indexed during the current and previous regulatory control periods.

[148] AGL, *Framework and Approach Paper: Powercor, Jemena, SP AusNet and United Energy*, 6 March 2009, p. 2.
[149] Origin, op cit, p. 2-4.
[150] VCOSS, *Framework and approach paper for the regulatory period commencing 1 January 2011*, 5 March 2009, p. 3.
[151] Citipower and Powercor, op cit, p. 5.
[152] United Energy, op cit, p. 4.
[153] SP AusNet, op cit, p. 13.
[154] Citipower and Powercor, op cit, p. 5-8.
[155] United Energy, op cit, p. 4.
[156] SP AusNet, op cit, p. 13.

Several submissions were received in relation to public lighting services:

- Citipower's, Powercor's[157] and Jemena's[158] submissions seek more information about the nature of a limited building block approach and what information will be required in their regulatory proposals
- The Streetlight Group of Councils submit that tariff rate changes in the current regulatory control period are problematic for Councils as they are not consistent between DNSP's or between years and further submit that they do not receive sufficient information about the rate changes,[159] and
- The Streetlight Group of Councils raise concern about the limitations in public lighting data and the need for future prices to be set using accurate data.[160]

Citipower and Powercor's joint submission seeks more detail regarding the basis on which individual prices for alternative control services will be determined, and propose the application of a top down approach to price setting.[161]

3.6 Issues and AER's considerations – standard control services

In its framework and approach paper the AER must state the form of control mechanism or mechanisms that will apply to standard control services during the 2011-16 regulatory control period.

The factors to which the AER must have regard when deciding on the control mechanism to apply to standard control services are set out in section 3.2.2 above.

The current control mechanism for prescribed distribution services for the Victorian DNSPs is a weighted average price cap. The basis of the control mechanism is an incentive based variant of CPI−X. Subject to the factors to which the AER must have regard in selecting a control mechanism for standard control services, the current control mechanism is available to the AER under clauses 6.2.5(b) and 6.2.6(a) of the NER.

3.6.1 Current regulatory arrangements applied to Victorian DNSPs

If the AER applied a weighted average price cap control mechanism to the Victorian DNSPs' standard control services then this would be the same control mechanism that is currently applied by the ESCV to the Victorian DNSPs' prescribed distribution services.

3.6.2 Incentives and risks

In determining the form of control mechanism for standard control services, and in addition to the factors prescribed in clause 6.2.5(c), the NER makes provision for the AER to also consider any other factor it considers relevant.[162] The AER considers that

[157] Citipower and Powercor, op cit, p. 8-9.
[158] Jemena, op cit, p. 6.
[159] Streetlight Group of Councils / Trans Tasman Energy Group, op cit, p. 5.
[160] Ibid, p. 2.
[161] Citipower and Powercor, op cit, p. 5-8.
[162] NER, cl. 6.2.5(c)(5).

both the incentive and risk properties generated by specific control mechanisms are important considerations in this respect.

The AER recognises that weighted average price caps can potentially have undesirable properties, such as:

- creating incentives on the DNSP to set prices which increase the usage of electricity, which can undermine efficient demand management practices
- creating incentives to increase connections to high-volume users, while reducing connections to low-volume customers, and
- exposing the DNSP to volume risks when electricity sales volumes fall below forecast levels (making it difficult for the DNSP to recover its costs), albeit that these risks can be managed through tariff re-balancing arrangements.

These incentive and risk properties arise because of the discrepancy that can occur between a DNSP's revenue and costs after initial prices have been set under a weighted average price cap. Under a weighted average price cap, the DNSP's revenue increases with the volume of electricity sales. In contrast, the costs of providing a distribution network are largely independent of electricity volumes and depend, rather, on factors such as the number of customers and the peak capacity that is required to deliver electricity to each customer.

The AER recognises, however, that a weighted average price cap also provides DNSPs with the ability to manage unexpected variations in volumes by re-balancing their tariffs, and encourages DNSPs to manage their costs within the constraints of their tariff revenue. Moreover, the Victorian DNSPs have also had significant experience in the use of weighted average price caps, having applied them over the last two regulatory control periods.

In its submission to the AER on the preliminary positions paper, VCOSS argues that the weighting average price cap should include a mechanism by which any "windfall profits" made by DNSPs caused by volume increases can be returned to consumers.[163] The AER does not favour this approach because:

- it would likely undermine the incentives in the weighting average price cap for DNSPs to re-balance their tariffs each year
- it would suggest that consumers should also share in the volume risks when electricity sales volumes fall below forecast levels, and
- it considers that the EBSS and STPIS provide better incentives for DNSPs regarding their service performance and business efficiency than the sharing of "windfall profits".

The AER considers that the potential impacts on incentives and risks are not sufficient to support a change from the current control mechanism that applies to prescribed distribution services in Victoria in regulating standard control services in the next regulatory control period. In addition, the application of incentive arrangements such as the STPIS and EBSS will provide additional incentives for the Victorian DNSPs to focus on areas which have the potential to be of particular concern to customers, such

[163] VCOSS, op cit, p. 3.

as service performance. The nature of, and values that apply to, these mechanisms are considered in the context of the incentive schemes discussed in chapters 4 and 5 of this paper.

3.6.3 The need for efficient prices

Clause 6.2.5(c)(1) of the NER requires the AER to have regard to the need for efficient tariff structures. In this context it is worth noting that the AER's application of a weighted average price cap control mechanism will be accompanied by:

- a robust approval process of prices for standard control services by the AER in accordance with the requirements of clause 6.18 of the NER
- re-balancing side constraints, applied in accordance with clause 6.18.6 of the NER, that can limit the tariff change that a DNSP can make each year, within the overall weighted average price cap constraint, and
- a requirement for the Victorian DNSPs to manage volume fluctuations, while requiring them to meet both the overall weighted average price cap constraint and side-constraint requirements on individual tariff movements.

The primary incentives for a DNSP under a weighted average price cap are to:

- grow load to the greatest extent possible in order to maximise the total revenue that it receives, and
- subject to side constraints, re-balance tariffs away from tariff groups which are experiencing lower than forecast volume growth to tariff groups which are growing more strongly than expected.

These objectives, of themselves, do not lead to inefficient pricing behaviour.

In their submissions to the AER on the preliminary positions paper, AGL[164] and Origin Energy[165] support the continued application of a weighted average price cap but express concern about:

- there being no requirements for distribution tariffs to be cost reflective, and
- the long term stability of tariffs and the alignment of tariff structures across the energy supply chain.

VCOSS submit that specific parameters should be placed around tariff re-balancing.[166]

Chapter 6 of the NER establishes separate processes for the AER setting a DNSP's control mechanism and for approving a DNSP's distribution prices. The control mechanism is set in this framework and approach paper and applied by the DNSP in its regulatory proposal. Once the AER has issued its distribution determination, which for the Victorian DNSPs will be by 31 October 2010, the DNSP will submit its pricing proposal to the AER for approval. The Victorian DNSPs will submit their pricing proposals to the AER in mid November 2010.

[164] AGL, op cit, p. 2.
[165] Origin, op cit, p. 2-4.
[166] VCOSS, op cit, p. 3.

The AER has considerable influence in setting prices for standard control services through the approval of the Victorian DNSPs' pricing proposals to be made under clause 6.18.8 of the NER. This approval requires the AER to be satisfied that the pricing principles in clause 6.18.5 of the NER have been met, which in turn requires the AER to be satisfied that, among other things, the revenue from tariff groups is within reasonable ranges and that tariffs reflect long run marginal costs.

On this basis, it is not appropriate for the AER to deal with pricing specific matters in setting the control mechanisms to apply to the Victorian DNSPs in this framework and approach paper. Rather, the types of distribution pricing issues that AGL, Origin Energy and VCOSS raise in their submissions on the preliminary positions paper will be dealt with when the AER considers the DNSPs' pricing proposals. In this context, the AER notes that clause 6.18.6 of the NER details the requirements on side constraints on tariffs for standard control services, which the DNSPs will need to have regard for in re-balancing their tariffs.

The AER will not, having regard to the need for efficient prices, alter the current control mechanism for standard control services in Victoria from a weighted average price cap.

3.6.4 The desirability of consistency

Clause 6.2.5(c)(4) of the NER require the AER to have regard to the desirability of consistency between regulatory arrangements for similar services, both within and beyond the relevant jurisdiction.

As noted above in this chapter, the current control mechanism in Victoria is a weighted average price cap. The continuation of this control mechanism into the future is therefore consistent with the previous approach.

In relation to the consistency of mechanisms across jurisdictions, the AER notes that no single control mechanism is currently applied to prescribed distribution services (and by presumption, standard control services) in the NEM. A weighted average price cap, average revenue cap and revenue cap (subject to minor variations) are each applied in different NEM jurisdictions, although a weighted average price cap is now applied in a number of jurisdictions.

The AER's considers that the pursuit of consistency in the control mechanisms between jurisdictions is a matter to be considered in the medium to longer term, and that consistency between jurisdictions should not be a driving consideration in selecting a control mechanism for the Victorian DNSPs at this time.[167]

The AER will in the future give more detailed consideration to the desirability of applying common control mechanisms to standard control services provided by all DNSPs across the NEM. Further analysis is expected to be conducted on this issue through a number of regulatory processes before the AER reaches a final position on this issue. Any such decision will be made with due regard to the reasons that different control mechanisms have been applied in particular jurisdictions to date.

[167] Notwithstanding this, it is noted that the AER's decision regarding the control mechanism for standard control services in South Australia over the 2010-15 regulatory control period is to apply a weighted average price cap.

The AER notes, however, that it is desirable for the control mechanism to be consistently applied to similar services within each NEM jurisdiction. For this reason, the AER's has decided that a single control mechanism should be applied to standard control services provided by the five Victorian DNSPs in the next regulatory control period.

3.6.5 Administrative costs

Clause 6.2.5(c)(2) of the NER requires the AER to consider the possible effects of the control mechanism on administrative costs of the AER, the DNSP and users or potential users.

Ideally, a control mechanism should minimise the complexity and administrative burden for the AER, the DNSP and users, without compromising the effectiveness of the constraint. Simplicity in regulatory approaches brings the potential benefits of more timely regulatory determinations, greater certainty and transparency, and reduced compliance costs for DNSPs.

The AER is required to base its control mechanism for standard control services on a building block approach. While there are unavoidable administrative and compliance costs associated with this basis of control, it is not practicable to quantify the administrative costs of one form of control relative to another. For that reason, the AER's starting point for consideration of this issue in the current context is the likely impact of any change in form of control from the current regulatory period to the next.

The AER's considers that administrative costs are best minimised in this instance by maintaining, with any necessary alterations, the current form of control. The AER only intends to depart from the current form of control where there is evidence that such a departure is more appropriate.

3.6.6 Form of control to apply to standard control services

Given the regulatory requirements and the AER's decision on the form of control, the AER has decided to vary the control formulae to that set out in the ESCV's EDPR.[168] The basis of control for the EDPR weighted average price cap formula is detailed below:

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

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

- "p" and "q" refer to price and quantity for years "t", "t-1" and "t-2" respectively
- "CPI", "X", "L" and "S" are defined in the EDPR
- "L" is the licence fee pass through adjustment to the distribution price control in the calendar year t, for a given distribution business

[168] ESCV, *EDPR, Final Decision Volume 2*, October 2006, p. 12.

- "S" is the service adjustment to the distribution price control in the calendar year t, for a given distribution business.

The AER will vary this formula with the removal of the "S" factor in its current form. The EDPR "S" factor will be replaced by a factor to make provision for impacts of the AER's STPIS.

In its preliminary positions paper, the AER also proposed removing the "L" factor from the formula on the basis that it understood that the Victorian DNSPs will not incur costs for licence fees during the next regulatory period. However, on the basis of advice from the DPI, the AER understands that the future arrangements for the current DNSP licence fees have not been determined at this stage. Having regard to this, the AER will retain the "L" factor in the control mechanism for as long as it is being charged. On this basis, the DNSPs should not include the costs of licence fees in their operating expenditure building blocks for the next regulatory control period.

The AER confirms that it will not include in the next regulatory control period a provision for the recovery of foregone revenue in the control mechanism arising from the application of the demand management incentive scheme. This is because the recovery of foregone revenue is better provided for under the demand management incentive scheme which is discussed in chapter 6 of this paper.

The AER will adjust the control mechanism each year to take account of, where applicable, the STPIS and where applicable the licence fee factor. The AER will make these adjustments to the CPI−X component of the control mechanism, such that the annual allowed increase or decrease in the weighted average price cap would depend on the outcomes of the schemes.

The AER will carryover any adjustments arising from the EDPR, for example in relation to "L" and "S" factor adjustments, that will impact in the 2011–15 regulatory period. These adjustments will be addressed through the revenue building block approach in accordance with chapter 6, Part C of the NER.[169]

The AER's revised formula can be viewed at Appendix F. A summary of this formula is:

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

where:

- CPI is as specified in the NER
- X is to be determined using the building block approach
- S is any adjustment required consequent to the operation of the STPIS, and
- L is the licence fee pass through adjustment.

[169] NER, cll. 6.4.3(a)(5),(6) and NER, cll. 6.4.3(b)(5),(6).

3.7 Issues and AER's considerations - alternative control services

The AER's framework and approach paper must state the form, or forms, of the control mechanisms that will apply to alternative control services during the next regulatory control period.

The factors to which the AER must have regard when deciding on the control mechanism to apply to standard control services are set out in section 3.2.3 of this chapter.

3.7.1 Current regulatory arrangements for the Victorian DNSPs

Clause 6.2.5(d)(3) of the NER provides that, in deciding on the control mechanism to apply to alternative control services, the AER must have regard to the current regulatory arrangements applicable to the Victorian DNSPs.

As discussed in chapter 2, the Victorian DNSPs currently provide:

- non-contestable excluded distribution services — fee based services and public lighting services
- non-contestable excluded distribution services — recoverable works and quoted services, and
- contestable excluded distribution services.

The Victorian DNSPs also provide existing prescribed metering services for unmetered supplies, which as discussed in chapter 2, the AER has proposed to re-classify as alternative control services. These services are currently regulated under a weighted average price cap control mechanism as part of a basket of prescribed metering services.

The current control mechanism in Victoria for fee based services, public lighting services, recoverable works and other quoted services is a price cap. Indexation is not automatically applied to the capped prices. Citipower, Powercor[170], United Energy[171] and SP AusNet[172] all express concern in their submissions on the preliminary positions paper regarding their current excluded services prices not being annually indexed during the current and previous regulatory control periods.

3.7.2 Scope of alternative control services

For the reasons set out in chapter 2, the AER's likely approach is that the following distribution services will be classified as alternative control services:

- connection — energisation
- metering services (unmetered supplies)
- operation, repair, replacement and maintenance of public lighting assets
- all fee based services, and

[170] Citipower and Powercor, op cit, p. 5-8.
[171] United Energy, op cit, p. 4.
[172] SP AusNet, op cit, p. 13.

- all quoted services.

With the exception of metering services (unmetered supplies), all of these services are currently subject to a price cap control mechanism, although in the case of quoted services (which include recoverable works) the price cap applies to the cost of the units that are employed in providing the services. Prescribed metering services (unmetered supplies) are currently regulated under a weighted average price cap control mechanism. The justification for changing the control mechanism for unmetered supplies is set out below.

The following sub-sections set out the matters which the AER must have regard to in selecting the appropriate control mechanism.

3.7.3 Form of control to apply to Alternative Control Services

The price cap control mechanisms that currently apply to the Victorian DNSPs' excluded distribution services are described in section 3.3.3 of this paper.

The AER will:

- continue to apply price caps on:
  - unit costs for the quoted services grouping of alternative control services, and
  - individual prices for all of the other alternative control services.
- commence the application of a price cap to those currently prescribed metering services (unmetered supplies), which the AER proposes to classify as alternative control services.

The reasons for these decisions are explained in the following sub-sections.

3.7.4 The influence on the potential for development of competition

The AER considered the potential for competition as part of classifying the Victorian DNSPs' direct control services as either standard or alternative control services in chapter 2 of this paper. The AER's assessment was that there is very little prospect for the development of competition in the provision of the services that it proposes to classify as alternative control services.

The AER considers that the application of a price cap control mechanism will not have any material impact on the competition for an alternative control service or impede the potential to develop competition for these services.

3.7.5 Administrative costs

Clause 6.2.5(d)(2) of the NER requires the AER to consider the possible effects of the control mechanism on the administrative costs of the AER, the DNSP and users or potential users. A control mechanism should aim to minimise the complexity and administrative burden for the AER, the Victorian DNSPs and users without compromising the effectiveness of the constraint. Simplicity in regulatory approaches brings the potential benefits of more timely regulatory determinations, greater certainty and transparency for all parties, and reduced compliance costs for DNSPs.

Given that the AER's control mechanism for alternative control services is the same as that which currently applies, with the exception of 'prescribed' metering services

(unmetered supplies), the AER does not consider that the implementation of a price cap for these services will impose additional administrative costs on users, the Victorian DNSPs or the AER. Further, the imposition of a price cap on the metering services (unmetered supplies) is not considered likely to impose material administrative costs on Victorian DNSPs. Moreover, the AER considers that it would be more appropriate to regulate unmetered supplies under a price cap than under a weighted average price cap having regard to the administrative costs of regulation. Unmetered supplies will be the only remaining metering service that was 'prescribed' (and previously subject to a weighted average price cap for prescribed metering services) under the ESCV's regulatory framework that will be regulated under the AER's 2011–15 distribution determination.

On this basis, the AER does not consider that regard to administrative costs would warrant continuing a weighted average price cap form of control for unmetered supplies or changing the current control mechanism for alternative control services. A price cap would appear appropriate for all of these services.

3.7.6 The desirability of consistency

Clause 6.2.5(d)(4) of the NER requires the AER to have regard to the desirability of consistency between regulatory arrangements for similar services, both within and beyond the relevant jurisdiction.

The AER notes that a consistent control mechanism is currently applied to excluded distribution services within each NEM jurisdiction, including Victoria — that is, the same control mechanism is applied to each DNSP within a particular jurisdiction. The AER considers that it is desirable that the same control mechanisms should be applied to like alternative control services across Victoria.

Different forms of control are applied across the NEM to excluded distribution services (which are most likely to be classified as alternative control services). For example, a negotiate arbitrate framework is applied in South Australia, a revenue cap is applied in the Australian Capital Territory, and a variant of a schedule of fixed prices is applied in New South Wales and Queensland. A weighted average price cap is not currently applied to excluded distribution services in any NEM jurisdiction.

While consistency is generally desirable, the AER considers that the pursuit of consistency in forms of control between jurisdictions should not be a driving consideration in the selection of a control mechanism to apply to the Victorian DNSPs' alternative control services for 2011-15 distribution determination.

3.7.7 Any other relevant factor

The NER allows the AER to consider any factor it considers relevant in deciding on a form of control for alternative control services.[173] The AER does not consider there are any other relevant factors that are important in deciding on the control mechanism to apply to the Victorian DNSPs' alternative control services in the next regulatory control period.

[173] NER, cl. 6.2.5(d)(5).

3.7.8 Form of control to apply to individual alternative control services

The AER is able to apply a control mechanism to a DNSP's alternative control services using chapter 6, Part C of the NER, which involves applying the building block approach, although it may elect to only apply certain elements of the building block approach. Alternatively, the AER may elect to implement a control mechanism that does not use the building block approach.

The AER will apply price cap forms of control to regulate all alternative control services for the next regulatory control period (see Appendix F), and requires the basis of the control to be as follows:

- the price cap for the operation, repair, replacement and maintenance of public lighting assets will be established based on a limited building block approach, where DNSPs will be required to forecast their opex and capex for public lighting services over the regulatory control period
- a price cap for all other individual alternative control services including currently prescribed metering services (unmetered supplies) will be established in the first year of regulatory period based on either a 'bottom up' or 'top down' approach, as described in section 3.7.8.2 below. The AER intends specifying in the regulatory information notices that it will issue to each Victorian DNSP prior to them submitting their regulatory proposals, which services must be established utilising a bottom up approach and which services must be established utilising a top down approach, and
- a price path for the price caps will be established utilising a CPI−X basis for the regulatory control period.

The Victorian DNSPs will be required to submit to the AER for approval an initial pricing proposal for the first year of the next regulatory control period and an annual pricing proposal for each subsequent year of the period. Such applications will need to cover standard control services and alternative control services and be prepared in accordance with Part I of chapter 6 of the NER.

3.7.8.1 Public lighting services

The AER will assess the efficient costs of the operation, repair, replacement and maintenance of public lighting assets under the price cap control mechanism through the use of a limited building block approach.

The AER will permit the Victorian DNSPs to simplify the building block approach in the following ways. The Victorian DNSPs:

- will not be required to provide a separate proposal on the weighted average cost of capital for alternative control services
- may propose reasonable simplifying assumptions within the building block model, and
- may base their opening asset valuation for existing public lighting assets on the existing asset valuation, with any adjustments for capital expenditure, disposals and depreciation in the current regulatory control period.

Citipower's, Powercor's[174] and Jemena's[175] submissions on the preliminary positions paper all seek more information about the nature of a limited building block approach and what information will be required in their regulatory proposals.

The AER intends specifying in the regulatory information notices that it will issue to each Victorian DNSP prior to them submitting their regulatory proposals, the minimum building block information it expects the DNSPs to provide in relation to the operation, repair, replacement and maintenance of public lighting assets and their forecast opex and capex for public lighting services over the regulatory control period.

The Streetlight Group of Councils submit that tariff rate changes in the current regulatory control period are problematic for Councils as they:

- are not consistent either between DNSP's or from year to year for a particular DNSP, and
- do not receive sufficient information about the amount of the rate changes and the timing of any annual increases. [176]

The AER acknowledges the Streetlight Group of Councils' concerns, but notes that under Chapter 6 of the NER there are no requirements for different DNSPs to have the same prices for the same services. Notwithstanding this, under the limited building block and price cap mechanisms that will apply, there will be transparency and predictability of price movements during the regulatory control period. As noted elsewhere in this paper, DNSPs will propose their prices in a pricing proposal, which will follow the release of the AER's distribution determination.

The Streetlight Group of Councils also raises concerns about the limitations in public lighting data and the need for future prices to be set using accurate data.[177] The AER notes this issue and will have regard to it when it considers the DNSPs' regulatory proposals and pricing proposals for the next regulatory control period.

3.7.8.2 Other individual alternative control services

The AER will not apply the building block approach in assessing the efficient costs of providing the Victorian DNSPs' remaining alternative control services for the purposes of setting a price cap for these services.

As discussed above, the AER will be utilising either a bottom up or top down approach in deriving the initial prices for each individual service. A bottom up approach would require the DNSPs to submit cost build up information relating to each individual service. A top down approach would utilise historical audited regulatory account information to derive an appropriate escalation mechanism which will be applied to existing prices.

For the remaining years of the regulatory control period the AER will establish a price path for the price cap utilising a CPI−X basis of escalation.

[174] Citipower and Powercor, op cit, p. 8-9.

[175] Jemena, op cit, p. 6.

[176] Streetlight Group of Councils / Trans Tasman Energy Group, op cit, p. 5.

[177] Ibid, p. 2.

Citipower's and Powercor's submission on the preliminary positions paper seeks more detail on the basis on which individual prices for alternative control services would be determined. Citipower and Powercor acknowledge in their submission that there are several approaches that can be applied to setting prices in the initial year of the next regulatory control period, including:

- a top down approach, involving an escalation of existing prices and check of the revenues that are likely to be recovered, and
- a bottom up approach, involving a build up of costs for each individual service in order to determine a price for the service.[178]

Once prices have been set for the first year, they would be escalated annually in the remaining years of the regulatory control period.

The AER recognizes that a bottom up approach to price setting is likely to be more involved, and entail higher administrative costs for DNSPs than a top down approach, although it may result in more cost reflective prices. Accordingly, the AER intends to require DNSPs to prepare initial prices for those services that have the highest number of transactions and levels of revenue on a bottom up basis. Initial prices for other services will be set on a top down basis.

The AER intends specifying in the regulatory information notices that it will issue to each Victorian DNSP prior to them submitting their regulatory proposals, which services must be priced on a bottom up approach and which services can be priced on a top down approach. These notices will also make clear what information needs to be provided by a DNSP in its regulatory proposal.

For clarity, the AER notes that it envisages that DNSPs may propose and justify more than one price for a particular fee based service, where the characteristics of the service differ between customers making it appropriate to charge them different prices.

Form of control to apply to quoted alternative control services

Quoted alternative control services

The AER will apply a price cap form of control to regulate quoted alternative control services for the next regulatory control period. The AER will not apply a building block approach to these services. A price cap formula for all quoted services will be established where the unit costs of inputs will be capped but not the overall service. In their regulatory proposals, the DNSPs will be required to propose an individual formula to calculate the tariff of each individual quoted service and submit information and costs of inputs in relation to these services. Where appropriate, the unit costs and prices charged for quoted services will be reviewed ex post through the annual pricing proposal process.

As with the other alternative control services, the Victorian DNSPs will be required to submit to the AER for approval an initial pricing proposal for the first year of the next regulatory control period and an annual pricing proposal for each subsequent year of

[178] Citipower and Powercor, op cit, p. 5-8.

the period. These annual pricing proposals will be prepared in accordance with Part I of chapter 6 of the NER.

3.8 Form of control mechanisms to be applied by the distribution determination

3.8.1 Standard control services

The AER will apply a weighted average price cap to standard control services in the next regulatory control period. The AER decision is based on the following considerations, which it has had regard to in accordance with clause 6.2.5(c) of the NER:

- a weighted average price cap is the current control mechanism for the Victorian DNSPs' prescribed distribution services and is one of the control mechanisms listed in clause 6.2.5(b) of the NER that can be applied in the next regulatory control period[179]
- the incentives and risks of this control mechanism are widely recognised. Importantly, this form of control allows the Victorian DNSPs to manage uncertainty in outturn volume by re-balancing their tariffs
- there are provisions in place under clause 6.18 of the NER that require the AER to carefully examine tariff structures for efficiency as part of the pricing proposal process
- retaining the current form of control for standard control services maintains consistency in the regulation of those services across Victoria. The AER considers that consistency of regulatory approaches within jurisdictions is an important initial goal, while noting that achieving consistency across jurisdictions is a medium to longer term objective,[180] and
- transitioning to a completely new form of control mechanism will not guarantee a reduction in administrative costs, and may itself create undesirable administrative costs.[181]

3.8.2 Alternative control services

The AER will apply price caps in the next regulatory control period to the:

- unit costs for the quoted services grouping of alternative control services, and
- individual prices for all of the other alternative control services, with a limited building block approach being applied to the operation, repair, replacement and maintenance of public lighting assets.

The AER's decision is based on the following considerations it has had regard to in accordance with clause 6.2.5(d) of the NER:

[179] NER cl. 6.2.5(b)(4).
[180] NER cl. 6.2.5(c)(4).
[181] NER cl. 6.2.5(c)(2).

- a price cap is the current control mechanism for the Victorian DNSPs' excluded distribution services and is one of the control mechanisms listed in 6.2.5(b) of the NER that can be applied in the next regulatory control period[182]
- it is considered unlikely that there will be any impact on the development of competition in the market for these services as a result of applying a price cap control mechanism
- retaining the current form of control for all alternative control services maintains consistency in regulation of those services across Victoria, and it is appropriate that this control mechanism be extended to the currently prescribed metering services (unmetered supplies) on the basis that it would not be appropriate to apply a weighted average price cap just to these services, and
- transitioning to a completely new form of control mechanism, other than in the case of the currently prescribed metering services (unmetered supplies), will not guarantee a reduction in administrative costs, and may itself create undesirable administrative costs.

[182] NER cl. 6.2.5(b)(4).

4 Application of service target performance incentive scheme

4.1 Introduction

This chapter discusses the AER's likely approach to the application of a service target performance incentive scheme (STPIS) to the Victorian DNSPs for the 2011–15 regulatory control period, and its reasons for that approach.

The objective of a STPIS is to provide incentives for DNSPs to maintain and improve service performance. Under an incentive regulation framework, DNSPs have an incentive to reduce costs. Cost reductions are beneficial to both the DNSP and its customers where service performance is maintained or improved. However, savings that result in lowered service levels provided to customers are not necessarily desirable. The STPIS serves to ensure that increased financial efficiency does not result in deterioration of service performance for customers.

The STPIS works as part of the building block determination. The STPIS provides a financial incentive (through its s-factor component) for DNSPs to maintain and improve performance by providing penalties (rewards) to the DNSP for diminished (improved) service compared to predetermined targets. A STPIS may also include a guaranteed service level (GSL) component, which sets threshold levels of service and provides for direct payments to customers who experience service worse than the predetermined level.

4.2 Requirements of the NER

The AER's building block determination for each Victorian DNSP for the next regulatory control period will specify how the STPIS is to be applied to the DNSP in that period.[183] This framework and approach paper must set out the AER's likely approach, together with its reasons for the likely approach, to the application of a STPIS in the determination.[184]

4.2.1 AER's distribution STPIS

As part of the new framework for economic regulation of distribution services, the AER is required to develop and publish an incentive scheme, or schemes, to ensure that DNSPs maintain and, where efficient, improve upon, agreed levels of service. That scheme is the STPIS.[185]

The AER's STPIS (version 1.1) was released in May 2009 following a period of public consultation in accordance with the distribution consultation procedures under clause 6.16 of the NER. The STPIS can be found at the AER's website, at www.aer.gov.au.

[183] NER, cl. 6.3.2(a)(3).
[184] NER. cl. 6.8.1(b)(2).
[185] NER, cl. 6.6.2(a).

4.2.2 Structure of the STPIS

The STPIS has four components:

1. Reliability of supply 2. Quality of supply 3. Customer service	}	**S-factor**
4. Guaranteed service levels (GSL)		

These components can apply in isolation, or in combination with each other, within a distribution determination.

4.2.2.1 S-factor

The s-factor is the percentage revenue increment or decrement that applies in each regulatory year. Only the first three components of the STPIS contribute to the s-factor. Application of one or more of these three components takes the form of a financial reward or penalty for exceeding or failing to meet predetermined service targets. The s-factor component is symmetrical as penalties are incurred at the same rate as rewards. The maximum revenue at risk under the s-factor is ± 5% of a DNSP's revenue for each year of the regulatory control period.[186]

Reliability of supply component

Three parameters are available under the reliability of supply component of the AER's STPIS:

- unplanned system average interruption duration index (SAIDI)
- unplanned system average interruption frequency index (SAIFI), and
- momentary average interruption frequency index (MAIFI).[187]

Performance targets for these parameters are usually based on a DNSP's average historical performance over the previous five years.[188] Targets for each parameter are set for segments of the distribution network identified, for example, by feeder type. This allows the STPIS to recognise variations in performance across a DNSP's network.

The incentive rates for this component, which are used in calculating the s-factor, are based on the value that customers place on reliability of supply, that is, the value of customer reliability (VCR) determined in the STPIS.

[186] The AER retains discretion as part of its STPIS to alter this figure, where doing so would satisfy the objectives in clause 1.5 of the scheme.

[187] SAIDI refers to the sum of the duration of each sustained customer interruption (in minutes) divided by the total number of distribution customers. SAIFI refers to the total number of sustained customer interruptions divided by the total number of distribution customers. MAIFI refers to the total number of customer interruptions of one minute or less, divided by the total number of distribution customers.

[188] This data is adjusted where necessary to account for improvements in reliability which have been included in the DNSPs expenditure program, and adjusted for any other material factors expected to affect network reliability performance.

Quality of supply component

There is no quality of supply component included in the STPIS at this time.

Customer service component

There are four available parameters in the customer service component of the STPIS:

- telephone answering
- streetlight repair
- new connections, and
- response to written enquiries.

Of these, the STPIS provides that telephone answering will be included as a parameter for each DNSP to which the customer service component applies. One or more of the remaining parameters may apply under the customer service component where application of that parameter would satisfy the objectives of the scheme.

As with reliability of supply, customer service parameter performance targets are based on average performance over the previous five years. Unlike targets for the reliability of supply component of the STPIS, targets for this component apply to the distribution network as a whole, and are not segmented.

The maximum revenue at risk for all customer service parameters in aggregate is ± 1% of a DNSP's revenue for each year of the regulatory control period. The maximum revenue at risk for any individual parameter is ±0.5 per cent of revenue for each year of the regulatory control period.

Under the STPIS, the incentive rate for the telephone answering parameter is set at either minus 0.040 or a value determined from an applicable assessment of the value that customers attribute to the level of service proposed.

Reporting requirements

The STPIS provides for a DNSP to report its performance against all applicable parameters an on annual basis, in accordance with any applicable regulatory information instrument issued by the AER.

4.2.2.2 Guaranteed service levels

The purpose of the GSL component of the scheme is to provide payments directly to customers if the level of service experienced by them falls below the performance thresholds specified in the STPIS. The GSL component can operate independently or concurrently with the s-factor component of the scheme. The AER will only apply the GSL component of its STPIS to DNSPs who are not currently subject to a jurisdictional GSL scheme.

4.2.3 Implementing the STPIS

The STPIS is designed to facilitate consistent application of a service performance incentive framework across the NEM, but can be implemented taking into account the circumstances of each DNSP.

In implementing the STPIS, the AER must take into account:[189]

- the need to ensure that benefits to consumers likely to result from the scheme are sufficient to warrant any penalty or reward under the scheme
- any current regulatory requirements to which the relevant DNSP is currently subject
- the past performance of the distribution network
- any other incentives available to the DNSP under the NER or the relevant distribution determination
- the need to ensure that the incentives are sufficient to offset any financial incentives the DNSP may have to reduce costs at the expense of service levels
- the willingness of the customer or end user to pay for improved performance in the delivery of services, and
- the possible effects of the scheme on incentives for the implementation of non-network incentives.

In implementing the STPIS, the AER must also:

- consult with the authorities responsible for the administration of relevant jurisdictional electricity legislation[190], and
- ensure that service standards and service targets (including GSLs) set by the scheme do not put at risk the DNSP's ability to comply with relevant service standards and service targets (including guaranteed service levels) as specified in jurisdictional electricity legislation.[191]

4.3 Overview of current arrangements for Victorian DNSPs

The Victorian DNSPs currently operate under a service standard framework implemented and administered by the ESCV, in accordance with its EDPR. The framework includes three key components:

- service standards
- service incentive scheme, and
- GSLs.

The AER has had regard to these existing arrangements in reaching the likely approach set out in this chapter.

[189] NER, cl. 6.6.2(3).

[190] NER, cl. 6.6.2(b)(1).

[191] NER, cl. 6.6.2(b)(2). The STPIS implemented by the AER must operate concurrently with any average or minimum service standards and GSL schemes that apply to the DNSP under jurisdictional electricity legislation.

4.3.1.1 Service standards

The Electricity Distribution Code (EDC) and the EDPR set out service standards for the Victorian DNSPs expressed in terms of the reliability of supply, quality of supply and customer service.

Reliability of Supply

Reliability is concerned with the availability of supply and is measured by the frequency and duration of supply interruptions. Supply interruptions can originate from problems at power stations, transmission lines (generally 275 kV and 132 kV), and the distribution network (generally 66 kV and less). The key parameters against which average reliability is measured are SAIDI, SAIFI and MAIFI.

The EDC requires the Victorian DNSPs to use its "best endeavours" to meet reliability targets set by the EDPR.[192] These targeted levels relate to planned and unplanned SAIDI and SAIFI, as well as MAIFI, by network feeder type. The targeted levels do not incorporate any improvement in the average measures of reliability over the 2006-10 regulatory control period.

The EDPR requires the Victorian DNSPs to report to the ESCV on their average reliability performance against these targeted levels.

In addition, the Victorian DNSPs are also required to report the annual minutes off supply experienced by the 15 per cent of customers who are experiencing the longest times off supply in that reporting year.

Quality of supply

Quality of supply is concerned with the characteristics of the electricity supply delivered to customers' premises, specifically whether there are short term or transient voltage increases (voltage surges) or reductions (voltage sags) and harmonic distortions. Quality of supply is measured at the customer's supply address and at other points on the network. The quality of supply standards that the Victorian DNSPs are required to achieve, or use their best endeavours to achieve, are set out in the ESCV's EDC.

Customer service

Under the ESCV's regulatory arrangements, the customer service component is measured by the:

- timeliness of responses to telephone calls to a fault line, that is calls to a DNSP's fault lines answered within 30 seconds, and
- overloading of the fault line.

The EDPR sets out the annual targeted level of call centre response, by a DNSP, for the 2006-10 regulatory control period.[193]

The "other" customer service components are for:

[192] ESCV, *EDPR, Final Decision Volume 1*, October 2006, p. 77.
[193] ESCV, *EDPR, Final Decision Volume 1*, October 2006, p. 32.

- complaints, street light repairs, appointments, new connections, and planned interruptions for which four days notice is not given, and
- any additional customer service measures identified by the ESCV through its "end-to-end project".[194]

4.3.1.2 Service incentive scheme

In 2000, the then Victorian Office of the Regulator-General (ORG) introduced a service incentive scheme (i.e. incorporating an 's-factor' scheme) for the Victorian DNSPs for the 2001-05 regulatory control period. The ESCV amended the scheme as part of its EDPR for the current regulatory control period.

Under the current ESCV s-factor scheme, a DNSP's weighted average price cap is increased or decreased based on changes in its average performance from one year to the next. The basis for calculating the increase or decrease is detailed in section 3.1.1 of volume 1 of the EDPR.

The s-factor is calculated by multiplying the 'performance gap' for a range of indicators and network types by incentive rates, where:

- the performance gap is the difference between the actual and targeted improvement in performance, where out-performance results in a positive performance gap and therefore a positive s-factor and an increase in the price cap. Under-performance results in a negative performance gap, a negative s-factor and a decrease in the price cap
- the key indicators are SAIDI, SAIFI, MAIFI and call centre performance. SAIDI and SAIFI were set at the incentive target for the end point of the previous regulatory period, being the 2005 level. MAIFI and the call centre measure were based on the trend of historical performance in the period 2001–04, adjusted for outliers
- incentive rates were set for each indicator based on consumers' willingness to pay. The ESCV used a state wide value of consumer reliability of $30 000 per MWh for all DNSPs except CitiPower.[195] The ESCV determined that the incentive rate for CitiPower's CBD customers would be $60 000 per MWh.[196] For the call centre performance measure, the ESCV based the incentive rate for each DNSP on a South Australian willingness to pay study commissioned by the Essential Services Commission of South Australia, and
- weightings are applied to each of the measures included in the scheme based on the results from the South Australian customer research referred to above, with variations made to the weightings by DNSP and network type. These weightings are set out in table 3.7 of Volume 1 of the EDPR.

[194] The ESCV's end-to-end project was concerned with facilitating the ongoing effectiveness of the systems and processes that contribute to supporting full retail competition. The ESCV's *Final Decision: E2E Project* can be found at: http://www.esc.vic.gov.au/NR/rdonlyres/EE09A98A-36AF-48B0-8184-473CEE274663/0/E2E_FinalDecisionMay06.pdf.

[195] The state wide value of consumer reliability was based on the Charles River Associates (CRA) study undertaken for VENCorp, although the value was adjusted by the ESCV. Refer to the ESCV, *EDPR, Final Decision Volume 1*, October 2006, p. 87.

[196] ESCV, *EDPR, Final Decision Volume 1*, October 2006, p. 4.

4.3.1.3 GSL scheme

The ESCV's EDPR made a number of changes to the GSL scheme that had applied during the previous 2001–05 regulatory control period.

The new GSL scheme requires the DNSPs to make payments to customers who receive service below defined thresholds in relation to:

- the timeliness of appointments
- the timeliness of connections
- the frequency and duration of supply
- the timeliness of repairing streetlights.

The revised GSLs are reflected in the ESCV's EDC and Public Lighting Code. They represent the minimum GSLs that the Victorian DNSPs are required to provide.

4.4 AER's preliminary positions on the application of a STPIS to the Victorian DNSPs

The AER's preliminary position was that it would likely apply the reliability of supply, customer service and GSL components of the STPIS to the Victorian DNSPs in the next regulatory control period.

Targets for the reliability of supply component would be attached to SAIDI, SAIFI and MAIFI with separate targets for each segment of the network, in accordance with the SCONRRR feeder categories identified in the STPIS. Targets will reflect the available data on average performance over the previous five years, with adjustments as necessary under the STPIS.

The AER indicated that it did not intend to apply a quality of supply component to the Victorian DNSPs for the next regulatory control period.

For the customer service component, the AER proposed that the telephone answering parameter (as defined in Appendix A of the AER's STPIS) would apply to the Victorian DNSPs for the next regulatory control period. The AER indicated that other parameters under this component may be proposed by the Victorian DNSPs in their regulatory proposals.

The AER's preliminary position was that it would apply all parameters under the GSL component of the STPIS to the Victorian DNSPs in the next regulatory control period. This was on the basis of the AER's understanding that the Victorian GSL scheme that currently applies to the Victorian DNSPs, and which is provided for under the ESCV's EDC and Public Lighting Code, would not apply in the next regulatory control period.

In forming this position, the AER had regard to the factors in clause 6.6.2(b)(3) of the NER.

4.5 Summary of submissions

The AER received submissions from the following stakeholders in response to its preliminary positions paper relating to the application of the STPIS to Victorian DNSPs in the next regulatory control period:

- SP AusNet
- United Energy
- the DPI
- AGL
- Origin Energy
- the Trans Tasman Energy Group, and
- the Streetlight Group of Councils.

The above stakeholders are generally supportive of the application of the STPIS to the Victorian DNSPs. However, as outlined below several stakeholders raise issues about the detailed application of the STPIS:

- SP AusNet:
  - argues that the Victorian DNSPs, and specifically SP AusNet, should not be subject to a capped revenue at risk under the AER's STPIS for the 2011-2015 regulatory control period
  - seeks clarification on which five year period should be used in setting the reliability performance targets from 2011, given that the 2009 and 2010 actual annual performance will not be known when it submits it's regulatory proposal to the AER in November 2009
  - seeks clarification as to the financial interaction between the current ESCV scheme and the STPIS, stating that the price cap formula will need to be incorporate revenue adjustments from penalties and benefits received in the current period, and
  - seeks clarification on how the AER will treat the 6 month period from 1 January 2011 to 1 July 2011 under the STPIS, noting that the ESCV service standards scheme will cease to apply on 30 December 2010[197]
- United Energy seeks confirmation that future exclusions calculated in accordance with the AER's STPIS would be assessed on the same basis as the exclusions regime applied in the current regulatory control period by the ESCV[198]
- the DPI:
  - suggests that the revenue at risk cap should be removed from the AER's STPIS generally, and no revenue at risk cap should be applied to Victorian DNSPs
  - raises concerns regarding the approach to setting performance targets, namely, that the target setting methodology under the AER's STPIS may result in more

[197] SP AusNet, op cit, p. 14-17.

[198] United Energy, op cit, p. 5.

demanding targets over time, without corresponding evidence that Victorian customers' value these improvements

- seeks clarification on how the AER has considered customers' willingness to pay in developing its STPIS
- seeks clarification regarding the carryover period for benefits or penalties under the scheme
- questions the application of the exclusion criteria in situations where major reconstruction works may be required to restore supply, or where large number of customers may not be in a position to take restored supply for an extended period, and
- questions the absence of GSL payment for momentary interruptions of supply, stating that the ESCV applied multi level GSL payments to more closely reflect customers willingness to pay[199]

- AGL suggests that performance targets under the STPIS should not be restricted to services provided to end customers. AGL submits that the AER's STPIS should extend to providing incentives to maintain and improve performance for services provided by DNSPs to retailers[200]
- Origin Energy suggests that a broader range of customer service parameters should be applied under the STPIS (beyond those already included in section 5 of the STPIS), such as for metering data quality,[201] and
- the Trans Tasman Energy Group and the Streetlight Group of Councils both argues for the retention of the public lighting GSL.[202]

4.6 Issues and AER's considerations

The following discussion examines the key features of the AER's STPIS, as released in May 2009. It also sets out the AER's proposed application of the STPIS to the Victorian DNSPs in the next regulatory control period.

The final decision accompanying the STPIS sets out the AER's considerations of stakeholder submissions received as part of consultation on this process. It also sets out the AER's mandated consideration of the objectives set out in clause 6.6.2 (3) of the NER.

4.6.1 s-factor

4.6.1.1 Revenue at risk

The AER's national STPIS sets a maximum ±5 per cent of revenue at risk. That is, the maximum amount that a DNSP can be penalised or rewarded under the s-factor component of the STPIS is ±5 per cent of its total allowed revenue for any year of the regulatory control period. This amount is distributed across all parameters (and in the case of reliability of supply parameters, all segments of the network).

[199] DPI, op cit, p. 3-5.
[200] AGL, op cit, p. 2-3.
[201] Origin Energy, op cit, p. 5-6.
[202] Streetlight Group of Councils / Trans Tasman Energy Group, op cit, p. 5.

The AER will generally apply a default revenue at risk of ±5 per cent for all DNSPs. Exceptions to this may be considered and implemented in the distribution determination, where an alternative proposal which satisfies the objectives of clause 1.5 of the STPIS is submitted by a DNSP.

SP AusNet's submission on the preliminary positions paper argues that the Victorian DNSPs should not be subject to a cap on revenue at risk under the STPIS, noting that the AER's preliminary position was to apply the default revenue at risk cap to all Victorian DNSPs. SP AusNet considers that a number of risk mitigation mechanisms inherent in the STPIS remove the need for SP AusNet to have financial rewards or penalties capped under the STPIS.[203] The DPI's submission also suggests that the revenue at risk cap should be removed from the AER's STPIS generally. The DPI also states that the revenue at risk cap should be removed in the application of the STPIS to Victorian DNSPs, stating that it may dilute incentives to improve performance.[204]

The issue of a revenue at risk cap was considered during consultation on the development of the STPIS. There was very limited stakeholder support for a default uncapped revenue at risk under the STPIS. Stakeholders generally supported a cap on the revenue at risk under the STPIS. As a result, the default cap was introduced, with the flexibility under the STPIS to apply alternatives where appropriate. The AER considers that a cap on revenue at risk under the STPIS serves as a risk mitigation mechanism, especially for those DNSPs who have not been subject to a scheme like the STPIS previously. An alternative revenue at risk figure can be applied in accordance with 2.5 (b) of the STPIS. The AER notes that it is open to DNSPs to propose such a departure from the default cap, and that the AER cannot mandate an alternative revenue at risk at the request of another stakeholder.

The AER's likely approach is to place ±5 per cent of each Victorian DNSP's revenue at risk under the STPIS. The distribution of the revenue at risk across performance parameters (and where applicable network segments), and the targets and incentive rates applied under the STPIS will ensure that the amount of any reward or penalty paid under the STPIS will be proportionate to the value customers place on the associated change in performance levels. A DNSP may propose an alternative revenue at risk (or an uncapped revenue at risk) in its regulatory proposal, in accordance with clause 2.2(b) of the STPIS. Where an alternative revenue at risk is proposed for application to that DNSP, it must provide justification in accordance the objectives contained in clause 1.5 of the STPIS (as required by clause 2.5 (b) of the STPIS). The AER will consider an alternative revenue at risk in accordance with these objectives in making its distribution determination.

4.6.1.2 STPIS applied within a control mechanism

The AER's likely approach is that the s-factor will be incorporated into the control mechanism as specified in section 3.3.2.2 of this paper.

[203] SP AusNet, op cit, p. 14-17.

[204] DPI, op cit, p. 3-5.

S–bank mechanism

The AER recognises that the s-factor may cause volatility in prices when service performance varies about the target performance from year to year. Consequently, the STPIS includes a mechanism that allows a DNSP to delay the action of a revenue increment or decrement, or a portion of the revenue increment or decrement, for one regulatory year.

In response to SP AusNet's submission on the interaction between the ESCV scheme and the AER STPIS[205], the AER notes that benefits and penalties accrued in the current regulatory control period under the ESCV scheme will not be incorporated in the price cap formula. Rather, financial carryover amounts from the current regulatory control period will be included as a building block element in the calculation of allowed revenue for the next regulatory control period.

4.6.1.3 Reliability of supply component

Parameters

The STPIS allows for the potential inclusion of three parameters for reliability of supply: SAIDI, SAIFI and MAIFI. The AER's likely approach is that these three parameters will apply to the Victorian DNSPs.

The STPIS provides that the DNSP's network must be segmented to measure reliability performance. The STPIS contemplates the use of the familiar, and commonly used, SCONRRR feeder categories for this purpose: CBD, urban, short rural and long rural. The STPIS allows network areas to be segmented by a method other than feeder type where the alternative better meets the objectives of the scheme set out in clause 1.5 of the STPIS.

The current ESCV service incentive scheme uses the SCONRRR feeder categories. The AER's preliminary position is that the Victorian DNSPs' networks will be segmented according to these feeder categories. The AER expects that this would have no impact on the way in which the Victorian DNSPs currently collect and report on their reliability data. Victorian DNSPs have for more than five years reported annually to the ESCV on their performance based on the SCONRRR feeder categories.

Performance targets

The STPIS bases performance targets on average performance over the past five years. This data can be modified[206] to reflect any reliability improvements that have affected (or are expected to affect) service reliability, or other factors that materially affect network reliability performance. Any modifications to performance data must be accompanied by an appropriate justification when submitted by a DNSP. Targets for each applicable parameter, and each segment to which the parameter is applied, will be set on this basis at the time of the distribution determination.

The Victorian DNSPs have been reporting reliability data to the ESCV for more than five years. On this basis, the AER expects that the Victorian DNSPs will be able to

[205] SP AusNet, op cit, p. 16.

[206] In accordance with cll. 3.2.1 (a)(1) or (2) of the AER's STPIS.

develop performance targets based on their average performance over a five year period.

SP AusNet's submission on the preliminary positions paper seeks clarification on which five year period should be used in setting the reliability performance targets when it submits its regulatory proposal to the AER in November 2009[207]. The AER notes that DNSPs should use the most recent actual five years of audited annual performance data when proposing their targets. For most Victorian DNSPs, the AER envisages that this will be data from the regulatory years 2004 to 2008 (inclusive).

SP AusNet also seeks clarification on the treatment of the six month period from 1 January 2011 to 30 June 2011. SP AusNet notes that:

> performance for the period 1 January to 30 June 2011 is excluded from both the ESC scheme which ends on 31 December 2010 and the AER's national scheme which it proposes to commence on 1 July 2011. [208]

SP AusNet further states that it is not desirable or necessary to exclude this period under the new AER scheme. It proposes that targets for this period can be generated, based on the average performance from the first six months of 2004-2005 to 2008-2009, subject to modifications proposed in the regulatory proposal. [209] The AER considers that this approach may be practical and will consult further with the Victorian DNSPs on this matter.

The DPI's submission expresses concern that the approach to setting performance targets under the AER's STPIS may result in more demanding targets over time, without corresponding evidence that Victorian customers' value, and are willing to pay for, these improvements.[210] The AER notes that the approach to setting performance targets under the STPIS was settled after extensive stakeholder consultation. Of the several methods for setting targets considered, the five year average method for setting performance targets received considerable stakeholder support. Further, the incentive rates and their application under the STPIS have been formulated so that penalties and rewards under the scheme are commensurate with customers' willingness to pay, regardless of the level at which the performance target is set. These incentive rates are based on recent analysis commissioned by VENCorp.

The DPI's submission also seeks clarification of the length of time that the DNSPs will retain benefits or penalties under the STPIS.[211] The AER has removed the carry forward mechanism in its recent amended STPIS (version 1.1). The carry forward of penalties or rewards was not considered to be essential to the successful operation of the STPIS. This was removed to reduce the complexity of version 1.0 of the scheme. Under the STPIS, a reward or penalty will only apply for one year if a DNSP's performance returns to the target level in the following year. The interaction between the STPIS and the efficiency benefit sharing scheme (EBSS) has been considered in light of this amendment (in accordance with clause 6.6.2 (3) (iv) of the NER). The AER considers that the removal of the carry forward mechanism neither leads to an

[207] SP AusNet, op cit, p. 15.
[208] SP AusNet, op cit, p. 16.
[209] SP AusNet, op cit, p. 15-16.
[210] DPI, op cit, p. 6.
[211] Ibid, p. 4.

inconsistency between the STPIS and the EBSS, nor does it reduce the effectiveness of either scheme. Further discussion of this issue is contained in the AER's final decision accompanying the STPIS, published in May 2009. This can be found on the AER's website, at www.aer.gov.au.

The AER's likely approach is that the Victorian DNSPs' performance targets under the STPIS would be based on their average performance over the previous five years.

Incentive rates

The DPI's submission seeks information on how the AER has had regard to customers' willingness to pay as part of the development of the STPIS.[212]

Incentive rates under the AER's STPIS are based on the VCR stated in the scheme.

The Victorian DNSPs, in their regulatory proposals, will be required to propose incentive rates in accordance with the methodology set out in the STPIS, but may elect to propose an alternative VCR to that stated in the STPIS. Should the Victorian DNSPs elect to do this, they must provide the AER with the methodology used to calculate the value and research supporting their calculation.

Incentive rates will be calculated at the commencement of the regulatory control period (in the distribution determination) and will apply for the duration of the regulatory control period.

The AER notes that the incentive rates contained in section 3.2.2 of the AER's STPIS are based on what it understands to be the most recent and robust study on customers' willingness to pay for improved performance at the time the STPIS was published. This study was commissioned by VENCorp.

Exclusions

The DPI's submission questions how the exclusion criteria would apply where major reconstruction works may be required to restore supply, or where a large number of customers may not be in a position to take restored supply for an extended period.[213] The AER notes that the DPI also raised this issue in its submission to the AER's proposed amendments to STPIS (published in February 2009) and that the AER has responded in its final decision accompanying the STPIS (version 1.1), published in May 2009. As noted in that decision, the IEEE 2.5 beta method has been adopted for the exclusion framework in the STPIS because the method is easy to understand, simple to administer and avoids the complexity of defining exclusion criteria for a range of events that might be excluded, together with the high administration burden likely to be associated with such an approach. The AER does not consider it appropriate to make discretionary decisions on whether certain events should or should not be excluded as a major event day as this places considerable uncertainty on the operation of the scheme. The STPIS was not designed to ensure that businesses return customers to service in the shortest possible timeframe when the duration of an interruption exceeds a major event day (MED) boundary (typically extreme infrequent

[212] DPI, op cit, p. 2.
[213] Ibid, p. 3.

events). The STPIS is designed to return the network to service in minimal time when any normal (non-MED) interruption occurs.

United Energy seeks confirmation that future exclusion applications will be assessed on the same basis as the exclusions assessed in the current regulatory control period.[214]

The exclusion arrangements contained in clause 3.3 of the STPIS will apply to the Victorian DNSPs.

The AER has clarified the operation of the exclusion arrangements in the STPIS (version 1.1), to provide further certainty to DNSPs. The AER will assess applications for exclusions from DNSPs as and when they are made. Given the many different circumstances that may give rise to an application for an exclusion, the AER does not consider it appropriate to comment on the way in which individual exclusion applications may be treated.

4.6.1.4 Quality of supply component

There are currently no quality of supply measures under the STPIS.

4.6.1.5 Customer service component

Parameters

The AER's likely approach is that the telephone answering parameter in the customer service component of the STPIS should be applied to the Victorian DNSPs in the next regulatory control period. It is noted that the definition of the telephone answering parameter adopted in the STPIS is slightly different to that currently applied under the Victorian service incentive scheme. The telephone answering measure in the STPIS does not apply to calls abandoned by the customer within 30 seconds of the call being queued for response by a human operator, whereas this is included in call centre performance in the current Victorian service incentive scheme.

The Victorian DNSPs may, in their regulatory proposals, propose the application of other customer service parameters under the STPIS.

Revenue at risk

The revenue at risk for all customer service parameters will be no more than ±1 per cent of total revenue for each year of the regulatory control period. The maximum revenue at risk for any individual parameter is ±0.5 per cent of revenue for each year of the regulatory control period. The AER's likely approach is that a maximum value of ±0.5 per cent will be attached to the telephone answering parameter in the next regulatory control period.

Performance targets

Clause 5.3.1(a) of the STPIS provides that performance targets for each customer service performance parameter are to be based on average performance over the previous five years.

[214] United Energy, op cit, p. 5.

AGL's submission argues that performance targets under the STPIS should not be restricted to services provided to end customers. AGL considers that the STPIS should also cover services provided by DNSPs to retailers.[215] The AER understands that DNSPs' service performance obligations to retailers are dealt with in a range of regulatory and other instruments, including NEMMCO's B2B Procedure—Service Order Process.[216] The AER does not consider that the STPIS is an appropriate instrument for imposing additional service obligations on DNSPs for services provided to retailers. The AER notes that, under the STPIS, it is ultimately customers, and not retailers, who experience changes in prices resulting from rewards and penalties received under the AER's STPIS.

Origin Energy's submission suggests that a broader range of customer service parameters should be applied under the STPIS, such as for metering data quality.[217] The AER considers that any additional customer service parameters that are proposed by DNSPs should be drawn from those listed in clause 5.1(a) of the STPIS. In relation to metering data quality, the AER notes that NEMMCO, rather than the AER, is responsible for overseeing meter data management undertaken by metering service providers, including metering data quality issues. The AER does not consider that the STPIS is an appropriate instrument for imposing additional service obligations on DNSPs in relation to metering data quality.

The Victorian DNSPs have been monitoring and reporting on the telephone answering component under the current Victorian service incentive scheme administered by the ESCV for more than five years. However, given the difference in the treatment of abandoned calls in the telephone answering measure under the STPIS and the current Victorian service incentive scheme, the AER acknowledges that the Victorian DNSPs may not have five years of historic average performance data on which to base performance targets applicable for the definition of telephone answering adopted in the STPIS. The AER's likely approach is that the Victorian DNSPs will provide appropriate justification of required modifications to its historic performance data in order to justify their proposed performance targets for application in the STPIS.

Any additional parameters proposed by the Victorian DNSPs should be accompanied by proposed targets and relevant historic performance data.

Incentive rate

The incentive rate for the telephone answering parameter is set by the STPIS at –0.040. For other customer service parameters proposed by the Victorian DNSPs the appropriate incentive rates should be based on the value that customers attribute to the level of service proposed.

Incentive rates will be calculated at the commencement of the regulatory control period (in the distribution determination) and will apply for the duration of the regulatory control period.

[215] AGL, op cit, p. 2-3.

[216] Available at http://www.nemmco.com.au/retail/648-0005.html.

[217] Origin Energy, op cit, p. 5-6.

Exclusions

Clause 5.4(a) of the STPIS provides that:

> Where the impact of an event is allowed to be excluded from the calculation of a revenue increment or decrement under the reliability of supply component of this scheme (under clause 3.3), the impact of that event may be excluded from the calculation of a revenue increment or decrement for the telephone answering *parameter*.

Where the Victorian DNSPs propose other customer service parameters in their regulatory proposals, they may also propose appropriate exclusions for these parameters.

4.6.2 GSL Component

On the basis of advice from the DPI, the AER understands that the Victorian GSL scheme that is currently provided for under the EDC and the Public Lighting Code will cease to apply at the end of the current regulatory control period.

The DPI's submission questions the absence of a GSL payment for momentary interruptions of supply.[218] The STPIS (version 1.0 and 1.1) was subject to an extensive public consultation prior to its finalisation in May 2009. GSL parameters were proposed initially by the AER, and subject to comments by stakeholders. The GSL parameters included under the STPIS were settled as part of this process and did not include a provision for payments for momentary interruptions of supply. The AER notes that parameters under the GSL component of the STPIS were developed with regards to current GSL arrangements in each jurisdiction and the objective of developing a national approach that is broadly reflective of these arrangements. The AER considers that it would be impractical to replicate all Victorian arrangements in a national scheme particularly where other jurisdictions have had less experience with GSL payments of this nature.

The submissions from the Trans Tasman Energy Group and the Streetlight Group of Councils both argue that the public lighting GSL should be retained for application to Victorian DNSPs. [219] The AER proposed in its preliminary positions paper that this GSL be included for the Victorian DNSPs and that the penalty payment be $25.

Accordingly, the AER's likely approach is that the GSL component of the STPIS will apply to the Victorian DNSPs in the next regulatory control period. The AER also proposes that all parameters in the GSL component of the STPIS will apply to the Victorian DNSPs. The GSL parameters are:

- frequency of interruptions
- duration of interruptions
- total duration of interruptions
- streetlight repair
- new connections, and

[218] DPI, op cit, p. 4-5.

[219] Streetlight Group of Councils / Trans Tasman Energy Group, op cit, p. 5.

- notice of planned interruptions.

The GSL component will require the Victorian DNSPs to provide payments to customers, as determined in the STPIS, if the level of service experienced by them falls below the thresholds specified in the STPIS.

Thresholds for parameters

The AER's likely approach is that the thresholds for the GSL parameters set out in the STPIS should be applied to the Victorian DNSPs in the next regulatory control period unless a DNSP proposes an appropriately justified alternative threshold in accordance with the STPIS. Under the STPIS, the DNSP may also propose to segment customers into groups by geographic area or by feeder type or by some other method and propose different thresholds for each customer group.

GSL payment amounts

The AER's likely approach is that the GSL payment amounts set out in the STPIS should apply to the Victorian DNSPs. The payment amounts in the STPIS were calculated based on the value of current payments in various jurisdictions.

In their regulatory proposals, the Victorian DNSPs may propose, or the AER may itself require, different payment amounts in accordance with clauses 6.3.3(c) and 6.3.3(d) of the STPIS.

Exclusions

The exclusions contained in clause 6.4 of the STPIS will apply to the Victorian DNSPs in the next regulatory control period.

4.6.3 Consideration of NER criteria

Clause 6.6.2(b)(3) of the NER lists the factors the AER must take into account in developing and implementing the STPIS. The AER's consideration of these factors is discussed below.

4.6.3.1 The need to ensure that benefits to consumers likely to result from the scheme are sufficient to warrant any penalty or reward under the scheme

Incentive rates for reliability parameters under the STPIS are set on the basis of an economic study of the VCR, which estimates the value of service reliability as a value per kilowatt hour of lost load for supply interruptions.[220] Weightings for each parameter are also based on the value that customers place on them. The incentive rate for the telephone answering parameter is based on the results of a customer willingness to pay survey undertaken in South Australia for ESCOSA.[221] Therefore, the potential penalty or reward available to the Victorian DNSPs reflects the potential benefit to consumers, and how they value performance under the parameter in question.

[220] The scheme draws on a study of VCR commissioned by Vencorp. Further information about the VCR can be found in the AER's final decision accompanying the STPIS (version 1.1) published in May 2009 and its final decision accompanying the STPIS (version 1.0) published in June 2008.

[221] The South Australian study was used by the ESCV for the Victorian service performance incentive framework, in the absence of Victorian specific data in relation to customers' willingness to pay for improvements in call centre performance.

4.6.3.2 Any current regulatory requirements to which the relevant DNSP is currently subject

The service standards framework that has applied to the Victorian DNSPs under the Victorian regulatory framework is discussed in section 4.3 of this chapter.

The Victorian DNSPs are currently subject to a GSL scheme administered by the ESCV. The AER understands that the Victorian GSL scheme will not apply in the next regulatory control period. Accordingly, the AER's likely approach is that the GSL component of its national STPIS will apply to the Victorian DNSPs in the next regulatory control period (assuming the current Victorian jurisdictional GSL scheme is removed).

The AER's STPIS does not currently include a quality of supply component, but for reliability of supply and customer service performance the AER will use similar parameters to those that currently feature in the service standards framework administered by the ESCV.

In setting performance targets for these parameters in the STPIS, the AER will have regard to targets currently set by the ESCV in its EDPR but notes that it is not bound to adopt them for the purpose of the scheme. In determining the targets the AER will also have regard to a DNSP's average performance over the current regulatory control period and any minimum service standards that a DNSP is required to comply with.

4.6.3.3 The past performance of the distribution network

Targets for the reliability and customer service components of the s-factor will be based on the average performance of Victorian DNSPs over the previous five years. This means that the AER will take into account the previous performance of the Victorian DNSPs, as reported to the ESCV, when setting targets.

In establishing these targets, expectations on the basis of past performance will be modified to take into account reliability improvements completed or planned, where these are:

- reflected in the Victorian DNSPs' approved forecast expenditure for the next regulatory control period, or
- approved in the expenditure allowed under the ESCV's EDPR and expected to result in material improvements in performance in the current regulatory control period.

Targets may also be modified if other factors are identified that are expected to materially affect network reliability performance.

4.6.3.4 Any other incentives available to the DNSP under the NER or the relevant distribution determination

Other incentive schemes applicable to the Victorian DNSPs as part of the distribution determination are the efficiency benefit sharing scheme (EBSS) and the demand management incentive scheme (DMIS).

The STPIS works as a 'counterbalance' to the EBSS, which creates incentives to realise operational efficiency gains. The STPIS serves to maintain or, where efficient,

improve service levels (where customers are willing to pay for improved service) so that the incentive to minimise operating expenditure does not result in lower levels of service for customers.

In relation to the DMIS, the STPIS is essentially neutral regarding the level of reliability of network and non network solutions, neither encouraging nor discouraging non-network alternatives to augmentation. However, as discussed below, the AER recognises that there may be a perceived disincentive to implement non-network alternatives to network augmentation created by the reliability performance measures in the STPIS.

4.6.3.5 The need to ensure that the incentives are sufficient to offset any financial incentives the DNSP may have to reduce costs at the expense of service levels

The STPIS will penalise the Victorian DNSPs for deteriorating service levels and reward them for efficient improvements in service. These penalties and rewards take the form of negative and positive adjustments to annual revenue, so that the revenue earned by the Victorian DNSPs will be tied to the level of service that they actually provide. Any incentive to reduce costs at the expense of service levels is countered by the penalties provided for under the STPIS.

4.6.3.6 The willingness of the customer or end user to pay for improved performance in the delivery of services

The willingness of the Victorian DNSPs' customers to pay for improved levels of service is factored into the incentive rates for each component. These incentive rates reflect the VCR, so that the weighting attached to each parameter, and therefore the amount of any reward or penalty, reflects the value customers place on it.

By segmenting the network for the purposes of determining targets for the reliability of supply component of the STPIS, the AER is able to set targets, and distribute revenue at risk (and therefore the amount of any reward or penalty available), in a way that reflects customers' priorities and their willingness to pay for improvements.

4.6.3.7 The possible effects of the scheme on incentives for the implementation of non-network incentives

The STPIS encourages a DNSP to maintain and improve service levels. The incentive created by the AER's DMIS is for a DNSP to implement innovative and/or broad–based demand management that can result in improved network utilisation. The STPIS does not necessarily counteract the incentives created by the DMIS.

However, the AER is aware of the perceived disincentive to implement non-network alternatives to network augmentation created by the reliability performance measures in its STPIS, such that incentives to undertake demand side management may be diminished in the absence of, for example, an adjustment to performance targets or an exclusion to recognise what is seen as a greater risk that targets will not be met.

The DMIS is designed to facilitate improved demand management capability and capacity, and to promote innovative and new developments in the area of demand management so that demand management projects may increasingly be identified as viable alternatives to network augmentation. This feature of the DMIS is designed to break down the barriers to implementation of demand management solutions, arising

from claims that such options remain largely unproven and reflect a higher risk to DNSPs than network-based solutions.

4.7 AER's likely approach to the application of a STPIS

The AER's likely approach is that it will apply the reliability of supply, customer service and GSL component of the STPIS to the Victorian DNSPs in the next regulatory control period.

Targets for the reliability of supply component will be attached to SAIDI, SAIFI and MAIFI with separate targets for each segment of the network, in accordance with the SCONRRR feeder categories identified in the STPIS. Targets will reflect the available data on average performance over the previous five years, with adjustments as necessary under the STPIS.

The AER does not intend to apply a quality of supply component to the Victorian DNSPs for the next regulatory control period.

For the customer service component, the AER's likely approach is that the telephone answering parameter (as defined in Appendix A of the AER's STPIS) will apply to the Victorian DNSPs for the next regulatory control period. Other parameters under this component may be proposed by the Victorian DNSPs in their regulatory proposals.

The AER's likely approach is that it will apply all parameters under the GSL component of the STPIS to the Victorian DNSPs in the next regulatory control period. This is on the basis of the AER's understanding that the Victorian GSL scheme that currently applies to the Victorian DNSPs, and which is provided for under the ESCV's Electricity Distribution Code and Public Lighting Code, will not apply in the next regulatory control period.

In forming this position, the AER has had regard to the factors in clause 6.6.2(b)(3) of the NER, and considers that:

- the use of VCR to determine incentive rates and weighting for parameters under the s-factor scheme reflect the willingness of customers to pay for improved performance in the delivery of services by the Victorian DNSPs. The use of VCR in setting incentive rates and weightings also means that any potential benefits to consumers under the STPIS are sufficient to warrant any reward or penalty under the scheme for the Victorian DNSPs
- the STPIS will operate concurrently with any jurisdictional minimum service standards that the Victorian DNSPs are required to comply with
- whilst the Victorian DNSPs will be penalised for diminished performance, they will also have the opportunity to gain financially for performance that exceeds the performance targets. Any incentive to reduce costs at the expense of service levels is counterbalanced by the corresponding penalties under the STPIS
- the STPIS accounts for the past performance of the distribution network by setting s-factor targets based on average performance of the Victorian DNSPs over the previous five years, and

- the STPIS is designed to operate in conjunction with both the DMIS and EBSS. The STPIS balances the potential for the EBSS to provide incentives to inefficiently reduce operating expenditure at the risk of service levels and, in respect of the DMIS, is essentially neutral regarding the level of reliability of network and non network solutions, neither encouraging nor discouraging non-network alternatives to augmentation.

5 Application of efficiency benefit sharing scheme

5.1 Introduction

The AER's building block determination for the Victorian DNSPs for the next regulatory control period must specify how any applicable efficiency benefit sharing scheme (EBSS) will apply to them.[222]

This chapter sets out the AER's likely approach to the application of an EBSS to the Victorian DNSPs in the next regulatory control period, and its reasons for that approach.

An EBSS provides for a fair sharing of efficiency gains and losses between DNSPs and their customers. These gains and losses result from underspends or overspends in a DNSP's operating expenditure for a regulatory control period.

In the absence of an EBSS, there is an incentive for DNSPs to realise efficiency gains early in the regulatory control period because these benefits can only be retained for the remainder of the period. The DNSPs may also have an incentive to increase their actual operating expenditure in the third or fourth year of the regulatory control period (beyond the efficient level), as amounts from these years are typically the basis of operating expenditure forecasts for the next regulatory control period. The consequent effect is that the incentive for DNSPs to improve the efficiency of their operating expenditure declines throughout the regulatory control period. One of the objectives of an EBSS is to create a continuous incentive for DNSPs to seek economically efficient ways to reduce their operating expenditure in each year of the regulatory control period.

5.2 Requirements of the NER

Clause 6.3.2 of the NER requires the AER's distribution determination for the Victorian DNSPs for the next regulatory control period to specify how the EBSS is to be applied to them in that period. The AER is also required in this framework and approach paper, under clause 6.8.1 of the NER, to set out its likely approach and its reasons for that approach, to the application of the EBSS in that determination.

5.2.1 AER's distribution EBSS

As part of the new framework for economic regulation of distribution services, the AER is required to develop and publish a scheme or schemes that provide for a fair sharing between DNSPs and users of:

- the efficiency gains derived from the operating expenditure of DNSPs for a regulatory control period being less than, and
- the efficiency losses derived from the operating expenditure of DNSPs for a regulatory control period being more than,

[222] NER, cl. 6.3.2(a)(3).

the forecast benchmark operating expenditure approved or substituted by the AER for that regulatory control period.[223]

In April 2008, the AER released its proposed EBSS to apply to DNSPs. The proposed scheme was then the subject of public consultation and submissions were received from interested parties. Issues raised in those submissions were taken into account in preparing the AER's final EBSS and accompanying explanatory statement, released in June 2008. The AER's final EBSS is available on the AER's website, at www.aer.gov.au.

The EBSS has been designed to provide an incentive for a DNSP to reveal its efficient level of expenditure through the retention of efficiency gains for five years after the year in which the gain is made. The scheme calculates revenue increments or decrements derived from the difference between a DNSP's actual operating expenditure and the forecast operating expenditure approved in its building block determination. It is these increments or decrements that provide for the fair sharing of gains and losses between DNSPs and their network users.

The EBSS is symmetrical in nature, allowing the DNSP to retain the benefits of an efficiency gain or bear the costs of an efficiency loss for the length of the carryover period, regardless of the year in which the gain/loss was realised within the regulatory control period.

The nominal five-year carryover period assumed in the AER's EBSS results in a benefit-sharing ratio of approximately 30:70 between DNSPs and their customers.[224] This means that the DNSP will retain 30 per cent of the benefits of efficiency gains and the remaining 70 per cent is passed on to the DNSP's customers through reduced prices.

Carryover amounts incurred in a regulatory control period are included as a building block element in the calculation of allowed revenue for the regulatory control period following the period in which the EBSS was applied.

5.2.2 Implementing the EBSS

In implementing the EBSS, the AER must have regard to:

- the need to ensure that benefits to consumers likely to result from the EBSS are sufficient to warrant any reward or penalty under the scheme for DNSPs
- the need to provide DNSPs with a continuous incentive, so far as is consistent with economic efficiency, to reduce operating expenditure
- the desirability of both rewarding DNSPs for efficiency gains and penalising DNSPs for efficiency losses
- any incentives the DNSP may have to capitalise expenditure, and

[223] NER, cl. 6.5.8(a).

[224] The EBSS assumes a nominal carryover period of five years, but allows a longer carryover period where the regulatory control period covered by the relevant distribution determination is longer than five years. The carryover period will not exceed 10 years. A 10-year carryover period results in a sharing ratio of approximately 50:50.

- the possible effects of the scheme on incentives for the implementation of non-network alternatives.[225]

The AER's distribution EBSS was developed, and will be applied to the Victorian DNSPs, having regard to these factors.

The AER's likely approach to the application of the EBSS to the Victorian DNSPs in the next regulatory control period is set out in the sections below.

5.3 Overview of current arrangements for Victorian DNSPs

The Victorian DNSPs are currently subject to an efficiency carryover mechanism, administered by the ESCV under the EDPR. This mechanism works in conjunction with the incentive contained within the CPI−X control mechanism to improve efficiency in expenditure during the regulatory control period.

The efficiency carryover mechanism that currently applies to the Victorian DNSPs is a modified version of the mechanism applied by the Victorian Office of the Regulator-General (ORG) for the 2001-05 regulatory control period. The current regulatory control period (2006-10) is the second regulatory control period in which the Victorian DNSPs have been subject to an efficiency carryover mechanism.

The ESCV's EDPR states that:

> An efficiency gain (or loss) in operating and maintenance expenditure in any year during the 2006-10 regulatory period is to be calculated as the reduction (or increase) in the level of recurrent operating and maintenance expenditure compared to the forecast for that year. Recurrent in this sense is taken as the underspend (overspend) between forecast and actual in year one, then incremental underspend (overspend) in subsequent years[226]

The efficiency gains (or losses) in operating and maintenance expenditure are retained by the DNSP for five years.

Unlike the earlier mechanism applied by the ORG, the ESCV amended the efficiency control mechanism in its EDPR to:

- exclude capital expenditure. This means that DNSPs are not able to carry over any efficiency gains associated with capital expenditure efficiencies achieved during the current regulatory control period into the next regulatory control period, and
- remove the "zero floor approach".[227] The ESCV determined that in calculating the carryover amounts arising from the current regulatory control period (2006-10) to be applied in the next regulatory control period commencing in 2011, the presumption would be that where a negative carryover amount arises it will be

[225] NER, cl. 6.5.8(c).

[226] ESCV, *EDPR, Final Decision Volume 1*, October 2006, p. 431.

[227] The zero floor approach involved setting any negative carryovers that would ordinarily be carried over in a particular year to zero. See ESCV, *EDPR, Final Decision Volume 1*, October 2006, p. 424.

applied in calculating the building blocks revenue requirement for the next regulatory control period.[228]

The EDPR also applied the carryover amounts arising from the previous regulatory control period to the revenue requirements for the current regulatory control period for each Victorian DNSP.

5.4 AER's preliminary position on the application of an EBSS to Victorian DNSPs

The AER's preliminary position was that the EBSS would be applied to the Victorian DNSPs in the next regulatory control period.

In forming this position, the AER had regard to the factors in clause 6.5.8(c) of the NER.

5.5 Summary of submissions

The AER received submissions from the following stakeholders in response to its preliminary positions paper in relation to the application of the EBSS to the Victorian DNSPs in the next regulatory control period:

- AGL
- SP AusNet, and
- Jemena.

AGL submits that there should be a specific incentive for DNSPs to maximise the effective use of AMI technology and to realise efficiency gains. AGL considers that any gains derived from the implementation of AMI technology should be shared with those paying for the AMI infrastructure.[229]

The AER notes that the EBSS already differentiates between management induced efficiency gains and those efficiency gains which are due to external factors and are uncontrollable. As a result, only management induced efficiency gains will be recognised under the EBSS.

SP AusNet submitted that as the EBSS removes actual operating expenditure increases or decreases associated with a recognised pass through event, the interaction between the EBSS and the pass through arrangements should be recognised in the EBSS.[230]

The AER notes that the issue raised by SP AusNet is explicitly dealt with in clause 2.3.2 of the AER's EBSS, which states that:

[228]The EDPR further stated that the treatment of any negative carryover amount in the 2011 building block requirement should be assessed in light of the "prevailing regulatory arrangements at that time". The EDPR notes that "future regulators should exercise discretion in determining whether this presumption should be applied to negative efficiency carryover amounts based on the circumstances that have given rise to the negative efficiency carryover amounts". See ESCV, EDPR, Final Decision Volume 1, October 2006, p. 435.

[229] AGL, op cit, p. 2.

[230] SP AusNet, p. 18.

- Approved increases or decreases in actual opex associated with recognised pass through events will be excluded from the actual and forecast expenditure amounts used to calculate carryover gains or losses under the EBSS.

Jemena submits that negative carryovers create an incremental penalty on the DNSP without providing any incremental incentives. It considers that under the current carryover scheme, where a DNSP overspends its regulatory allowance for operating expenditure, the overspend cannot be recovered from regulated revenue. Jemena argues that a strong incentive therefore already exists to not overspend and it is not clear to Jemena what additional benefit is achieved by imposing an additional penalty through the EBSS equal to the amount of the overspend.[231]

The AER considered the issue of negative carryovers in the development of the EBSS and adopted a negative carryover mechanism so that the scheme would provide DNSPs with a continuous incentive for efficient operating expenditure. The AER's final decision for its EBSS and sections 5.6.1.2 and 5.6.1.3 below contain further discussion on this matter. The AER's final decision for its EBSS is available on the AER's website, at www.aer.gov.au.

5.6 Issues and AER's considerations

The AER has developed an EBSS in accordance with the requirements of the NER, which it intends to apply to the Victorian DNSPs in the next regulatory control period. In its application of the EBSS to the Victorian DNSPs, the AER has had regard to the factors in clause 6.5.8(c) of the NER. In this way, the design of the EBSS will itself ensure that its application to the Victorian DNSPs (and other DNSPs) is consistent with the criteria established in the NER.

5.6.1 Consideration of the NER factors

The AER must have regard to a number of factors in implementing the EBSS. These are discussed in turn below. Recognition of these factors in the development of the EBSS itself is discussed in more detail in the AER's final decision for its EBSS.

5.6.1.1 The need to ensure that benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for Victorian DNSPs

In developing the EBSS, the AER selected a five year carryover period (the length of a standard regulatory control period). This results in a sharing ratio between Victorian DNSPs and customers of 30:70. Where an efficiency gain is realised and a subsequent operating expenditure underspend occurs, the DNSP retains the benefit of the efficiency gain for the duration of the carryover period, after which time, the price reductions as a result of the efficiency gain are passed on to customers. In this way, the DNSP retains 30 per cent of the total benefits of the efficiency gain, and the remaining 70 per cent is passed on to customers. The carryover period may extend into the following regulatory control period (if the efficiency was realised in year two or after).

Due to the symmetrical nature of the scheme, consumers are still subject to the 70 per cent sharing ratio allocation where a loss is made. Therefore, whilst the

[231] Jemena, op cit, p. 12.

Victorian DNSPs must share the benefits of any gains, the costs of any losses are also borne by consumers in the form of increased prices. However, the risk that customers incur higher prices due to efficiency losses is mitigated by the continuous incentive for the Victorian DNSPs to strive for efficiency gains created by the EBSS.

The EBSS provides greater certainty to the Victorian DNSPs on how actual operating expenditure will be used to set forecasts in future regulatory control periods. Without an EBSS, the incentive to improve efficiency decreases as the period progresses and there can be uncertainty as to how operating expenditure will be forecast in future regulatory control periods. The EBSS therefore provides a constant incentive to improve efficiency. The EBSS will encourage efficient and timely expenditure throughout the regulatory control period, removing the incentive to only seek efficiency gains in the first half of or early in the period. This encourages the Victorian DNSPs to reveal their efficient operating expenditure. Consequently, the AER will be better placed to determine efficient forecasts going forward, and in time, these benefits will be passed on to consumers.

5.6.1.2 The need to provide DNSPs with a continuous incentive, so far as is consistent with economic efficiency, to reduce operating expenditure and, if the scheme extends to capital expenditure, capital expenditure

The EBSS is designed to ensure that a DNSP facing a potential efficiency gain does not perceive a material advantage in either deferring or advancing an efficiency gain or loss, but rather that it faces an essentially constant benefit or cost from implementing a gain or loss as it arises. The measurement of gains and losses should not be artificially affected by, for example, shifting costs between years. Rather, it should represent genuine business outcomes that have arisen in the ordinary course of conducting the business in a prudent and diligent manner.

Under an economic regulation incentive framework, efficiencies are normally only retained until the end of the regulatory control period. In the absence of an EBSS this may create a natural incentive for the Victorian DNSPs to realise operating expenditure efficiencies early in the regulatory control period, so that the benefit of that efficiency can be retained for a longer period of time. By allowing the Victorian DNSPs to retain the benefit of an efficiency gain for the length of the carryover period regardless of the regulatory year in which it is achieved, the EBSS reduces this incentive.

There may also be a perceived incentive for the Victorian DNSPs to increase operating expenditure in the later years of the regulatory control period, as the third or fourth year of the regulatory control period is commonly used in regulatory proposals as the starting point in forecasting operating expenditure requirements for the following regulatory control period.

This incentive to increase operating expenditure for the regulatory period in the base year is at least partly counteracted by the symmetrical nature of the scheme. DNSPs may be inclined to strategically defer operating expenditure until the base year to increase operating expenditure forecasts for following regulatory periods. However, the symmetrical nature of the EBSS means that any overspend in that year will be penalised for the length of the carryover period. Any potential gains to the DNSP from increasing operating expenditure in the base year will have to be weighed up against the penalties that will be incurred for five years after the overspend.

The AER's EBSS thus provides the Victorian DNSPs with a continuous incentive to achieve efficiency gains (and minimise efficiency losses) in each year of the regulatory control period.

The AER's EBSS does not extend to capital expenditure, and deals only with operating expenditure. This decision is explained in detail in the AER's final decision for its EBSS.

5.6.1.3 The desirability of both rewarding DNSPs for efficiency gains and penalising DNSPs for efficiency losses

In developing the EBSS, the AER's modelling demonstrated that application of positive and negative carryovers was important for the continuity of incentives to improve efficiency. Without symmetrical carryovers, there is a perceived incentive to shift operating expenditure into the base year on the expectation that this will increase forecasts for the next regulatory control period. The AER concluded that symmetry in the EBSS was therefore appropriate.

Under the EBSS, any negative or positive carryover amount will be included as a building block element in the calculation of the Victorian DNSPs' allowed revenue for the regulatory control period following the 2011-15 regulatory control period. Negative and positive gains are treated equally, to ensure that the incentives created by the EBSS are not skewed in favour of realising operating expenditure efficiencies only during the early years of the regulatory control period.

5.6.1.4 Any incentives that DNSPs may have to capitalise expenditure

An important outcome of the EBSS is that it provides a constant incentive to the Victorian DNSPs to improve the efficiency of operating expenditure throughout the regulatory control period. Because the EBSS only applies to operating expenditure and not capital expenditure, the Victorian DNSPs may have an incentive to reallocate operating expenditure to capital expenditure, thereby creating an artificial efficiency improvement. This incentive is mitigated by the AER's requirement that the Victorian DNSPs provide the AER with a detailed description of any changes to its capitalisation policy, and a calculation of the impact of those changes on forecast and actual operating expenditure. To negate any incentive to capitalise operating expenditure, where it is not efficient to do so, the AER will adjust the forecast and actual operating expenditure figures used to determine the carryover amounts to account for any changes in capitalisation policy.

5.6.1.5 Possible effects of the EBSS on incentives for implementation of non network alternatives

Expenditure on non-network alternatives generally takes the form of operating expenditure, rather than capital expenditure. Because the EBSS is not applied to capital expenditure, the incentive later on in the regulatory control period to reduce capital expenditure is less than the incentive to reduce operating expenditure. Therefore, where expenditure for non-network alternatives is operational, the Victorian DNSPs may have a greater incentive to augment networks later in the period than to implement non-network alternatives. The EBSS excludes all costs associated with non-network alternatives. This removes the potential impact of the EBSS on such decisions, which may otherwise discourage the Victorian DNSPs from considering demand side management.

5.7 AER's likely approach to the application of an EBSS

The AER's likely approach is that the EBSS will be applied to the Victorian DNSPs in the next regulatory control period. In forming this position, the AER has had regard to the factors in clause 6.5.8(c) of the NER, and considers that:

- the benefits to Victorian consumers derived from the EBSS are sufficient to warrant any financial reward or penalty that the Victorian DNSPs may incur, because Victorian DNSPs' customers would receive 70 per cent of the efficiency gains realised by the Victorian DNSPs under the EBSS.[232] Because the EBSS is symmetrical, any efficiency losses would also be shared between customers and the Victorian DNSPs, so that the potential for financial penalty is balanced.[233] The symmetry of the scheme also provides that incentives are not skewed in favour of realising efficiencies only during the first years of the regulatory control period. This also removes the perceived tendency towards strategic deferral of operating expenditure to the final years of the regulatory control period to create an artificially high base year for future forecasts
- the EBSS provides a continuous incentive for the Victorian DNSPs to achieve operating expenditure efficiencies throughout the regulatory control period. Any efficiency gains or losses realised within the regulatory control period are retained for the length of the carryover period, regardless of the year in which the gain or loss is realised [234]
- the EBSS counters any artificial incentive to capitalise expenditure, by requiring the Victorian DNSPs to report any changes to its capitalisation policy to the AER. The AER will adjust the forecast and outturn operating expenditure figures used to determine the carryover amounts to account for any changes in capitalisation policy, [235] and
- the exclusion of costs associated with demand side management from consideration under the EBSS removes any deterrents to the use of non-network alternatives that might otherwise arise under the EBSS.[236]
- for efficiency gains/losses realised in the current 2006-2010 regulatory control period, each annual carryover amount under the efficiency carryover mechanism will be calculated and used in the building block determination for the next regulatory control period, 2011-2015. The AER will incorporate all carryover amounts accrued in any year of the current regulatory period into forecast opex amounts for the next regulatory control period.

The EBSS allows the Victorian DNSPs to propose cost categories which it considers to be uncontrollable for exclusion from the scheme. These categories must be proposed by a Victorian DNSP in its regulatory proposal for consideration in the AER's distribution determination.

When making a decision to approve an uncontrollable cost category, the AER will have regard to whether the cost category is genuinely beyond the control of the

[232] NER, cl. 6.5.8(c)(1).
[233] NER, cl. 6.5.8(c)(3).
[234] NER, cl. 6.5.8(c)(2).
[235] NER, cl. 6.5.8(c)(4).
[236] NER, cl. 6.5.8(c)(5).

DNSP. DNSPs who propose uncontrollable operating expenditure categories will be required to maintain and provide disaggregated operating expenditure figures in support of any proposed uncontrollable operating expenditure categories to allow proper administration of the EBSS. The AER notes that outturn operating expenditure for uncontrollable cost categories will not be assumed to be efficient for the purposes of forecasting costs for future regulatory control periods. Therefore, the efficiency of base year costs for these categories will need to be established in a DNSP's regulatory proposal.

6 Application of demand management incentive scheme

6.1 Introduction

This chapter sets out the AER's likely approach to the application of a demand management incentive scheme (DMIS) to the Victorian DNSPs for the next regulatory control period and its reasons for that approach.

The objective of a DMIS is to provide incentives for DNSPs to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.[237] The DMIS operates in conjunction with existing incentives in the regulatory framework to pursue these objectives.

Demand management refers to the implementation of any strategy to address growth in demand or peak demand. Network owners can seek to undertake demand management through a variety of mechanisms, such as incentives for customers to change their demand patterns, operational efficiency programs, or load control technologies. Demand management can provide efficient alternatives to network investments, by deferring the need for augmentations to relieve network constraints. This can have positive impacts by reducing inefficient peaks and encouraging more efficient use of existing network assets, resulting in lower prices for network users.

6.2 Requirements of the NER

Clause 6.3.2 of the NER requires the AER's distribution determination for the Victorian DNSPs for the next regulatory control period to specify how a DMIS will be applied to the Victorian DNSPs. Clause 6.8.1 of the NER requires that the AER set out in this framework and approach paper, its likely approach, together with the reasons for that approach, to the application of the DMIS in its determination for the Victorian DNSPs.

As part of the new framework for economic regulation of distribution services, the NER allow the AER to develop and publish an incentive scheme or schemes to provide incentives for DNSPs to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.[238] Unlike the STPIS and the EBSS, the AER is not required to develop a DMIS. However, where it does elect to do so, it must follow the distribution consultation procedures set out in the NER.[239]

6.3 Demand management incentive schemes under chapter 6 of the NER

In developing and implementing a DMIS, the AER must have regard to the factors in clause 6.6.3(b) of the NER, being:

[237] NER, cl. 6.6.3(a).

[238] NER, cl. 6.6.3(a).

[239] NER, r. 6.16.

- the need to ensure that benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for DNSPs
- the effect of a particular control mechanism (i.e. price – as distinct from revenue – regulation) on a DNSP's incentives to adopt or implement efficient non-network alternatives
- the extent the DNSP is able to offer efficient pricing structures
- the possible interaction between a DMIS and other incentive schemes, and
- the willingness of the customer or end user to pay for increases in costs resulting from implementation of the scheme.

The distribution consultation procedures in clause 6.16 of the NER require the AER to publish a proposed DMIS and explanatory statement, inviting submissions and giving stakeholders and interested parties at least 30 business days to respond. Within 80 business days of publishing the proposed DMIS, the AER must publish its final decision and DMIS.

The AER's demand management incentive scheme to apply to Victorian DNSPs (DMIS) was released in April 2009 and is available on the AER's website, at www.aer.gov.au. Accompanying the DMIS is a final decision which sets out the AER's considerations of submissions received on the proposed DMIS, released in December 2008. This final decision also sets out the AER's consideration of the objectives in clause 6.6.3 (b) of the NER.

As in the preliminary positions paper, the AER's likely approach is that it will apply both the demand management innovation allowance (DMIA) and foregone revenue components of the DMIS to the Victorian DNSPs in the next regulatory control period.

6.4 Context for introduction of DMIS in Victoria

6.4.1 Operating environment in Victoria

The ESCV's EDPR states that:

> Currently, Victoria has the second highest peak load (in percentage terms) of all the Australian States, with only South Australia having a more peaky load. Victoria's peak demand arises from several contributing factors including large businesses and industry having peak loads at coincident times, and the increasing penetration and use of air conditioning in homes.[240]

The ESCV provided for a range of measures in the EDPR to encourage the implementation of demand management and non-network initiatives to manage peaky load in the current regulatory control period. The ESCV stated in its EDPR that its intention was that these measures would 'remove barriers that impede demand management', rather than incentivise the active pursuit of demand management and non-network initiatives.[241] In summary, these measures include:[242]

[240] ESCV, *EDPR, Final Decision Volume 1*, October 2006, pp. 492-493.

[241] Ibid., p. 499.

[242] Ibid., pp. 494–99.

- allowing the DNSPs to fund demand management implementation costs out of the capital expenditure deferral (cost savings) arising from these initiatives. In particular, where deferral benefits accrue within a regulatory period, DNSPs can retain these cost savings in full to cover any demand management implementation costs
- the mandated roll-out of interval meters. The EDPR states that 'the improved metering data that these meters will provide has significant potential to improve tariff design and provide information about network constraints to enable a much more efficient and effective demand side response'
- the provision of an additional $0.6 million of revenue (operation and maintenance) for each DNSP for 'the trial of demand management initiatives during the 2006–2010 regulatory period'
- the exclusion (for a trial period only) of distributed (embedded) generation or other approved demand management initiatives from the service incentive scheme
- the provision of further information, to be included in the DNSP's Annual Tariff Reports, on current and emerging network constraints. The provision of such information is intended to 'assist in the establishment of demand management and non-network solutions', and
- the approval of licences for distributed (embedded) generators. These generators are connected in areas of localised network constraints.

The nature of peak demand in Victoria indicates that there is a role for demand management. Demand management may assist the Victorian DNSPs to meet forecast demand requirements while maintaining or reducing the level of planned expenditure on their networks.

6.4.2 Other existing and potential opportunities for demand management

The Victorian operating environment suggests that a DMIS has a role to play in managing future demand. Aside from any DMIS, there are other factors that may have an impact on the level of demand management carried out by DNSPs in Victoria. For example:

- as discussed in chapter 3 of this paper, the NER allow the AER to apply different control mechanisms, such as a tariff basket, a revenue yield or a revenue cap, to a DNSP's distribution services. The AER is aware that different control mechanisms may have different incentive effects on a DNSP's willingness to undertake demand management. As noted in chapter 3, under a weighted average price cap, a DNSP may have lower incentives to undertake demand management as it could result in lower demand and therefore lower revenues
- DNSPs may have an incentive to conduct demand management where it is more economically efficient than implementing network augmentation. The AER will approve the recovery of a certain amount of forecast capital expenditure for each DNSP at the time of its distribution determination. For any planned capital expenditure that is deferred or deemed no longer necessary during the regulatory control period, DNSPs are able to retain the return on, and return of, these underspends for the remainder of the regulatory control period. This may provide incentives for DNSPs to seek ways to meet their supply obligations by managing

demand on their networks, thereby deferring the need for capital expenditure and retaining the return on, and return of, the costs for the amount of capital expenditure deferred for the remainder of the regulatory control period

- clauses 6.5.6(a)(1) and 6.5.7(a)(1) of the NER require that a building block proposal must include the total forecast operating expenditure and capital expenditure which the DNSP considers is required to meet or manage the expected demand for standard control services over the regulatory control period. Inclusion of forecast operating and capital expenditure for demand management in a building block proposal is explicitly allowed under the NER, subject to the requirements of clauses 6.5.6(a)(1) and 6.5.7(a)(1) of the NER and the AER's building block determination
- clauses 6.5.6(e) and 6.5.7(e) of the NER require that, in determining whether it is satisfied with a DNSP's forecasts of capital and operating expenditure, the AER must have regard to the extent to which the DNSP has considered and made provision for non-network alternatives. While these clauses may not expressly place obligations on the DNSPs to demonstrate that they have had specific regard to demand management alternatives to capital expenditure and operating expenditure projects, this information is necessary to inform the AER's assessment of DNSPs' expenditure forecasts. As such, DNSPs will need to put forward details of their consideration of efficient non–network alternatives as part of their regulatory proposals
- in June 2008, the Ministerial Council on Energy (MCE) committed to a roll-out of smart meters, including in Victoria, and identified a range of potential opportunities and benefits that may arise from the roll-out of smart meters. These include an 'increase [in] retail competition through product differentiation, the potential for consumers to reduce and manage their bills through increased access to consumption and other information, a wide range of potential innovations in services, such as home energy management and links to water and gas metering, and synergies with other infrastructure developments such as smart grids'[243]
- broader climate change policies and initiatives mandated in the future, for example such as a national carbon pollution reduction scheme, may also facilitate demand management.
- changes to the roll-out of smart meters in Victoria were announced by the Victorian Government in September 2008[244]. The Victorian roll-out will commence in mid 2009 and is required to be completed by the end of 2013. The four core services the meters will provide include:[245]
    - Recording electricity used every half hour, so households can better monitor their energy use and cost
    - Meters read remotely, to help make bills more accurate, help retailers respond to customer enquiries better and distributors can more easily identify faults;
    - Remotely connecting supply, and

[243] MCE, *Smart Meter Decision Paper,* 13 June 2008.

[244] Victorian Government Media Release, *Smart Meter Roll-out Streamlined to Align with National Scheme,.* 29 September 2008.

[245] Ibid.

- Remotely disconnecting supply, making it more convenient for people moving house

Also, the Australian Energy Market Commission (AEMC) is undertaking a review of demand side participation in the NEM, and is exploring the potential for greater incentives for demand management. In April 2009, it published a draft report entitled '*Demand-Side Participation in the National Electricity Market*'. [246] The AER notes that this process will have implications for how demand side management programs may be considered in the future, in the context of a national demand management scheme. Amongst other findings, the AEMC's draft report presented the following three conclusions:

- the current method for re-setting network price appears to penalise businesses who, in the previous regulatory period, decided to use demand management expenditure to defer capex. The AEMC is seeking views on how to remove this bias
- the limited financial incentives for businesses to innovate under the current forms of regulation are likely to act as a barrier to businesses making appropriate use of demand side participation. The AEMC considers that 'use it or lose it' funding for innovation may be a proportionate way of addressing such a barrier, and
- the AEMC considers that a business under a price cap form of regulation has private incentives for undertaking demand side participation which are consistent with socially efficient levels of demand side participation. As a part of the AEMC's review, many stakeholders submitted that a price cap penalises the use of demand side participation by network businesses because it reduces network demand, which in turn reduces network revenue. The AEMC considers that this view is erroneous.[247]

The AER notes that submissions to the AEMC's draft report are due in June 2009. The AER anticipates that definitive conclusions about the role of national demand management and related national incentive schemes under the NER will be made following the AEMC's review process.

Notwithstanding the incentives and initiatives related to demand management discussed above, the AER considers that there are benefits to be gained by consumers and DNSPs by facilitating further demand management in Victoria. Accordingly, the AER considers that there are sufficient reasons for it to apply a DMIS to the Victorian DNSPs. The AER's reasons under the NER for applying a DMIS and its likely approach are discussed in section 6.7.2 below.

6.5 AER's preliminary position on the application of a DMIS to Victorian DNSPs

Having had regard to the requirements of the NER, the AER's preliminary position was to apply a DMIS to the Victorian DNSPs in the next regulatory control period that comprises a DMIA and a mechanism for the recovery of forgone revenue.

[246] This can be found at http://www.aemc.gov.au/pdfs/reviews/Review%20of%20Demand-Side%20Participation%20in%20the%20National%20Electricity%20Market/aemcdocs/008Stage%202%20-%20Draft%20Report.pdf

[247] Ibid.

In determining the appropriate amount of the DMIA for the Victorian DNSPs (i.e. CitiPower, Powercor, Jemena, SP AusNet and United Energy), the AER had regard to the relative size of each Victorian DNSP's average annual revenue allowance in the 2006-10 regulatory control period. Despite submissions that the DMIA should be an uncapped amount, the AER maintains the approach taken in its preliminary positions paper, and notes that this approach is consistent with that used to determine the DMIA for the South Australian and Queensland DNSPs.

Considering each Victorian DNSP's current revenue allowance, and the approach previously taken by the AER, the AER proposed the following annual DMIA amounts for each Victorian DNSP:

Table 6.1 Proposed annual DMIA amounts for Victorian DNSPs (nominal)

DNSP	Proposed DMIA amount
Jemena	$200 000
CitiPower	$200 000
United Energy	$400 000
SP AusNet	$600 000
Powercor	$600 000

Source: AER analysis.

6.6 Summary of submissions

The AER received submissions from the following stakeholders in response to its preliminary positions paper in relation to the application of the DMIS to the Victorian DNSPs in the next regulatory control period:

- AGL
- the Consumer Utility Advocacy Centre
- CitiPower/Powercor
- Department of Primary Industries
- Energy Response
- Jemena
- Origin Energy
- SP AusNet
- the Total Environment Centre
- United Energy.

The AER has considered these submissions in finalising its DMIS for the Victorian DNSPs. The DMIS and the AER's final decision were published in April 2009 and are available on the AER's website, at www.aer.gov.au. The AER's consideration of the issues raised in these submissions can be found in the final decision. In light of issues raised in submissions, the AER made one substantive change to the Victorian DMIS, this being an up front, indicative approval process under the scheme. Further discussion of this is contained in section 6.7.1.

6.7 Issues and AER's considerations

6.7.1 Structure of the DMIS applicable to the Victorian DNSPs

The AER's DMIS that will apply to the Victorian DNSPs has two parts:

- a DMIA, and
- a provision for the recovery of foregone revenue.

These are discussed in turn below. Further information about the DMIS is contained in the AER's DMIS.

6.7.1.1 Demand management innovation allowance

The first part of the DMIS is a DMIA that allows the recovery of costs for demand management projects and programs undertaken throughout the regulatory control period, subject to satisfaction of defined criteria. The DMIA is provided as a capped, annual *ex ante* allowance, and subject to a single adjustment in the subsequent regulatory control period to return any expenditure not approved, or any amount of the DMIA that is not spent, to customers.

In response to stakeholder submissions, the AER, in its final DMIS for Victorian DNSPs, has also included an optional, up-front, indicative approval process as part of the DMIA. Under this process, the AER will examine proposed demand management initiatives (under the DMIS) and provide an indicative assessment of whether or not these projects or programs satisfy the DMIA assessment criteria. Where the expenditure assessed as part of the ex post review does not differ in substance or form from the expenditure proposed at the commencement of the regulatory year under the in principle up-front approval process, the AER expects that it would approve recovery of those costs. Where expenditure differs in substance and/or form from that proposed by the DNSP under the in principle up-front approval process, it will be scrutinised against the ex post approval criteria. DNSPs wishing to submit proposed expenditure as part of this process must do so by 31 January of the relevant regulatory year.

Annual reporting requirements will create transparency in the operation of the DMIA, and allow the AER, DNSPs, users and other stakeholders to monitor the effectiveness and outcomes of the scheme.

In its final decision on the DMIS for Victorian DNSP, the AER noted the potential for double recovery of costs if DMIS capex is rolled into the RAB. Double recovery would occur where capex is fully recovered under the DMIS and is rolled into the RAB and a return on that capex is also recovered over the life of the asset(s). It is considered that DMIS capex is more akin to connections and capital contributions

which are funded separately by particular customers and are not included in the RAB. It is envisaged that the majority of expenditure under the DMIS will be in the form of opex, however, capex was included under the DMIS so as not to inhibit the scope of projects that DNSPs could undertake through the scheme. Allowing capex under the DMIA through the DMIS criteria allows cost recovery of innovative and potentially untested demand management capex projects and programs. Through the DMIA, the DMIS offers a mechanism to recover such capex, without necessary recourse to the capex criteria in clause 6.5.7 of the NER.

6.7.1.2 Recovery of forgone revenue

The second part of the DMIS allows recovery of revenue forgone by a DNSP within the relevant regulatory control period as a result of a reduction in the quantity of electricity sold due to the implementation of non-tariff demand management projects and programs approved under the DMIA. This arrangement will only apply to a DNSP where the form of control that applies to its standard control services results in its approved regulated revenue for those services being dependent on the quantity of energy actually sold, such as a weighted average price cap.

Recovery of forgone revenue is in addition to the capped amount of the DMIA, however the actual amount that can be recovered is limited to approved revenue forgone resulting from a successful project established under the DMIA. The forgone revenue will be provided in the subsequent regulatory control period, at the same time as the single adjustment under the DMIA.

6.7.2 Consideration of NER criteria

In applying a DMIS to the Victorian DNSPs, the AER must have regard to the factors in clause 6.6.3(b) of the NER which are discussed below.

6.7.2.1 The need to ensure that benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for DNSPs

The rewards and penalties payable under a DMIS must be set at a level that ensures that the costs to consumers resulting from the associated adjustment to regulated revenues do not exceed the benefits expected to result from the implementation of the DMIS. In striking the appropriate balance, it must be recognised that the operation of such a scheme may result in cost impacts within a regulatory control period where benefits are unlikely to be revealed until later periods.

The AER's DMIS for the Victorian DNSPs is designed to encourage the implementation of demand management initiatives which provide long term efficiency gains to energy users that are expected to outweigh any short term price increases. The allowance is designed to provide incentives for the Victorian DNSPs to conduct efficient, broad-based and/or innovative demand management programs. As Victoria has 'the second highest peak load … of all the Australian States',[248] a scheme which targets both broad-based and peak demand reduction across the distribution network is considered appropriate.

[248] ESCV, *EDPR, Final Decision Volume 1*, October 2006, pp. 492-493.

The DMIS is a modest scheme, with allowances provided on a use-it-or-lose-it basis. Consequently increases in customer prices arising from the scheme are expected to be minimal.

The AER considers that the scheme's expenditure allowance will allow the Victorian DNSPs to carry out a number of small-scale demand management projects, or a single larger-scale demand management project during the regulatory control period. The application of the forgone revenue component of the DMIS to the Victorian DNSPs is intended to remove a disincentive to make full and effective use of the DMIA under a weighted average price cap form of control. It will, in effect, mirror regulated revenue that would have otherwise have been earned within the regulatory control period, but for the implementation of the relevant demand management project or program.

6.7.2.2 The effect of a particular control mechanism (i.e. price – as distinct from revenue – regulation) on a DNSP's incentives to adopt or implement efficient non-network alternatives

In applying a DMIS to the Victorian DNSPs, the AER has had regard to the effects that particular control mechanisms may have on the incentives or disincentives for DNSPs to undertake demand management. The AER accepts that incentives for demand management may be affected by the control mechanism applied to a DNSP's standard control services. Under forms of control where revenue is at least partially dependent on the quantity of electricity sold (e.g. a price cap or a weighted average price cap), a successful demand management program that causes a reduction in demand may result in less revenue to a DNSP.

The AER has decided that the Victorian DNSPs will be subject to a weighted average price cap for their standard control services, which may result in their revenue being at least partially dependent on the amount of electricity sold, creating disincentives for the Victorian DNSPs to undertake demand management initiatives. To remove this disincentive, the AER's likely approach is to apply a mechanism within the DMIS so that, within the next regulatory control period, the Victorian DNSPs will be able to recover any forgone revenue directly attributable to a reduction in the quantity of electricity sold due to the implementation of a non-tariff demand management program approved under the DMIA part of the DMIS. Application of the ability to recover forgone revenue under the scheme is intended to remove the disincentive to make full and effective use of the DMIA that may otherwise occur under a weighted average price cap.

6.7.2.3 The extent the DNSP is able to offer efficient pricing structures

In applying a DMIS to the Victorian DNSPs, the AER must have regard to the extent that they are able to offer efficient pricing structures.

Ideally, efficient pricing structures exist where the price of electricity at a particular point in the network reflects the true costs of its supply at that location at a particular point in time. For instance, efficient pricing structures should reflect increases in costs of supplying electricity in times of peak demand.

The AER considers that efficient pricing structures can assist the effectiveness of demand management programs, and that the availability of a DMIA will provide

capacity for the Victorian DNSPs to conduct tariff-based demand management programs which will provide further information on mechanisms for efficient pricing.

6.7.2.4 The possible interaction between a DMIS and other incentive schemes

In applying a DMIS to the Victorian DNSPs the AER must have regard to the interaction of that scheme with other incentive schemes. As outlined in chapters 4 and 5 of this paper, the AER's likely approach is that both an EBSS and STPIS will be applied to the Victorian DNSPs in the next regulatory control period.

Increased expenditure on demand management within the regulatory control period may increase operating expenditure above the levels forecast in the distribution determination. This could lead to a corresponding and unintended penalty under the EBSS. To minimise the impact of the EBSS on the incentives to undertake efficient demand management programs, the EBSS excludes all costs associated with non-network alternatives, including operating expenditure on demand management and expenditure under the DMIS, from the calculation of operating expenditure overspends and underspends. This removes the potential impact of the EBSS on a decision to implement demand management or non-network alternatives, which may otherwise discourage the Victorian DNSPs from doing so.

The AER is aware of the perceived disincentive to implement non-network alternatives to augmentation created by the reliability performance measures in its STPIS, such that incentives to undertake demand side management may be diminished by what is seen as a greater risk that performance targets will not be met. The DMIS is designed to facilitate improved demand management capability and capacity, and to promote innovative and new developments in the area of demand management so that demand management projects may increasingly be identified as viable alternatives to network augmentation. This feature of the DMIA is designed to break down the barriers to implementation of demand management solutions, arising from claims that such options remain largely unproven and reflect a higher risk to DNSPs than network-based solutions.

The AER considers that the application of the DMIS to the Victorian DNSPs will not negatively interact with the incentives created by other incentive schemes or send conflicting signals in terms of desired expenditure outcomes.

6.7.2.5 The willingness of the customer or end user to pay for increases in costs resulting from implementation of the scheme.

In considering its likely approach to the application of a DMIS to the Victorian DNSPs, the AER has had regard to the extent to which Victorian customers and end users are willing to pay for increases in costs resulting from the implementation of the scheme.

The AER considers that the application of a modest, low cost and administratively streamlined scheme, such as the DMIS to be applied to the Victorian DNSPs, under which the cost increases experienced by customers and end users will be minimal, is appropriate at this time. Implementation of the scheme will allow the Victorian DNSPs to investigate and undertake demand management initiatives which will provide long term benefits to consumers that will outweigh the short-term costs of implementing the scheme.

6.8 AER's likely approach to the application of a DMIS

Having had regard to the requirements of the NER, the AER's likely approach is to apply a DMIS to the Victorian DNSPs in the next regulatory control period that comprises a DMIA and a mechanism for the recovery of forgone revenue.

In determining the appropriate amount of the DMIA for the Victorian DNSPs (i.e. CitiPower, Powercor, Jemena, SP AusNet and United Energy), the AER has had regard to the relative size of each Victorian DNSP's average annual revenue allowance in the 2006-10 regulatory control period. This was also the approach taken by the AER in determining the DMIA for the South Australian and Queensland DNSPs. In the framework and approach for ETSA Utilities (South Australia) the AER proposed a DMIA of $600,000. In the framework and approach for Energex and Ergon Energy (Queensland), the AER proposed a DMIA of $1,000,000 for each DNSP.

Considering each Victorian DNSP's current revenue allowance, and the approach previously taken by the AER, the AER's likely approach is to allow annual DMIA amounts for each Victorian DNSP as follows:

Table 6.2 Likely Annual DMIA amounts for Victorian DNSPs (nominal)

DNSP	Likely DMIA amount
Jemena	$200 000
CitiPower	$200 000
United Energy	$400 000
SP AusNet	$600 000
Powercor	$600 000

Source: AER analysis.

Under these arrangements, a total of $10 million would be allowed as DMIA expenditure by the Victorian DNSPs over the next regulatory control period.

The AER will apply a weighted average price cap to the Victorian DNSPs' standard control services, which may result in its recovery of the annual revenue requirement being at least partially dependent on the amount of electricity sold, creating disincentives for the Victorian DNSPs to undertake demand management initiatives. To counter this disincentive, the AER's likely approach is to allow the Victorian DNSPs to recover any forgone revenue directly attributable to a reduction in the quantity of electricity sold due to the implementation of a non-tariff demand management program approved under the DMIA.

The DMIS complements the incentive properties that are expected to flow from the application of the STPIS and EBSS within the broader incentive framework set out in chapter 6 of the NER. The AER is satisfied that the combination of the capped DMIA and the forgone revenue component of the DMIS will provide appropriate incentives to the Victorian DNSPs to adopt or implement efficient non-network alternatives

under a weighted average price cap. The AER also considers that the scheme will not provide a reward that outweighs the benefits to consumers likely to result from the scheme or the willingness of customers and end users to pay for its implementation.

7 Other matters

7.1 Cost Allocation

Clause 11.17.5(c) of the NER provides that:

> The AER must include in its framework and approach paper prepared for a Victorian Distribution Network Service Provider, in relation to the first building block proposal to be submitted by the provider after the commencement of Chapter 6, a statement of its likely approach to cost allocation based on the guidelines then in force.

The AER issued the *Victorian electricity distribution network service providers - Cost allocation guidelines* (Victorian Cost Allocation Guidelines) on 26 June 2008 in accordance with clause 6.15.3(a) of the NER.

Under Clause 11.17.5(a) of the NER, Victorian DNSPs must submit their proposed Cost Allocation Method at, or by, the time their building block proposal is submitted.

Clause 11.17.5(d) of the NER states that the AER:

- must, in deciding whether to approve a Cost Allocation Method submitted by a Victorian DNSP, have regard to previous cost allocation in accordance with the ESCV distribution pricing determination
- must not approve the Cost Allocation Method unless it allows effective comparison of historical and forecast cost allocation between the period to which the ESCV distribution pricing determination applies and later regulatory control periods, and
- may, subject to the relevant Guidelines, refuse to approve the Cost Allocation Method if it differs from the method previously used by the Victorian DNSP.

The AER's preliminary position was that:

- the Victorian DNSPs prepare and submit a Cost Allocation Method to the AER in accordance with the NER and section 3 of the AER's Victorian Cost Allocation Guidelines
- it will approve, or reject, a Victorian DNSP's proposed Cost Allocation Method in accordance with section 4 of the Victorian Cost Allocation Guidelines, and
- the Victorian DNSPs apply their approved Cost Allocation Method in accordance with section 5 of the Victorian Cost Allocation Guidelines.

Both Jemena[249] and United Energy[250] support the AER's proposed approach to cost allocation in their responses to its preliminary positions paper. No further comments were provided by stakeholders.

On this basis, the AER maintains its likely approach as outlined above.

[249] Jemena, op cit, p. 15.

[250] United Energy, op cit, p. 7.

7.2 Dual function assets

Clause 6.8.1(ca) of the NER requires that the framework and approach paper must include the AER's determination under clause 6.25(b) as to whether or not Part J of Chapter 6A is to be applied to determine the pricing of any transmission standard control services provided by any dual function assets owned, controlled or operated by the DNSPs.

The Victorian DNSPs have advised the AER that they do not own, control or operate any dual function assets.

7.3 Other matters raised in submissions

Clause 6.8.1(b)(5) of the NER provides that the framework and approach paper should set out the AER's likely approach, together with its reasons for the likely approach, in the forthcoming distribution determination, to any other matters which it thinks fit to give an indication of its likely approach.

The AER received a number of submissions from stakeholders identifying issues that they considered the AER should set out its likely approach in this framework and approach paper.

7.3.1 Cost pass-throughs events

CitiPower and Powercor jointly submits that additional cost pass-through events should be included in the framework and approach paper, including in relation to the financial failure of a retailer, a declared retailer of last resort, a force majeure event, an emissions trading scheme event and a transfer of non-pricing distribution functions event.[251]

Clause S6.1.3(2) of the NER states that a DNSP's building block proposal must contain a proposal as to the events that should be defined as pass through events.

Consistent with the AER's framework and approach paper for the Queensland DNSPs, the AER considers that an indication of its likely approach is not appropriate at this time given that it is required to make a decision on nominated events at the time of making a distribution determination. Such a decision will be made after assessing the DNSPs regulatory proposal and submissions from interested parties.

7.3.2 Price setting

Victorian electricity retailers are required to publish tariffs 30 days before a retail price change. To allow retailers to make their own tariff adjustments by 1 January each year, AGL proposes that DNSPs' distribution tariffs be published by mid October.[252]

Clause 6.18.2(a) of the NER provides that a DNSP must:

> (1) submit to the AER, as soon as practicable, and in any case within 15 business days, after publication of the distribution determination, a pricing proposal (the

[251] Citipower and Powercor, op cit, p. 14-19.

[252] AGL, op cit, p. 3.

"initial pricing proposal") for the first regulatory year of the regulatory control period; and

(2) submit to the AER, at least 2 months before the commencement of the second and each subsequent regulatory year of the regulatory control period, a further pricing proposal (an "annual pricing proposal') for the relevant regulatory year.

In accordance with clause 6.11.2 of the NER, the AER is not required to issue its distribution determination for a DNSP until at least two months before the start of the regulatory control period. In combination, clauses 6.11.2 and 6.18.2(a) mean that a DNSP's prices for each regulatory year of the next regulatory control period are not likely to be known until shortly before the regulatory control period begins.

Given these time constraints under the NER, the AER considers that AGL's proposed mid October deadline for finalising distribution tariffs each year is not feasible.

7.3.3 Expenditure levels

Energy Safe Victoria submits that the AER's framework and approach paper, and subsequent distribution determinations, should make appropriate allowances for expenditure to maintain and renew assets, and to manage vegetation, to promote the long term safety and security of Victoria's electricity network.[253]

The AER is likely to have regard for the types of issues raised by Energy Safe Victoria in assessing the DNSPs' regulatory obligations and the cost of meeting these obligations and other requirements to maintain service performance, as part of considering their regulatory proposals in accordance with Chapter 6 of the NER. The basis for the AER considering a DNSP's capital and operating expenditure building block proposals is set out in clauses 6.5.6 and 6.5.7 of the NER. These clauses, together with clauses S6.1.1 and S6.1.2 of the NER, also set out the matters that DNSPs must address in their regulatory proposals to the AER.

7.3.4 Advanced metering infrastructure

AGL submits that the Victorian DNSPs are currently over-recovering metering charges related to the 2006 rollout of Type 5 interval meters.[254] AGL seeks clarification that until new advanced metering infrastructure requirements come into effect, the current metering data and metering provision service level requirements will remain in place.

The VCOSS submits that the roll out of advanced metering infrastructure will create an extensive infrastructure network, which may have application outside the provision of metering services. The VCOSS further suggests that given that this infrastructure will be paid for by consumers, any revenue from ancillary services provided through this infrastructure should be returned to consumers through future price reviews.[255]

The AER notes that all metering services will be regulated under the November 2008 AMI Order in Council, including 'above standard services' provided by the Victorian

[253] Energy Safe Victoria, *Request for submission on the AER "Framework and Approach Paper, December 2008"*, 6 March 2009, p. 1.
[254] AGL, op cit, p. 1.
[255] VCOSS, op cit, p. 3.

DNSPs to customers with annual consumption of less than 160 MWh, regardless of whether they currently have a revenue meter that is an accumulation meter or a manually read interval meter. The future regulation of metering services and the AMI framework is discussed in section 2.4 of this framework and approach paper.

The AER considers that it is not appropriate for this framework and approach paper to comment on the matters related to manually read interval meters and AMI raised by AGL and the VCOSS. The AER notes that in January 2009 it released its framework and approach paper applying to DNSPs' budget and charges applications for AMI. This paper outlines consultation arrangements regarding the AER's consideration of AMI costs and charges, and is available on the AER's website, at www.aer.gov.au.

7.3.5 Relationships with other Jurisdictions

Origin Energy submits that the framework and approach paper for Victorian DNSPs should have regard for the classification of services already approved for other jurisdictions.[256]

As noted in chapter 2 of this framework and approach paper, the NER require the AER to have regard to the desirability of consistency in the regulatory approach and form of regulation within, and beyond, NEM jurisdictions. The NER also require the maintenance of consistency with previous regulatory approaches, which may differ across jurisdictions.

While noting Origin Energy's submission, the AER maintains its position as stated in its preliminary positions paper that greater consistency in the classification of similar services and forms of control across jurisdictions is a medium to longer term objective, to the extent that this is possible.

7.3.6 Information gathering and reporting

The DPI submits that the AER has not implemented the ESCV's annual 'health card' reports to assess the impact of DNSPs investment decisions on the long-term reliability and security of the distribution system. As such, the DPI enquires as to how the AER intends to assess ongoing threats to the long-term reliability and security of the distribution system.[257]

The VCOSS proposes that the AER should prepare a report in order to facilitate consumers' understanding of distribution pricing and its impacts.[258]

The AER notes these submissions, but considers these matters to be beyond the direct scope of this framework and approach paper, as the paper is intended to deal with matters that the AER will address in its forthcoming distribution determination. The AER will publicly report on the service performance of DNSPs in the future. The AER is consulting separately with DNSPs and other stakeholders on the reporting measures through consultation on the AER's future annual reporting arrangements. Further information about these arrangements can be found on the AER's website, at www.aer.gov.au.

[256] Origin Energy, op cit, p. 4-5.
[257] DPI, op cit, p. 7-8.
[258] VCOSS, op cit, p. 2.

7.3.7 Conclusion

On the basis of the above discussion, the AER does not propose, for the purposes of clause 6.8.1(b)(5) of the NER, to detail its likely approach to any other matters in this framework and approach paper that it will address in its forthcoming distribution determination.

Appendix A: AER's likely service groups and classifications

Table 1 of this appendix sets out the AER's likely distribution service groups and the applicable classifications and the current ESCV classifications. For guidance, the table includes general descriptions of the type of activities that fall within each service group. It is not a complete listing of the underlying services provided by the Victorian DNSPs.

Table 1 AER's likely service groups and classifications

AER service group	ESCV current classification	AER likely classification	Service / Activity
Network services	Prescribed distribution service	Standard control service	Constructing the distribution network
			Maintaining the distribution network and connection assets
			Operating the distribution network and connection assets for DNSP purposes
			Planning the distribution network
			Designing the distribution network
			Emergency response
			Administrative support (e.g. call centre, network billing)
Connection services	Excluded distribution service	Alternative control service	Energisation of new connections
	Excluded distribution service	Negotiated distribution service	Connection and augmentation works for new connections

AER service group	ESCV current classification	AER likely classification	Service / Activity
Metering services	Excluded distribution service	Alternative control service	Metering data provider services for unmetered supplies with Type 7 metering installations
Public lighting services - Operation, repair, replacement and maintenance of DNSP public lighting assets	Excluded distribution service	Alternative control service	Operation, repair, replacement and maintenance of DNSP public lighting assets
Public lighting services - Alteration and relocation of DNSP public lighting assets	Excluded distribution service	Negotiated distribution service	Alteration and relocation of DNSP public lighting assets
Public lighting services - New public lighting	Excluded distribution service	Negotiated distribution service	New public lighting
Quoted services	Excluded distribution service	Alternative control service	Rearrangement of network assets at customer request, *excluding* alteration and relocation of existing public lighting assets
			Supply enhancement at customer request
			Emergency recoverable works (i.e. emergency works where customer is at fault and immediate action needs to be taken by the DNSP)
			Auditing of design and construction
			Specification and design enquiry fees
Fee Based Services	Excluded distribution service	Alternative control service	De-energisation of existing premises
			Re-energisation of existing premises

AER service group	ESCV current classification	AER likely classification	Service / Activity
Fee Based Services	Excluded distribution service	Alternative control service	Temporary disconnect / reconnect services
			Temporary supply services
			Wasted attendance - not DNSP fault
			Service truck visits
			Location of underground cables
			Elective underground service where an existing overhead service exists
			Covering of low voltage mains for safety reasons
			Re-test of types 5 and 6 metering installations for first tier customers with annual consumption greater than 160 MWh
			Supply abolishment
			Fault response — not DNSP fault
			Damage to overhead service cables caused by high load vehicles
			High load escorts — lifting overhead lines
Unregulated services	Metering provider services - prescribed metering services and excluded distribution service	Not classified	All “metering provider services” other than as detailed above

AER service group	ESCV current classification	AER likely classification	Service / Activity
Unregulated services	Metering data agent services - prescribed metering services and excluded distribution service	Not classified	All “metering data provider services” other than as detailed above
	Watchman lights	Not classified	The installation and maintenance of watchman (security) lights

Source: AER analysis.

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Appendix B: Prescribed Distribution Services in 2005 Tariff Order

Part B of the Attachment to the 2005 Tariff Order lists the prescribed distribution services as:

1. the transportation of electricity, except as contemplated in paragraph 1 of Part A of this Attachment[259];

2. the Distribution of electricity to customers connected at the following existing connection points:

   (a) Public Transport Corporation - Caulfield;

   (b) Public Transport Corporation - Cremorne;

   (c) Public Transport Corporation - Burnley;

   (d) Public Transport Corporation - North Melbourne;

   (e) Public Transport Corporation - Rushall;

   (f) Public Transport Corporation - Victoria Park;

3. the carrying out of works or the provision of maintenance or repair for the purpose of carrying out Distribution of electricity; and

4. the provision of any meters, except as contemplated in paragraphs 3(c), 17 and 18 of Part A of this Attachment[260].

[259] Paragraph 1 of Part A of the 2005 Tariff Order classifies the transportation of electricity between DNSPs as an excluded service.

[260] These clauses relate to the provision of pre-payment meters to customers, the provision of above standard metering and the collection and processing of metering data.

Appendix C: Excluded Distribution Services in Part A of Attachment to 2005 Tariff Order

Part A of the Attachment to the 2005 Tariff Order provides that distribution services or kinds of distribution services that are taken to be excluded distribution services as at the date of the Tariff Order are as follows:

1. the transportation of electricity not consumed in the Distributor's Distribution System (i.e. inter-network provider distribution);
2. connection to the Distributor's Distribution System;
3. services (including metering, electric lines or electrical plant) for the specific benefit of any third party (and requested by the third party) and not made available by the Distributor as a normal part of standard service to all customers. These services include:
   (a) the movement of mains, services or meters forming part of the Distributor's Distribution System to accommodate extension, re-design or re-development of any premises;
   (b) the provision of electric plant for the specific purpose of enabling the provision of top-up or standby supplies or sales of electricity; and
   (c) the provision of pre-payment meters to customers;
4. the relocation of electric lines plant and the carrying out of associated works pursuant to any statutory obligation imposed on the Distributor;
5. specific services for identified customers;
6. temporary supplies;
7. capital contributions for new works and augmentation;
8. network services for connection points where customers operate parallel generation requiring a stand-by supply;
9. reserve (duplicate) supply;
10. supplies with higher quality and reliability standards than required by the Electricity Distribution Code;
11. the provision of connection points requiring more than the "least overall cost, technically acceptable" assets;
12. Distribution services and system augmentation required to receive energy from:
    (a) an embedded generator, as defined in a licence issued under Division 3 of Part 2 of the EIA to distribute electricity; or
    (b) another Distributor;
13. the provision of services as a result of customer non compliance with the Electricity Distribution Code or Electricity Retail Code including but not limited to reactive power, line losses in excess of deemed distribution losses due to customer's poor power factor, harmonics, voltage dips and test supplies;

14. the provision of multiple connection points to a single property to the extent that the charges for the provision of those connection points are not recovered through charges for the use of the Distribution System which are regulated by a Price Determination;
15. public lighting operations and maintenance;
16. the provision of public lighting assets constructed after 1 July 1994;
17. the provision of metering to a standard in excess of that required for the billing of network tariffs;
18. the collection and processing of meter data; and
19. the provision of reactive power and energy to a connection point or the receipt of reactive power and energy from a connection point.

Appendix D: Excluded Distribution Services in EDPR

The ESCV determined that, in accordance with clause 2.2(a) of the Tariff Order, certain additional services will be classified as excluded distribution services. These are set out in clause 6.1.1 of volume 2 of the EDPR, as follows:

(i) The repair, maintenance and replacement of street lighting;

(ii) The provision of under grounding services at the request of a third party;

(iii) Metering services for first tier customers who consume more than 160 MWh per annum or have an interval meter that is remotely read;

(iv) Subject to the National Electricity Rules, metering services for second tier customers with a metering installation type 1, 2, 3 or 4 or a metering installation type 5, which is an interval meter that is remotely read;

(v) Exit fees for a distribution customer who has been charged a prescribed metering service tariff in accordance with clause 4.1.3;

(vi) The installation of an interval meter that is not remotely read to existing premises which are installed at the request of the distribution customer in advance of the distribution business's scheduled interval meter roll-out, insofar as the cost of this service is a cost in respect of which the distribution business is not remunerated under the distribution business's distribution tariffs and prescribed metering service tariffs; and

(vii) The installation of an interval meter that is not remotely read which is installed after business hours at the request of the distribution customer (as defined in clause 4.1.3), insofar as the cost of this service is a cost in respect of which the distribution business is not remunerated under the distribution business's distribution tariffs and prescribed metering service tariffs.

Appendix E: Excluded Distribution Services in 2007 AMI Order in Council

Section 3 of the 2007 AMI Order in Council states that:

> Notwithstanding clause 4 or clause 6 of the Current Price Determination (Volume 2), or clause 2 of, and the Attachment to, the Tariff Order, with effect from the Start Date, each of the following services shall be deemed to be an Excluded Service for the purposes of the Tariff Order and the Tariff Order is amended accordingly pursuant to section 15A(2) of the Act:
>
> (a) metering services supplied to first tier customers or second tier customers with annual electricity consumption of 160MWh or less where the electricity consumption of that customer is (or is to be) measured using a revenue meter that is either an accumulation meter or a manually read interval meter;
>
> (b) metering services supplied to first tier customers or second tier customers with annual electricity consumption of 160MWh or less where the electricity consumption of that customer is (or is to be) measured using a revenue meter that is a remotely read interval meter; and
>
> (c) the services described in clauses 7.1 and 8.1 of this Order.[261]

[261] These clauses refer to a payment of exit fee and a payment of restoration fee.

Appendix F: Form of the control mechanisms to be applied by the distribution determination

Standard control services

The weighted average price cap distribution price control is expressed by the formula set out below.

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

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

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

q_{t-2}^{ij} 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 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*.

Alternative control services

Individual services

The price cap for the individual alternative control services is expressed by the formula set out below. The basis of this control mechanism for alternative control services will be of the CPI−X form.

$$p_t \leq p_{t-1} \times (1 + CPI_t) \times (1 - X)$$

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"*;

p_t is the price cap for each individual alternative control service in *regulatory year "t"*;

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 September 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 September Quarter immediately preceding the start of *regulatory year t-1*;

X to be determined using the building block approach.

Appendix G: Submissions received on Preliminary Positions Paper

Submissions were received by the AER on its preliminary positions paper from the following stakeholders:

- AGL
- Citipower and Powercor (jointly)
- Energy Safe Victoria
- Jemena
- Origin Energy
- SP AusNet
- Streetlight Group of Councils
- Trans Tasman Energy Group
- United Energy
- Victorian Council of Social Services, and
- Victorian Department of Primary and Industries.

Glossary

2005 Tariff Order	Victorian Electricity Supply Industry Tariff Order 2005
2007 AMI Order in Council	2007 Order in Council in relation to Advanced Metering Infrastructure
November 2008 AMI Order in Council	2008 Order in Council in relation to Advanced Metering Infrastructure
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
cl. / cll.	clause / clauses
CPI	Consumer price index
CPI−X	CPI minus X
CRA	Charles River Associates
DMIA	Demand management incentive allowance
DMIS	Demand management incentive scheme
DNSP	Distribution network service provider
DUOS	distribution use of system
EBSS	Efficiency benefit sharing scheme
EDC	Electricity Distribution Code
EDPR	ESCV Electricity Distribution Price Review for the regulatory control period 1 January 2006 to 31 December 2010
ESCV	Essential Services Commission of Victoria
GSL	Guaranteed service level
m	million
MAIFI	Momentary average interruption frequency index
MCE	Ministerial Council on Energy
MWh	Megawatt hours
NEC	National Electricity Code
NEL	National Electricity Law

NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
NER	National Electricity Rules
ORG	Victorian Office the Regulator-General
PTRM	Post-tax revenue model
RAB	Regulatory asset base
RFM	Roll-forward model
ROLR	Retailer of last resort
s.	section
SAIDI	System average interruption duration index
SAIFI	System average interruption frequency index
SCONRRR	Steering Committee on National Regulatory Reporting Requirements
STPIS	Service target performance incentive scheme
VCR	Value customer reliability
WACC	Weighted average cost of capital