

Control mechanisms for standard control services in the ACT and NSW

Response to the Australian Energy Regulator's
discussion paper on the Framework and Approach
for the 2014-19 electricity network determinations

May 2012

Summary

- ActewAGL Distribution agrees with the AER’s proposed assessment criteria. However, the AER’s assessment does not give sufficient weight to the Rules requirement for the AER to have regard to: “the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination”.
- ActewAGL Distribution considers that the AER should require a shift away from the existing control mechanism only if it can establish that there is a clearly superior option and there will be net benefits from moving to that option.
- As the AER’s assessment indicates, there is no clearly superior control mechanism option – each has relative strengths and weaknesses. The AER’s initial preference – a revenue cap – has some important shortcomings relative to the other control mechanism options.
- An average revenue cap currently applies to ActewAGL Distribution’s standard control services. The AER does not include this mechanism in its detailed assessment on the basis that the average revenue cap “comprises elements of WAPC’s (weighted average price caps) and revenue caps”. The AER does include the average revenue cap in the summary table (4.1). However, the summary rankings provide a misleading and inaccurate representation of the comparison between average revenue caps and the AER’s preferred option of revenue caps.
- When the differences between the two mechanisms, as identified in the AER’s summary table, are more closely examined and the requirement to have regard to the existing control mechanism is addressed, it is apparent that the case has not been made for switching from the current average revenue cap to a revenue cap.
- ActewAGL Distribution considers that there is no case for changing the current control mechanism for ActewAGL Distribution’s standard control services and it should be retained for the 2014-19 regulatory period.

Introduction

ActewAGL Distribution welcomes the opportunity to respond to the Australian Energy Regulator's (AER's) *Discussion paper – control mechanisms for standard control electricity distribution services in the ACT and NSW*, released on 2 April 2012. ActewAGL Distribution, a partnership between ACTEW Distribution Ltd and Jemena Networks (ACT) Pty Ltd, owns and operates the electricity distribution network in the Australian Capital Territory.

ActewAGL Distribution's standard control services, which comprise network connection and use services, are currently subject to an average revenue cap. The Independent Competition and Regulatory Commission (ICRC) also applied average revenue caps to ActewAGL Distribution's network services in the previous two regulatory periods. For 1999-2004 the average revenue cap was based on forecast load. For the 2004-09 regulatory period the ICRC amended the mechanism so that it used the actual load in the most recent calendar year. The ICRC decided to base the cap on "objective and verifiable data, rather than a forecast, where such data are available". The average revenue cap for the current regulatory period is also based on actual load data for the most recent calendar year.

The AER does not include the average revenue cap control mechanism in its detailed assessment of control mechanism options on the basis that it "comprises elements of WAPC's (weighted average price caps) and revenue caps". Based on the comparison of these two mechanisms, the AER's initial preference is for revenue caps.

ActewAGL Distribution considers that the AER has not established that there would be net benefits from shifting away from the current average revenue cap mechanism to a revenue cap. Our comments on the AER's assessment criteria and the comparison of revenue caps with average revenue caps are provided in the following two sections. Responses to the questions the AER poses in the discussion paper are provided in the final section.

The AER's assessment criteria

The AER's assessment criteria are based on the factors set out in the National Electricity Rules (6.2.5(c)). While ActewAGL Distribution agrees that the AER's criteria are appropriate, we consider that the AER has not put appropriate weight on the Rules requirement to have regard to the control mechanism currently in place.

One of the four factors that the National Electricity Rules require the AER to have regard to when deciding on the control mechanism is “the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination”.¹

In the assessment criteria applied in the discussion paper, the AER combines the requirement relating to the current mechanism with the Rules requirement to have regard to “the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction)”. The AER’s criterion is: “consistency across jurisdictions and control periods”.

Under the heading “consistency”, the AER asks “is it desirable to have consistent control mechanisms across jurisdictions?”² But it does not ask whether consistency across control periods is appropriate.

ActewAGL Distribution considers that the AER should require a shift away from the existing control mechanism only where it can establish that there is a clearly superior option and there will be net benefits from moving to that option. The AER has taken this approach in previous Framework and Approach reviews. For the most recent distribution determinations in Victoria, Queensland, South Australia and Tasmania, the AER adopted the approach of taking the current mechanism as a starting point and assessing whether “it is more appropriate to move away from the current form of control”³. The AER said in its South Australian framework and approach decision that it “only intends to depart from the current form of control where there is evidence that such a departure is appropriate”.⁴

ActewAGL Distribution notes that the AER has commented that in future framework and approach reviews it may put greater weight on consistency across jurisdictions. For example, in its review of the control mechanism for the Victorian determinations the AER said:

“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.”⁵

There may be some advantages of consistency across jurisdictions, in terms of the AER’s administration of the control mechanisms. However, given that there is no clearly

¹ NER 6.2.5(c). In addition to the four specified factors the AER must have regard to “any other relevant factor”.

² AER 2012, *Matters relevant to the framework and approach, ACT and New South Wales DNSPs 2014-19, control mechanisms for standard control services, Discussion paper*, April, p.14

³ AER 2008, *Queensland Framework and Approach, Proposed Positions*, p. 31.

⁴ AER 2008, *South Australian Framework and Approach, Final Decision*, p. 46.

⁵ AER 2008, *Victorian Framework and Approach, Preliminary Positions*, p. 63.

superior mechanism, when assessed against the AER's criteria, it is not appropriate to require changes in order to achieve consistency across jurisdictions.

Average revenue caps versus revenue caps

The AER does not include average revenue caps in its detailed assessment of control mechanism options, noting that:

“the average revenue cap and hybrid control mechanisms comprise elements of WAPCs and revenue caps. Therefore, by addressing both WAPCs and revenue caps the AER will address the strengths and weaknesses of average revenue caps and hybrid control mechanisms.”⁶

The summary in table 4.1 of the discussion paper provides a high level indication of how the AER sees the comparison between revenue caps, the AER's preferred mechanism, and average revenue caps. However, ActewAGL Distribution considers that the high level rankings in the table provide a misleading and inaccurate comparison between average revenue caps and revenue caps.

The comparisons shown in table 4.1 indicate that each of the five control mechanism options has strengths and weaknesses, relative to the AER's assessment criteria. There is no clearly superior option, and there are some important shortcomings with revenue caps, the AER's preferred mechanism. A closer assessment of the main differences that the AER has identified between revenue caps and average revenue caps indicates that there is no conclusive case for switching from the current mechanism for ActewAGL Distribution's standard control services to a revenue cap.

Volume risk and revenue recovery

The AER's comparison shows that under revenue caps consumers bear volume risks and distribution network service providers (DNSPs) are guaranteed to recover the revenue approved in the distribution determination.⁷ It follows that revenue caps also result in low “price certainty”, because prices must adjust annually to correct for differences between forecast and actual volumes. In contrast, under average revenue caps the DNSP bears volume risk, it may recover above or below the revenue allowance set in the determination, and there is high price certainty (as the average price changes each year by CPI – X per cent).

⁶ AER 2012, *Matters relevant to the framework and approach, ACT and New South Wales DNSPs 2014-19, control mechanisms for standard control services, Discussion paper*, April, p. 9.

⁷ However the operation of side constraints may mean that the DNSP is unable to adjust prices in one year to fully offset an under-recovery of revenue in the previous year.

Underpinning the AER's initial preference for revenue caps is the view that:

"A control mechanism should provide DNSPs with an opportunity to recover efficient costs, while limiting revenue recovery above the forecast."⁸

ActewAGL Distribution agrees that DNSPs should be provided with an opportunity to recover efficient costs. However, it does not follow that in achieving this objective the control mechanism should limit revenue recovery above the forecast.

With unexpected growth there may be additional efficient costs which cannot be recovered if revenue is capped. A revenue cap will allow recovery of efficient costs if the forecasts (of throughput, maximum demand, connections and costs) on which the revenue allowance is based are exactly realised over the 5 year regulatory period. However, where there is higher than forecast growth, it is appropriate for DNSPs to have an opportunity to recover any additional efficient costs.⁹ This is possible, to some extent, under both the average revenue cap and WAPC.

The AER's initial preference for revenue caps on the basis of revenue certainty implies that the AER considers it appropriate for consumers, not DNSPs, to bear volume risk. Consumers must also face price instability under a revenue cap, as prices must adjust to ensure exact revenue recovery. ActewAGL Distribution considers that the question of who should bear volume risk raises difficult equity and efficiency issues. There is no conclusive case that consumers should fully bear the risk of differences between actual and forecast volumes during the period.

In terms of economic efficiency, the party that is best able to manage or deal with the risk should bear it. Both average revenue caps and WAPCs give DNSPs an opportunity to adjust prices to manage, to some extent, volume risks – for example by adjusting tariffs during the regulatory period in response to information on unexpected increases, or decreases, in growth for some or all tariffs or changes in load profiles. This results in some sharing of risks between consumers and DNSPs, which is likely to be more equitable and efficient than requiring consumers to fully bear volume risk, and face potentially significant annual price fluctuations, under a revenue cap.

The issue of whether DNSPs or consumers bear volume risk is particularly important for the upcoming regulatory period, given the high degree of uncertainty surrounding future electricity demand. There is uncertainty about the impacts that policies to reduce carbon emissions and improve energy efficiency may have on electricity consumption and

⁸ AER 2012, *Matters relevant to the framework and approach, ACT and New South Wales DNSPs 2014-19, control mechanisms for standard control services, Discussion paper*, April, p. 7.

⁹ The Queensland Competition Authority recognised this in its 2005-10 determination, by including provision for a review of the revenue allowance if customer numbers or maximum demand were 3 per cent above or below the forecast in the determination.

maximum demand. The outlook for other key drivers of consumption and maximum demand, such as economic growth, is also uncertain.

Given the difficulty of developing accurate forecasts for a five-year period, ActewAGL Distribution considers that it is not appropriate to apply a fixed revenue cap, which forces customers to bear the full volume risk (and DNSPs to bear earnings risk, as efficient additional costs associated with growth cannot be recovered)¹⁰. It is more appropriate to adopt a mechanism which allows some sharing of the risks. As noted above, the average revenue cap and WAPC provide an opportunity for DNSPs to use their knowledge of changing load profiles and growth trends during the period to adjust tariffs to manage volume risk, to some extent.

The AER may also want to consider adding an explicit adjustment mechanism to the average revenue cap, to limit the volume risk that the DNSP faces, thereby sharing the risk with consumers. This type of mechanism was applied as part of the average revenue cap for ETSA Utilities for the 2005-10 regulatory period. A “Q factor” adjustment reduced the sensitivity of the DNSP’s revenue to volume fluctuations above or below the forecast in the final determination.

For the 2009-14 New South Wales distribution determination Energy Australia proposed that a G-factor adjustment mechanism be added to the WAPC to address the risk of actual consumption falling below (or above) the AER’s forecast and revenue falling below (or exceeding) the allowance set in the determination. The AER rejected the proposal on the grounds that it would involve a change in the form of the control mechanism (which was not permitted under the transitional Rules) and it involved new information that could not be considered by the AER at that stage of the distribution determination process.¹¹

Demand side management incentives

The AER says in the discussion paper:

“A control mechanism should create an incentive for DNSPs to undertake an efficient level of demand side management.”¹²

The AER “places weight” on the demand side management benefits provided under a revenue cap.¹³

¹⁰ If there is no growth adjustment in the Efficiency Benefit Sharing Scheme, the DNSP could also be penalised in the next regulatory period through carry forward effects for exceeding forecast opex.

¹¹ AER 2009, *New South Wales Final Decision*, April, p. 54.

¹² AER 2012, *Matters relevant to the framework and approach, ACT and New South Wales DNSPs 2014-19, control mechanisms for standard control services, Discussion paper*, April p. 8

¹³ AER 2012, *Matters relevant to the framework and approach, ACT and New South Wales DNSPs 2014-19, control mechanisms for standard control services, Discussion paper*, April, p. 15.

ActewAGL Distribution agrees with the AER's assessment that under a revenue cap the DNSP has an incentive to undertake demand side management projects that reduce demand and reduce costs. The AER explains that the DNSP receives the same revenue regardless of the volume of services provided, so it can increase profits by minimising the costs of providing services.

However, it does not follow that the revenue cap provides incentives for an *efficient* level of demand side management. Efficient demand side management involves not simply reducing demand, but rather finding more efficient ways of meeting demand. Revenue caps provide an incentive to undertake measures which reduce costs, without any consideration of the benefits. The marginal benefit of selling an additional unit is zero (because revenue is fixed). This can result in an incentive for excessive demand side management. In its most recent Framework and Approach review, for the Tasmanian DNSP Aurora, the AER commented on the incentive under a revenue cap to set inefficiently high tariffs on demand sensitive services in order to reduce the volume of the services it sells.¹⁴

While the control mechanism will influence incentives to undertake demand side management, its impact must be considered in the broader context of the incentive regulation framework. Other elements of the framework – for example the demand management incentive scheme (DMIS), the efficiency benefit sharing scheme (EBSS) and the general incentive for DNSPs to seek out least cost options and make better use of the existing network – provide more powerful incentives for demand side management.

The AER says in its summary table that under an average revenue cap DNSPs face “very low” incentives to undertake demand side management. ActewAGL Distribution disagrees. Operating under an average revenue cap ActewAGL Distribution has responded to strong incentives to find ways to improve network utilisation and control the costs of delivering services.

ActewAGL Distribution has been able to significantly improve load factors in recent years by offering customers opportunities and incentives for demand management. More than 50 per cent of the total load in the ACT is now subject to time-of-use or controlled load (off-peak) charges. For the non-residential sector, 80 per cent of the load is on time-of-use or controlled load tariffs. The application of maximum demand and capacity charges in several commercial tariff options has further strengthened price signals to customers and provided incentives to use the network more efficiently. Between 1999/00 and 2010/11, customers on the low voltage demand network tariff improved their load factor and therefore their utilisation of the network by 12.9 per cent, increasing the average energy consumed relative to the average of their monthly maximum demand from 40.1

¹⁴ AER 2011, *Tasmanian Framework and Approach Final Decision*, p. 66. Also see quote in response to question 2 below.

per cent to 45.3 per cent. Over the same period, high voltage customers increased their load factor, and therefore their utilisation of the network, from 54.2 per cent to 60.5 per cent, an improvement of 11.7 per cent.

Administrative costs

In summary table 4.1 the AER ranks each of the control mechanism options as “intermediate” against the administrative cost criterion. ActewAGL Distribution disagrees with this assessment. The relatively low cost of implementing an average revenue cap and checking compliance is an important advantage, relative to both revenue caps and WAPCs.

As noted in the introduction to this submission, ActewAGL Distribution’s current average revenue cap is calculated using *actual* load from the previous full calendar year. Once the prices for a year are approved, there is no need to determine the actual revenue and make adjustments for differences between forecast and actual load at the end of the year. In comparison, the operation of a revenue cap is more complex. For the unders and overs adjustment, actual revenue for each year must be determined and this can be complex, especially where half the load is metered using accumulation meters.

Compared with the average revenue cap, the WAPC is also more costly to implement and enforce. While the base for the average revenue cap simply increases in line with the X factor and the CPI each year, the WAPC depends on the prices and quantities for each tariff component. The AER needs audited data on this information to implement the WAPC. For the DNSP, the need to forecast changes in every tariff component, and adjust tariffs to manage the risks associated with unexpected changes, adds to the administrative costs of a WAPC.

Responses to AER questions

Question 1

A. What weighting or ranking should be applied to the assessment criteria listed in Clause 6.2.5(c) of the NER and the additional criteria considered by the AER?

B. Are there other criteria that the AER should consider in determining the control mechanism to apply to standard control services? How important are these other criteria?

Responses

A. ActewAGL Distribution considers that the AER has applied insufficient weight to the requirement to have regard to the control mechanism applicable to the service immediately before the start of the regulatory period. Two of the additional factors that

the AER has considered – volume risk and revenue recovery, and price flexibility and stability – are appropriate and should be given a high priority. The third additional factor – incentives for demand side management – is relevant, but to a lesser degree, given that the control mechanism is not the primary driver of incentives for demand side management.

B. The AER’s criteria are comprehensive. No additional criteria need to be considered.

Question 2

A. Do you consider a price cap or a revenue cap provides the best incentives to create efficient prices?

B. To what extent do external factors override the incentives provided by the form of the control mechanism?

Responses

A. ActewAGL Distribution agrees with the AER’s assessment (as summarised in table 4.1) that revenue caps provide relatively weak incentives to create efficient prices. This is because of the relationship between marginal revenues and marginal costs. For revenue caps, marginal revenue is zero (because revenue is fixed), and this will be less than marginal cost.

The AER commented on the incentives for inefficient pricing under revenue caps in the Tasmanian Framework and Approach process:

“One possible incentive for a DNSP under a revenue cap is to set inefficient tariffs on demand sensitive services. By increasing prices on these services the DNSP will reduce the demand and therefore reduce the volume of the services it sells. This will reduce the overall costs of supplying these services whilst maintaining a similar level of return.”¹⁵

The AER’s assessment of WAPCs is that they provide a “high” incentive to set efficient prices. While ActewAGL Distribution accepts that, in theory, the incentive may be stronger under a WAPC than a revenue cap or average revenue cap, the “high” incentive needs to be qualified. The AER provided a qualified endorsement of the pricing incentive properties in the South Australian Framework and Approach review:

“Under certain assumptions it is possible that a WAPC will lead to efficient tariffs¹⁶

While the AER ranks WAPCs as “high” in providing incentives for efficient pricing in the summary table, in its detailed assessment it comments that WAPCs may result in inefficient pricing:

¹⁵ AER 2011, *Tasmanian Framework and Approach Final Decision*, p. 66.

¹⁶ AER 2010, *South Australian Framework and Approach Final Decision*, p. 46

“Anecdotal evidence suggests a WAPC may result in inefficient pricing, such as through advantageous tariff rebalancing.”¹⁷

ActewAGL Distribution notes that considered tariff rebalancing should not be equated with inefficient pricing if it does not distort economic based price signals to customers. We also note that the incentive to establish an efficient tariff structure was one of the factors IPART considered in its 2001 form of regulation review, which resulted in a change from revenue caps to WAPCs for the New South Wales DNSPs. In the review Integral Energy commented on the incentive in the long run for prices to be set efficiently under a WAPC.¹⁸

The AER assesses average revenue caps as “low” against the factor “incentive to set efficient prices”. The AER does not provide an explanation for this view.

ActewAGL Distribution notes that in the discussion of efficient pricing the AER observes that:

“The application of LRMC-pricing by DNSPs in the NEM has also been limited under WAPCs and revenue caps.”

The AER says that charging structures do not reflect LRMCs:

“as they do not vary with the time of use or location.”¹⁹

However, this observation by the AER cannot be applied to ActewAGL Distribution’s pricing under an average revenue cap. More than 50 per cent of the total load in the ACT is now subject to time-of-use or controlled load (off-peak) charges. For the non-residential sector, 80 per cent of the load is on time-of-use or controlled load tariffs. The application of maximum demand and capacity charges in several commercial tariff options has further strengthened price signals to customers and provided incentives to use the network more efficiently.

ActewAGL Distribution also considers that the criteria “incentives to set efficient prices” should not be weighted as heavily as some of the other criteria. This is because the incentives created by the control mechanism are only one of a number of factors influencing pricing efficiency. Other factors – particularly the Rules requirements relating to network pricing – override the control mechanism pricing incentives to a large degree (see response to question B below).

¹⁷ AER 2012, *Matters relevant to the framework and approach, ACT and New South Wales DNSPs 2014-19, control mechanisms for standard control services, Discussion paper*, April, p. 10

¹⁸ Integral Energy 2001, *Response to IPART Discussion Paper on the Form of Regulation for NSW Electricity Network Charges*, p. 17.

¹⁹ AER 2012, *Matters relevant to the framework and approach, ACT and New South Wales DNSPs 2014-19, control mechanisms for standard control services, Discussion paper*, April, p. 18

B. External factors – particularly the Rules requirements relating to network pricing – override the control mechanism pricing incentives to a large degree. The theoretical incentives that may encourage inefficient pricing are constrained by the side constraints in the Rules, which limit the increases in revenue recovery from each tariff class, as well as the requirement for subsidy-free prices for each tariff class (the avoidable and stand alone cost bounds) and the requirement for prices to reflect long run marginal cost. As the AER notes in the discussion paper, the extent to which retailers pass network price structures and levels through to customers is a further factor which can override the pricing incentives in the control mechanisms. In addition, transmission use of system (TUOS) charges, which represent around 22 per cent of total network tariffs, are not set on a fully cost reflective basis (approximately 73 per cent of TUOS charges to the ACT are on a postage stamp basis – only 27 per cent are on a cost reflective basis). This constrains the scope for network users to face efficient prices.

Question 3

A. Do you consider a price cap or a revenue cap is better able to provide DNSPs with an opportunity to recover efficient costs, while limiting revenue recovery above forecast?

B. Who should bear the risk of errors in forecast volumes, DNSPs or customers?

C. Is there scope for windfall gains for DNSPs under WAPCs due to (a) sales volume forecast error and (b) price changes during the regulatory control period?

Responses

A. A revenue cap is better able to limit revenue recovery above the forecast adopted by the AER. However, this is not, in itself, an appropriate objective. The opportunity to recover efficient costs is the relevant objective. Additional efficient costs may arise during the period as a result of unexpected growth, but the revenue cap does not provide an opportunity to recover these. Under a WAPC, and to a lesser extent an average revenue cap, the DNSP may be able to rebalance tariffs in a way that allows it to recover some additional efficient costs. For example, if there is unexpected growth in connections during the period, the DNSP may be able to adjust connection charges in order to generate some additional allowed revenue to at least partly recover the additional costs.

B. The question of who should bear volume risk raises equity and efficiency issues. In economic efficiency terms the party that is best able to manage the risk should bear it. If the DNSP has full flexibility to set tariffs in a way that manages the risks of unexpected increases or declines in growth rates or changing load profiles during the regulatory period, then it may be appropriate for the DNSP to bear the risk. However, given the high degree of uncertainty about future demand, and the high possibility of significant forecast errors, it may be more appropriate to have some sharing of the risks between DNSPs and customers – for example, by applying an average revenue cap with some limit on the

extent to which revenues can vary as a result of forecast errors – rather than requiring consumers to bear the full volume risk.

C. There is scope for gains, in the sense that revenue exceeds the allowance set in the determination, for DNSPs under a WAPC due to sales volume forecast error. There is also scope for losses due to volume forecast errors. The DNSP may also gain, or earn revenue above the allowance, as a result of tariff rebalancing during the regulatory period. But there are risks associated with this. The DNSP must accurately forecast growth for each tariff component during the period, and must also accurately predict customers' price responsiveness, and have the flexibility to adjust tariffs in response to this information.

A balanced assessment of the control mechanism options must also consider the potential gains (and losses) under revenue caps. Under a revenue cap, DNSPs may also receive a “windfall” gain if volumes fall short of forecasts and costs fall (for example if there are fewer connections) while revenues remain unchanged, thereby increasing earnings.

Question 4

A. What incentives does a DNSP have to conduct demand side management under a WAPC?

B. Is there any evidence to suggest that a revenue cap results in greater levels of demand side management than a WAPC?

Responses

A. ActewAGL Distribution has not operated under a WAPC. However, we do not agree with the AER's conclusion that “WAPCs provide a disincentive to undertake demand side management in the short and long run”²⁰. As noted above (in response to question 2), in theory the WAPC provides incentives for efficient pricing, which is a key requirement for managing demand in the most efficient way.

B. ActewAGL Distribution has not examined any evidence of demand side management under revenue caps or WAPCs. However, as explained above (in the discussion of incentives for demand side management), there is evidence that ActewAGL Distribution has, while operating under an average revenue cap, undertaken several important initiatives to efficiently manage demand on its network.

Question 5

²⁰ AER 2012, *Matters relevant to the framework and approach, ACT and New South Wales DNSPs 2014-19, control mechanisms for standard control services, Discussion paper*, April, p. 11.

A. Do you consider a price cap or a revenue cap is likely to provide lower administration costs? How significant are the differences in administration costs between these two forms of control?

B. What are the likely administrative costs of changing from one control mechanism to another?

Responses

A. ActewAGL Distribution considers that the average revenue cap, as currently applied to its standard control services, involves lower administration costs than both revenue caps and WAPCs. The operation of the annual unders and overs account adds to the administrative costs for revenue caps. For WAPCs, the need to determine reasonable estimates for new or changed tariffs also adds to administrative costs. In contrast the administration of the average revenue cap involves a simple check that the cap for the year has been correctly calculated and the proposed average revenue complies.

B. The administrative costs of changing mechanisms are likely to be significant. In the case of a change from an average revenue cap to a revenue cap, there would be additional costs associated with operation of the annual unders and overs adjustment for differences between forecast and actual volumes, which is not required under the average revenue cap. In the case of a change from an average revenue cap to a WAPC, there would be additional costs, for both the DNSP and the AER, in determining reasonable estimates of quantities for new or changed tariffs, in order to incorporate new tariff structures in the WAPC and side constraint formulas. For the DNSP, the need to forecast changes in every tariff component, and adjust tariffs to manage the risks associated with unexpected changes, adds to the administrative costs of a WAPC.

Question 6

A. Do you consider a WAPC or a revenue cap can better provide price flexibility?

B. What are the benefits/detriments from a high level of price flexibility?

C. What is the magnitude of disruption caused by annual price changes from the overs and unders account variations under revenue caps?

Responses

A. Under both mechanisms (and the average revenue cap) the DNSP has flexibility to determine the level and structure of individual tariffs, subject to side constraints and the pricing principles in the Rules. The key difference is that the operation of the annual unders and overs for a revenue cap can result in price instability during the regulatory

period. In its 2010-15 final determination for the Queensland DNSPs, the AER included a mechanism to limit the extent of unders and overs price adjustments in any year.²¹

B. The main benefits of pricing flexibility are that it allows DNSPs to develop cost reflective prices which recover revenue in an efficient way and respond to changing patterns of consumption during the regulatory period. Excessive price fluctuations or changes to tariff structures may be detrimental to consumers.

C. While ActewAGL Distribution has no experience in the application of a revenue cap unders and overs mechanism, we expect that the disruption caused by the annual forecasting error price adjustments, in addition to other required adjustments such as TUOS overs and unders, could be significant. This seems to be why the AER has applied tolerance limits on annual price adjustments under the Queensland revenue caps.

Question 7

A. Is it desirable to have consistent control mechanisms across jurisdictions?

Response

There may be some limited advantages to the AER of consistency across jurisdictions, in terms of the AER's administration of the control mechanisms. However, given that there is no clearly superior mechanism, when assessed against the AER's criteria, it is not appropriate to require changes to an existing mechanism that is working well in order to achieve consistency across jurisdictions.

Question 8

A. Is it appropriate to adopt a revenue cap for standard control services for the NSW and ACT 2014–19 distribution determinations?

B. What other issues should be considered in determining which control mechanism to adopt?

Responses

A. It is not appropriate to adopt a revenue cap for standard control services for the 2014-19 ACT distribution determination. ActewAGL Distribution considers that the current control mechanism for ActewAGL Distribution's standard control services should be retained for the 2014-19 regulatory period. The AER has not made a case for moving away from the current control mechanism to a revenue cap.

B. As explained in response to question 1, ActewAGL Distribution considers that the AER should require a shift away from the existing control mechanism only if it can establish that there is a clearly superior option and there will be net benefits from moving to that

²¹ AER 2010, *Queensland Final Decision*, May, p. 22.

option. In its assessment the AER should place more weight on the Rules requirement to have regard to the prevailing control mechanism in the jurisdiction.