



Stage 1 Framework and approach paper

ActewAGL

Transitional regulatory control period 1 July 2014 to 30 June 2015

Subsequent regulatory control period 1 July 2015 to 30 June 2019

March 2013

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Contents

Contents	3
Shortened forms	4
About the framework and approach	5
Part A: Overview	7
Part B: Attachments	12
Attachment 1: Classification of distribution services	13
1.1 AER’s proposed approach to classification	14
1.2 AER’s assessment approach	16
1.3 Reasons for the AER’s proposed approach	17
1.4 AER’s proposed approach to service classification.....	27
Attachment 2: Control mechanisms	28
2.1 AER decision	28
2.2 Submissions	29
2.3 AER’s assessment approach	29
2.4 Reasons for decision — control mechanism and formulae for standard control services	33
2.5 Reasons for decision— control mechanism and formulae for alternative control services.....	39
Attachment 3: Dual function assets	43
3.1 AER decision	43
3.2 Distributor view	44
3.3 AER’s assessment approach	44
3.4 Reasons for AER’s position	45
Appendix A: Rule requirements for classification	50
Appendix B: ActewAGL’s distribution services	52
Appendix C: Efficient pricing	55
Appendix D: Revenue recovery	61

Shortened forms

Shortened Form	Extended Form
ActewAGL	ActewAGL Distribution
ACT	Australian Capital Territory
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
CPI	consumer price index
CPI-X	consumer price index minus X
current regulatory control period	1 July 2009 to 30 June 2014
DNSP/distributor	distribution network service provider
DUOS	distribution use of system
F&A	Stage 1 Framework and approach
ICRC	Independent Competition and Regulatory Commission (ACT)
kWh	Kilowatt hour
MAR	maximum allowable revenue
NEL	National Electricity Law
NEM	National Electricity Market
NER/Rules	National Electricity Rules
RAB	regulatory asset base
SRMC	short run marginal cost
subsequent regulatory control period	1 July 2015 to 30 June 2019
transitional regulatory control period	1 July 2014 to 30 June 2015
TNSP	transmission network service provider
WAPC	weighted average price cap

About the framework and approach

The Australian Energy Regulator (AER) is the economic regulator for transmission and distribution services in Australia's national electricity market (NEM).¹ We are an independent statutory authority, funded by the Australian Government. Our powers and functions are set out in the National Electricity Law (NEL) and National Electricity Rules (the Rules or NER).

The framework and approach (F&A) is the first step in a process to determine efficient prices for electricity distribution services. The F&A determines, amongst other things, which services we will regulate and the broad nature of any regulatory arrangements. It also facilitates early public consultation and assists network service providers prepare regulatory proposals.

ActewAGL is the licensed, regulated operator of the Australian Capital Territory (ACT) monopoly electricity distribution network. The network comprises the poles, wires and transformers used for transporting electricity across urban and rural population centres to homes and businesses. This distribution network service provider (distributor) designs, constructs, operates and maintains distribution networks for ACT electricity consumers.

The AER regulates a variety of services provided by ActewAGL. Where there is considerable scope to take advantage of market power, our regulation is more prescriptive. Less prescriptive regulation is required where prospect of effective competition exists. In some situations we may remove regulation altogether.

The current five year NSW distribution regulatory control period concludes on 30 June 2014. Recent changes to the Rules establish a one year transitional regulatory control period, commencing 1 July 2014 and ending 30 June 2015. A subsequent regulatory period will cover the remaining years, expected to be from 1 July 2015 to 30 June 2019. On 25 June 2012, we published our *Preliminary Positions Framework and Approach Paper* (Preliminary F&A paper). This F&A paper sets out our approach in relation to the transitional and subsequent regulatory control periods for ActewAGL.

Instead of publishing the F&A by 30 November 2012, the Rules require us to publish the ACT F&A paper in two stages.² This Stage 1 F&A paper, sets out our decisions on:³

- distribution service classification (which services are to be regulated)
- control mechanisms (how will prices be determined) and the formulae that give effect to the control mechanisms
- dual function assets (how will transmission type assets be treated).

Part A of this paper sets out an overview of our decision and reasons for each of the above matters. Part B sets out our substantive reasoning for each matter. Our position with respect to the control mechanisms and dual function assets are final and binding on ActewAGL.⁴ We may not change our position on these matters. We may change our position on the classification of distribution services⁵ and the formulae that give effect to the control mechanisms, if unforeseen circumstances arise.⁶

¹ In addition to regulating NEM transmission and distribution, we regulate the NEM wholesale market and administer the National Gas Rules.

² Prior to the November 2012 Rules changes, a single final F&A paper was required.

³ NER, cl. 11.56.4(l)(1).

⁴ NER, cl. 6.25(d).

⁵ NER, cl. 6.12.3(b).

⁶ NER, cl. 6.12.3(c1).

The Stage 2 F&A *paper* will be published in early 2014 and will set out our decisions on the application of any:⁷

- service target performance incentive scheme
- efficiency benefit sharing scheme
- capital expenditure incentive scheme
- demand management and embedded generation connection incentive scheme
- expenditure forecast assessment guidelines, and
- whether depreciation will be based on forecast or actual capital expenditure.

Table 1 summarises the ACT distribution determination process.

Table 1: ACT distribution determination process

Step	Date
AER published preliminary positions F&A paper for ActewAGL	25 June 2012
AER to publish Stage 1 F&A paper for ActewAGL	29 March 2013
AER to publish Stage 2 F&A paper for ActewAGL	31 January 2014
ActewAGL submits Transitional Regulatory Proposal to AER	31 January 2014
AER to publish distribution determination for transitional regulatory control period	30 April 2014
ActewAGL submits Subsequent Regulatory Proposal to AER	31 May 2014
Submissions on Subsequent Regulatory Proposal close	August 2014**
AER to publish Draft Distribution Determination	November 2014*
AER hold public forum on Draft Distribution Determination	December 2014**
ActewAGL to submit revised Subsequent Regulatory Proposal to AER	January 2015
Submissions on revised Subsequent Regulatory Proposal and Draft Determination close	February 2015**
AER to publish distribution determination for subsequent regulatory control period	30 April 2015

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

** The dates provided for submissions and the public forum are based on the AER receiving compliant proposals. These dates may alter if the AER receives non-compliant proposals.

Source: NER, chapter 6, Part E.

⁷ NER, cl. 11.56.4(l)(2).

Part A: Overview

This Stage 1 F&A paper covers three issues: classification of distribution services, control mechanisms and dual function assets.

Classification of distribution services

Classification is important to electricity customers because it determines the need for and scope of regulation applied to distribution services central to electricity supply. Distribution services include, for example, the provision and maintenance of poles and wires and connection or disconnection to electricity. Classification of these services determines how the price of these services will be set. This has a direct impact on electricity customers.

When we classify distribution services, we determine the nature of the economic regulation that we will apply to those services. The Rules establish a limited range of service classification categories, to which varying levels of economic regulation apply. When we classify services we therefore determine whether we directly control prices, become involved only to arbitrate disputes, or do not regulate at all. The classification that we apply to a distribution service also determines whether ActewAGL recovers service costs by averaging across all customers or only charging those benefiting directly from specific services.

The classification of most distribution services will not change from the 2009–2014 regulatory control period. The majority of services provided by ActewAGL relate to building and maintaining its network and these will remain standard control services. Connection services will also remain standard control services. Metering services will remain classified as alternative control services. This will facilitate more choice for customers. We proposed to classify ancillary services provided to individual customers as alternative control services to create a greater focus on 'user pays' for these services.

Our approach to ActewAGL distribution service classification has changed since our Preliminary F&A in June 2012. The changes relate to some service groupings and our proposed classification of connection services. Some changes reflect distributor and stakeholder submissions, which assisted us to understand better the nature of distribution services in the ACT and their future opportunities.

The following ActewAGL distribution service classifications represent our decision on our proposed approach for the transitional and subsequent regulatory control periods. ActewAGL must adopt the classifications set out in this paper unless we consider that unforeseen circumstances justify departing from them.⁸

Direct control services

The Rules contain factors we must consider when determining appropriate levels of economic regulation for the range of electricity distribution services. Following consideration of those factors, we may determine a prescriptive approach is required. We will classify such services as direct control services. That is, we will directly set prices distributors will charge customers, or set revenues distributors may recover from customers.⁹

⁸ NER, cl. 6.12.3(b).

⁹ We regulate distributors by determining either the prices they may charge (price cap regulation) or by determining the revenues they may recover from customers (revenue cap regulation).

Most distribution services fall within the network services group, which include poles, wires, and other core infrastructure of a distribution business.¹⁰ These are central to ActewAGL's business and are used by the broad customer base. We will classify ActewAGL's network services as direct control services because they are central to ActewAGL's monopoly power and are frequently subject to licence restrictions. We will also classify ActewAGL's connection services as direct control services because they are subject to limited, or no, supply competition. We must further determine whether we will classify a direct control service as a *standard control* or *alternative control* service.

Standard control services

We will classify as standard control services those distribution services that are central to electricity supply and therefore relied on by most (if not all) customers. We will classify most distribution services as standard control, reflecting the integrated nature of an electricity distribution system. We will regulate these services, typically, by determining prices or an overall cap on the amount of revenue that may be earned for all standard control services.

The services we will classify as standard control services are those that form the core component of an electricity bill. For instance, we will classify network and connection services as standard control services. These services encompass construction, maintenance and repair of the network for existing and new customers as well as new and altered connections to the network.

Alternative control services

Alternative control services are customer specific or customer requested services. These services may also have potential for provision on a competitive basis rather than by a single distributor. Alternatively, certain customers may require these services. For these services, we will set service specific prices to enable the provider of the service to recover the full cost of the service from customers using that service.

We will determine prices for individual alternative control services in a variety of ways, suitable to specific circumstances. For example, only a few customers purchase ancillary network services (like a request for a special meter reading or to relocate a power pole). It would be inappropriate for all customers to fund the provision of these services. We therefore classify ancillary network services as alternative control.

We intend to classify metering services as alternative control services because provision of these services is likely to become open to more competition in the near future. Further, the range of metering services customers may wish to use (for example, increasing use of smart meters) suggests an alternative control classification is appropriate.

Negotiated distribution services

Negotiated distribution services are those services we consider require a less prescriptive regulatory approach because all relevant parties have sufficient market power to negotiate the provision of those services.

Distributors and customers are able to negotiate prices according to a framework established by the Rules. We are available to arbitrate if necessary.

¹⁰ Defined in appendix B.

We will not classify any service provided by ActewAGL as a negotiated distribution service as we consider none are subject to sufficient competition.

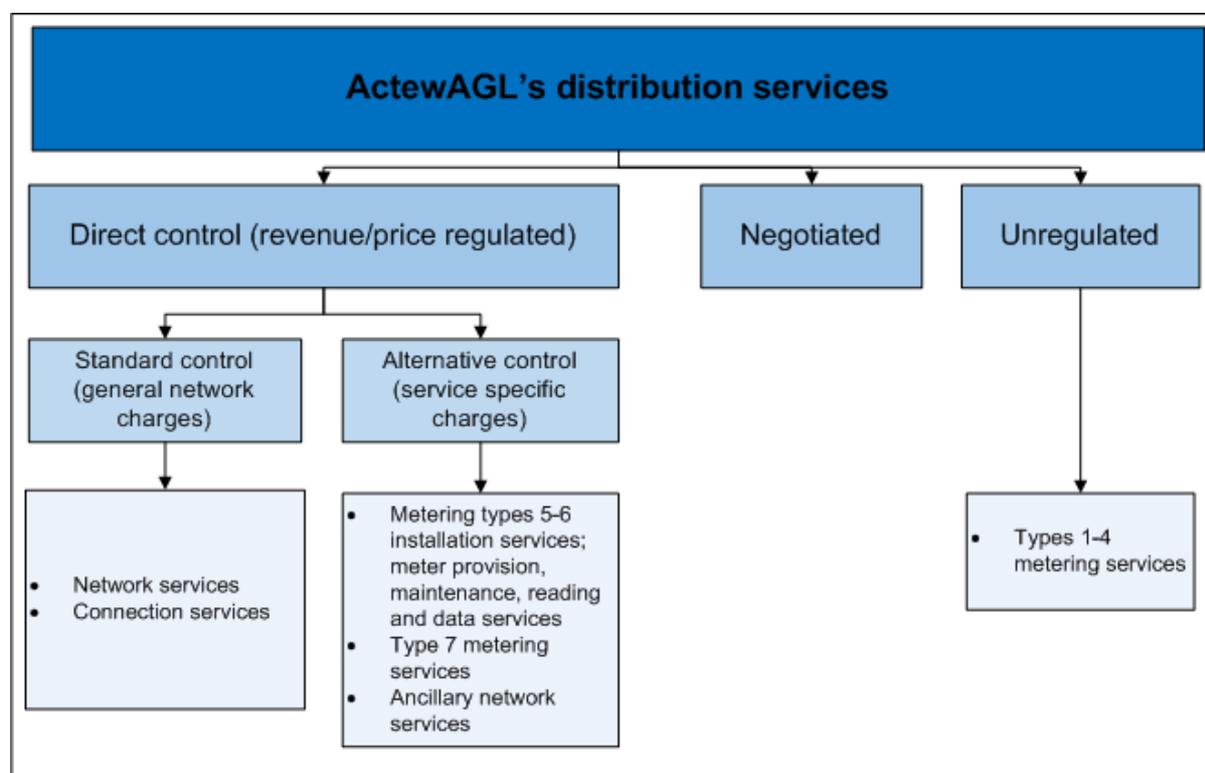
Unclassified (unregulated)

Unclassified or unregulated distribution services are those services we consider competitively available requiring no regulation at all. We will not classify such services.

We will not classify types 1 to 4 metering services (mostly used by large consumers) in the ACT as we consider they are fully contestable and consumers have sufficient capacity to effectively negotiate efficient prices for these services. This means we will have no role in pricing these services over the transitional or subsequent regulatory control periods.

We use the above service classifications throughout this Stage 1 F&A paper. Figure 1 sets out our proposed classification of ActewAGL's distribution services.

Figure 1: AER's proposed classification of ActewAGL's distribution services



Source: AER

Control mechanisms

Following on from service classifications, our regulatory determination must impose controls on direct control service prices and/or their revenues.¹¹ We may only accept or approve control mechanisms in ActewAGL's regulatory proposal if they are consistent with this paper.¹²

Our decisions on the form of control mechanisms we will apply for ActewAGL's regulatory proposal are:

¹¹ NER, cl. 6.2.5(a).
¹² NER, cl. 6.12.3(c).

- standard control services— average revenue cap
- alternative control services— caps on the prices of individual services.

The Rules require us to decide the control mechanism *forms*¹³ and the formulae to give effect to the control mechanism, but not the *basis* of the control mechanism. In deciding control mechanism *forms*, we must select one or more from those listed in the Rules.¹⁴ These include price schedules, caps on the prices of individual services, weighted average price caps, revenue caps, average revenue caps and hybrid control mechanisms. In deciding which form of control mechanism to apply, the Rules require us to have regard to specified factors.¹⁵ These include the need for efficient tariffs, administrative costs, previous regulatory arrangements and consistency.

To inform our control mechanism decisions, we undertook additional consultation, including releasing a discussion paper in April 2012.¹⁶ We then published draft control mechanism decisions in our Preliminary F&A paper, released in June 2012.

For standard control services, the Rules mandate the *basis* of the control mechanism must be the prospective CPI–X form, or some incentive-based variant.¹⁷ For alternative control services, we will confirm a control mechanism *basis* through the distribution determination process.

Standard control services

We consider that theoretically the average revenue cap provides weak incentives to ActewAGL in terms of efficient pricing, provision of demand side management and recovery of efficient costs. However, our analysis, and evidence provided by ActewAGL indicates that ActewAGL has not acted on these incentives in the current or previous regulatory control periods. We therefore consider that the benefits of price stability and lower administrative costs under the average revenue cap outweigh any benefit from a change in control mechanism.

Alternative control services

Our main consideration is that caps on the prices of individual services will result in benefits in the provision cost reflective prices. We consider this benefit outweighs any detriment from an increase in transitional administration costs.

The AER's detailed reasons and analysis on the control mechanisms for direct control services are set out in Part B, attachment 2.

Dual function assets

Dual function assets are high voltage transmission assets within a distribution network.

Transmission network service providers (TNSPs) usually operate such assets. Considering transmission assets as part of a distribution determination avoids need for a separate transmission regulatory proposal. The Rules, by allowing this, save time and money for network service providers and the AER. These savings ultimately benefit electricity consumers and taxpayers.

¹³ NER, cl. 6.2.5(b).

¹⁴ NER, cl. 6.2.5(b).

¹⁵ NER, cl. 6.2.5(c) and cl. 6.2.5 (d).

¹⁶ AER discussion paper, *Control mechanisms for standard control electricity distribution services in the ACT and NSW*, April 2012. We received 9 submissions.

¹⁷ NER, cl. 6.2.6(a).

We are required to decide whether dual function asset prices will be set under distribution or transmission pricing rules. The Rules establish transmission pricing as the default approach where the assets form a material proportion of the distributor's regulatory asset base (RAB). The Rules further require us, when deciding pricing approaches, to consider impacts on distribution prices and consumption, production and investment. We may also account for other factors we consider relevant.

Distribution and transmission pricing represent different ways of recovering service costs. Under transmission pricing, distributors may allocate dual function asset costs to both a TNSP's broader customer base and the distributor's customers. However, under distribution pricing rules, distributors with dual function assets may not allocate costs to a TNSP.

ActewAGL reported that its dual function assets represent 6.3 per cent of its RAB. Because of its likely price impact, we consider this a material proportion of ActewAGL's RAB, justifying application of transmission pricing. Transgrid submitted that ActewAGL's actual dual function asset value is significantly lower than reported by ActewAGL. However, we do not accept Transgrid's submission.

Further, applying distribution pricing would materially impact ActewAGL's distribution customers and affect consumption, production and investment. In terms of cost reflectivity, ActewAGL's dual function assets support Transgrid's transmission network. As such, they benefit a broader set of customers than just ActewAGL's distribution customer base. We therefore consider transmission pricing is appropriate.

The AER and industry expect electricity to flow predominantly into the ACT over these assets. However, electricity will flow into NSW when an alternative transmission route is closed. Additionally, future transmission flows are difficult to predict. Should flows into the ACT be larger than foreseen, applying distribution pricing would not be cost reflective. This is because under distribution pricing Transgrid may not be charged for *any* related asset costs. We consider this a significant risk of materially inefficient pricing. Even as reserve capacity for Transgrid, ActewAGL's dual function assets benefit Transgrid's customers. We consider it appropriate that Transgrid's customers provide support for ActewAGL's dual function assets.

Part B: Attachments

1 Attachment 1: Classification of distribution services

This attachment sets out the AER's proposed approach to classification of distribution services provided by ActewAGL. Classification determines the nature of economic regulation, if any, applicable to specific distribution services. Classification therefore determines whether we directly control prices, allow parties to negotiate services and prices and only arbitrate disputes if necessary, or do not regulate at all.¹⁸ If we intend to control prices directly, classification further determines whether distributors will recover service costs from all customers or only those benefiting directly from specific services.¹⁹

Classification is important to customers as it determines which network services to include in basic electricity charges, which services will be sold as additional services and which services the AER will not regulate. Our decisions reflect our assessment of competition or the potential for competition of distribution services. Where limited competition for the provision of services exists, we classify them to achieve a more prescriptive form of regulation. If competition exists, we classify to less prescriptive regulation or do not regulate the service at all. If only identifiable customers use a service, we may consider classifying these services to encourage a user pays approach to pricing.

The AER's proposed approach to classification of distribution services in the Australian Capital Territory (ACT) is for both the transitional regulatory control period (1 July 2014 to 30 June 2015) and for the subsequent regulatory control period (expected to be 1 July 2015 to 30 June 2019).²⁰ Our classifications set out in this F&A paper must be adopted in a distribution determination, unless we consider that unforeseen circumstances justify a different approach.²¹

The Rules set out a three stage classification process we must follow. We must consider a number of specified factors at each stage. Figure 2 outlines the classification process under the Rules.

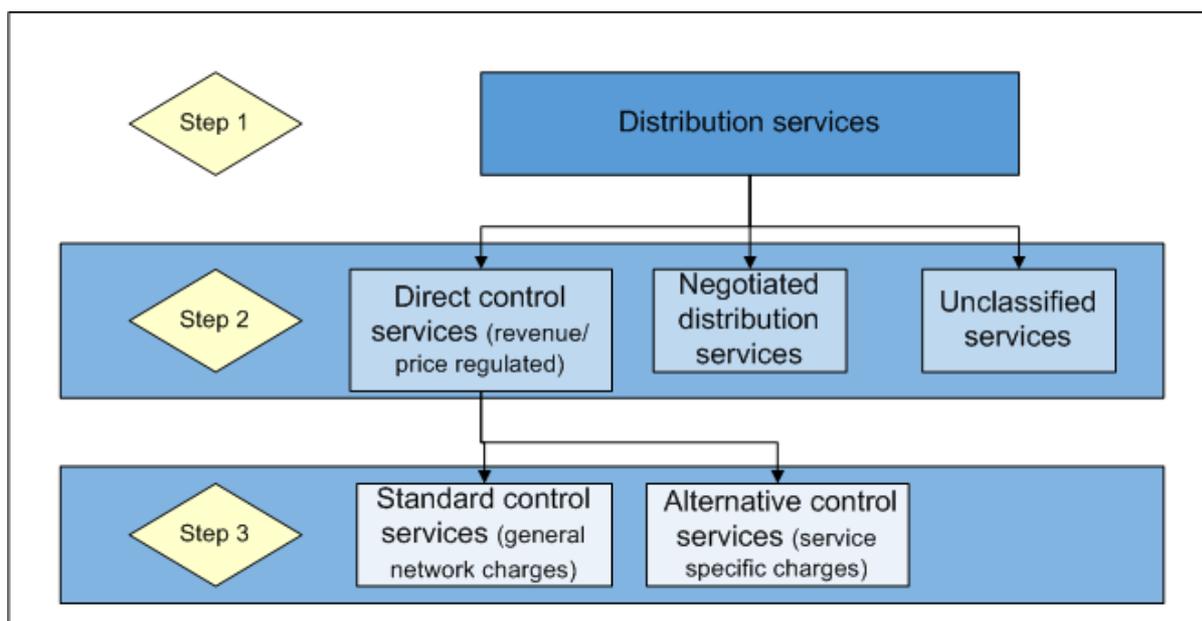
¹⁸ The control mechanism available for each service depends on the classification. The control mechanisms available for direct control services are listed under cl. 6.2.5(b) of the NER. These include revenue caps, average revenue caps, price caps, weighted average price caps, a schedule of fixed prices 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. Control mechanisms are discussed in detail in attachment 2 of the F&A paper.

¹⁹ In general, the costs of providing standard control services would be expected to be recovered through DUOS tariffs paid by all or most customers. Costs of providing alternative control or negotiated distribution services would be expected to be recovered from the individual customers that are the recipients of such services.

²⁰ We may refer to the transitional and subsequent regulatory control periods as the 'next regulatory control periods'.

²¹ NER, cl. 6.12.3(b).

Figure 2: Distribution service classification process



Source: NER, chapter 6, part B.

First, we must determine whether a service is a 'distribution service'. At a high level, distribution services are services provided by means of, or in connection with, a distribution electricity network.²²

Second, we classify the distribution services. We may:

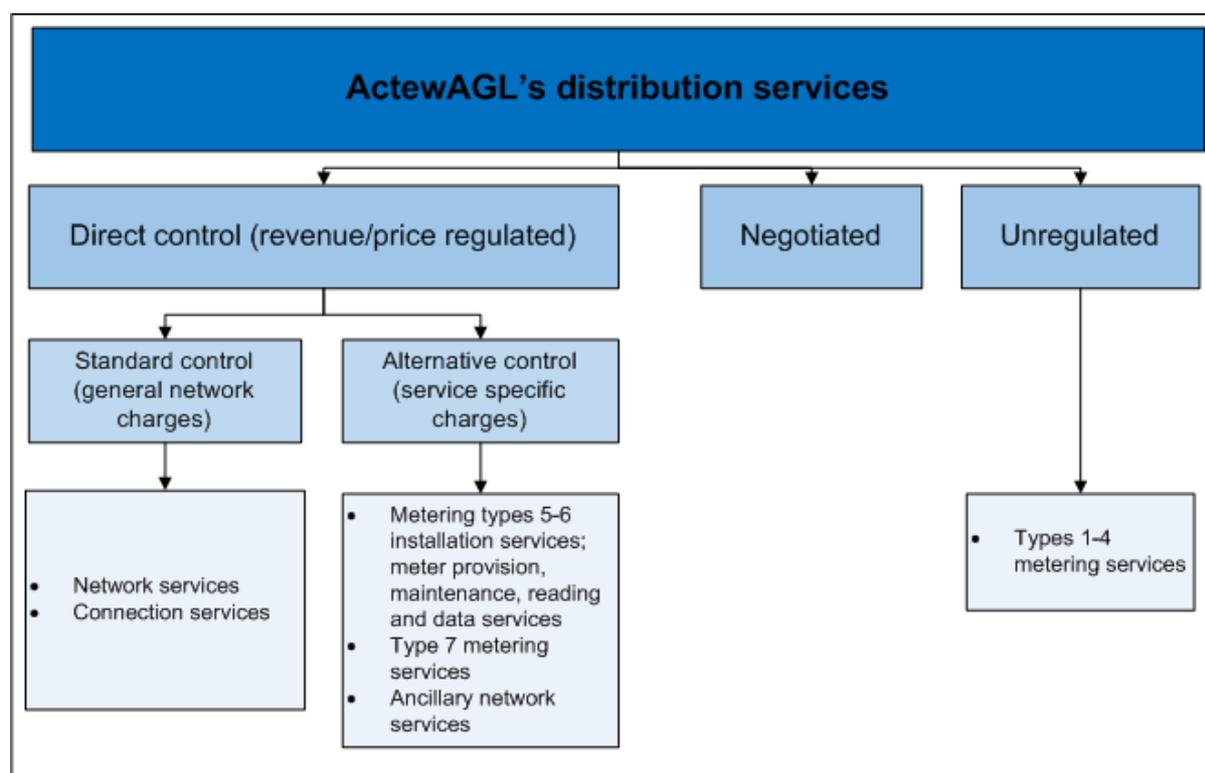
- classify a service that benefits all customers so that the distributor may attribute costs to all customers (direct control and standard control)
- classify a service so that the user benefiting from the service pays (direct control and alternative control)
- allow customers and distributors to negotiate the provision and price of some services. The AER's only role will be to arbitrate should negotiations stall (negotiated distribution service)
- not classify a service. In this instance, the AER has no regulatory control over this service or the prices charged by the distributor for the service (unclassified service).

1.1 AER's proposed approach to classification

The AER's proposed classification of ActewAGL's distribution services is set out in figure 3.

²² NER, Chapter 10.

Figure 3: Our proposed classification of ActewAGL's distribution services



Source: AER

Most distribution services fall under network services. This group of services form the core of what an electricity distributor does and includes activities like constructing and maintaining the network. ActewAGL provides network services under a restrictive licence issued by the ACT Government, which precludes other service providers. As it would be inefficient to have multiple providers of network services, competition for these services would not be in the interests of consumers. When competition is absent, we apply the most prescriptive form of regulation— direct control.

Because ActewAGL's network services are used by most (if not all) of its customers, it is appropriate for ActewAGL to recover these costs from all customers. We therefore classify network services as standard control.

ActewAGL is the only provider of connection services and changes to this arrangement by the ACT Government are not foreseeable. In some circumstances a capital contribution charge is required if the costs of connecting a customer would be detrimental to other customers. Because connection services are not contestable in the ACT, we consider that these services should remain classified as standard control.

Increasingly, customers are able to make choices about the types of meter used to measure electricity consumption. For example, some customers value the additional information about energy use provided by a more expensive smart meter. Similarly, ancillary network services (like a special meter read or relocation of a power pole) are provided to customers on request. It would be inappropriate for all customers to pay for services provided to an identifiable group of users. Therefore, we set service specific charges to recover the full cost of the service from each customer demanding it. Accordingly, we intend to classify these services as alternative control.

Sitting between direct control and unregulated services, is the negotiated service classification. This is a light handed approach to regulation. Negotiated service prices are set by negotiation between the parties according to a framework set out in the Rules. The AER is available to arbitrate if negotiations stall. This classification relies on both parties possessing sufficient market power for effective negotiations. We do not consider any of ActewAGL's distribution services would benefit from this classification.

Finally, metering services types 1 to 4 (for large electricity consumers and those with remotely read meters) are fully contestable. That is, ActewAGL does not have an exclusive right to provide these metering services. We consider consumers have sufficient market power, within contestable markets, to negotiate efficient prices for these services effectively. We therefore do not classify these services. This means we will have no role in the pricing of types 1 to 4 metering services over the transitional and subsequent regulatory control periods.

The AER's proposed approach to service classification has changed somewhat since its Preliminary F&A in June 2012. The changes relate to some service groupings and the AER's proposed classification of connection and ancillary network services. Some changes reflect ActewAGL's submissions, which assisted us to understand better the nature of distribution services in the ACT and their future opportunities.

1.2 AER's assessment approach

The AER follows a three stage assessment process when classifying distribution services. Figure 2 outlines this process:

1. We must first satisfy ourselves that a service is a 'distribution service' (step 1 in figure 2). The Rules define a distribution service, which in general terms is a service provided by means of, or in connection with, a distribution system.²³ A distribution system is a 'distribution network, together with the connection assets associated with the distribution network, which is connected to another transmission or distribution system'.²⁴
2. We then consider whether economic regulation of the service is appropriate for the distribution service (step 2 in figure 2). Where we do not think economic regulation is appropriate, because of the presence of competition, we will not classify the service. If there is little or no competition in relation to a service, we consider whether to classify the service as either a direct control or negotiated distribution service.²⁵
3. Where we consider a service should be classified as direct control service, we further classify it as either a standard control or alternative control service (step 3 in figure 2).²⁶

We must consider factors set out in the Rules when classifying distribution services. These are set out at appendix A.²⁷

The Rules also specify that for services regulated previously, we must act on the basis that unless a different classification is clearly more appropriate:

²³ See Chapter 10 of the NER for the definition of 'distribution service'. Connection assets alone do not constitute a distribution system.

²⁴ NER, ch. 10.

²⁵ NER, cl. 6.2.1.

²⁶ NER, cl. 6.2.2.

²⁷ NER, cll. 6.2.1 and 6.2.2.

- 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 AER's classification should be consistent with the previous regulatory approach.²⁸

The Rules also allow the AER to group distribution services. We may classify a class of activities rather than the specific activities that form part of the service. This provides ActewAGL with flexibility to alter the exact specification (but not the nature) of a service during the regulatory control periods. Where we make a single classification for the group of services, it applies to each service in the group.

The AER intends to group distribution services provided by ActewAGL as:

- network services
- connection services
- metering services
- ancillary network services.

We have varied the groups from those proposed in our Preliminary F&A paper. Specifically, we intend to replace the groups of 'fee based services' and 'quoted services' with a group called 'ancillary network services'. Section 1.2.4 details our reasons for this change.

The AER considers that the groups of services above are distribution services. They each provide services by means of, or in connection with, a distribution service.²⁹

The AER's Preliminary F&A paper set out proposed distribution service classifications and sought submissions on those positions. We received submissions in response to proposed classification of services and considered these in determining our intended approach to service classification.

1.3 Reasons for the AER's proposed approach

Generally, classification is an assessment of the extent to which distributors provide services in a competitive market. We also consider whether all customers benefit from the service or whether customers request specific services for their direct benefit.

The majority of distributors' services are provided in a monopoly environment. Often this is because of strict legislative licensing provisions permitting only the distributor to perform the service. Most of these services benefit all customers. Therefore, distributors share the costs of these services across the customer base as general network charges. Such services include network services and connection services. Our intended classification of these services as direct control and further, as standard control services is not controversial.

The AER intends to classify types 5 to 7 metering services and ancillary network services as alternative control services. A distributor generally provides these services for the benefit of an identifiable customer and/or there is potential to develop competition in these areas. In these instances, we consider it appropriate that the distributor levy service specific charges to the customer

²⁸ NER, cl. 6.2.1(d) and 6.2.2(d).

²⁹ NER, chapter 10. The AER considers that each service group is provided 'in connection' with or 'in conjunction' with a distribution system. The AER also relies on *Ergon Energy Corporation Ltd v Australian Energy Regulator* [2012] FCA 393.

receiving these alternative control services. This provides transparency in the real cost of the service and allows for a 'user pays' system where appropriate.

The AER intends not to regulate types 1 to 4 metering services (used by large electricity consumers). This is because they are competitively available. ActewAGL supported our intended approach to classification of these services.³⁰

This attachment will now address, in detail, the classification of each of the service groups.

1.3.1 Network services

The AER considers network services predominately relate to a distributor's services provided over its shared distribution network to service all customers connected to it. Network services are an important group of distribution services. These services are associated with the safe and reliable conveyance, and controlling the conveyance, of electricity through the network.³¹ Consumers use or rely on network services on a daily basis. General examples of network services include:

- maintenance of substations, poles, lines and cables
- pole and other asset repairs and replacements
- planning and designing the network.

Network services do not include metering or connection services.³²

We intend to classify network services as direct control services and further, as standard control services. Our proposed approach is consistent with the position proposed in our Preliminary F&A paper.³³

ActewAGL holds an electricity distribution licence.³⁴ This licence is the only distribution licence currently issued for the ACT. Similarly, under the *Utilities Act 2000* (ACT), a person must not provide a utility service except in accordance with a licence.³⁵ The same legislation obliges ActewAGL to operate, maintain (including repair and replace as necessary) and protect its supply network. This is to ensure safe, reliable and economic supply of electricity to users.³⁶ Therefore, only ActewAGL can provide network services relating to the safe and reliable conveyance, and controlling the conveyance, of electricity through the distribution network. Additionally, consumers cannot source network services in their distribution district from external providers.

The AER considers these arrangements together effectively amount to an absolute regulatory barrier preventing third parties from providing network services.³⁷ Therefore, we consider that the market for network services is closed to competition from third parties. Because of the current legislative and

³⁰ ActewAGL, *Response to the AER's preliminary framework and approach paper*, 24 August 2012, p. 11.

³¹ NER, chapter 10.

³² Network services exclude metering data services. However, the AER considers distributor's use of meter data for managing and planning the network, for example, are included in network services.

³³ AER, *Preliminary positions paper, Framework and approach for NSW DNSPs, Regulatory control period commencing 1 July 2014*, June 2012, p. 16.

³⁴ The licence is issued by the Independent Competition and Regulatory Commission (ICRC) (ACT). A copy of the licence is available on ICRC's website at www.icrc.act.gov.au/utilitieslicensing/current_licences.

³⁵ Section 21 of the *Utilities Act 2000* (ACT). Section 6(a) of the same Act defines a 'utility service' to include 'the distribution of electricity through an electricity network.'

³⁶ For example, ss. 2 and 79 of the *Utilities Act 2000* (ACT).

³⁷ NEL, s. 2F(a).

licensing arrangements, ActewAGL possesses complete market power for the provision of network services.³⁸ We therefore intend to classify network services as direct control services.

The AER must further classify direct control services as standard control or alternative control services.³⁹ We intend to retain the current classification of network services as standard control services as:

- There is little, if any, potential to develop competition in the market for network services. The absence of competition is due to ActewAGL holding the only licence to provide network services in the ACT.
- There would be no material effect on administrative costs to the AER, ActewAGL, users or potential users. This is because classifying network services as standard control services is consistent with the current regulatory approach.
- We currently classify network services in the ACT and all other NEM jurisdictions as standard control services.
- ActewAGL provides network services through its shared network and cannot directly attribute the costs of these services to individual customers.

For the above reasons, the AER considers that it should continue to classify network services as standard control services. ActewAGL supported our proposed approach.⁴⁰

1.3.2 Connection services

Chapter 10 of the Rules defines connection services.⁴¹ Put simply, a connection service is used to:

- connect a person's home, business or other premises to the electricity distribution network
- get more electricity from the distribution network than is possible at the moment;
- extend the network to reach a person's premises.

The above services currently form part of ActewAGL's 'monopoly' services'.⁴² We currently classify these services as direct control and further, as standard control services.

Initially, we proposed to classify components of connection services as either standard or alternative control services. ActewAGL did not support this approach, and submitted that connection services should be one group and that the current standard control classification should remain. This is because it may recover costs through shared network charges to the extent that costs have not been recovered as capital contributions under Chapter 5A of the Rules.⁴³

Following ActewAGL's submission explaining how connection services operate in the ACT, we have changed our proposed approach. The AER's proposed approach is to classify connections services (collectively) as direct control services and further, as standard control services. Although we still

³⁸ NEL, s. 2F(d).

³⁹ NER, cl. 6.2.2(c),

⁴⁰ ActewAGL, *Response to the AER's preliminary framework and approach paper*, 24 August 2012, p. 3.

⁴¹ NER, Chapter 10 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.

⁴² 'Monopoly' services are services only ActewAGL may perform to facilitate connections.

⁴³ ActewAGL, *Response to the AER's preliminary framework and approach paper*, 24 August 2012, p. 11.

consider it possible to classify separate components of connection services,⁴⁴ we do not consider it the most appropriate approach for the ACT.

In addition to our assessment of the factors set out in the Rules,⁴⁵ the AER has considered Chapter 5A of the Rules and its Connection charge guideline (Guideline).⁴⁶ The purpose of Chapter 5A and the Guideline is to provide a framework and charging principles for new connections or connection alterations.⁴⁷ We are mindful of classifying ActewAGL's connection services in a way that supports the operation of Chapter 5A and the Guideline. ActewAGL is yet to submit its Connection Policy (indeed, they may be some way from being drafted). Consequently, the classification may be inconsistent with the Connection Policy. Depending on the circumstances, the AER may consider the situation unforeseeable and accept adjustments to the classification. The AER would consider any such adjustments in its draft determination.

Under Chapter 5A and the Guideline, connection services classified as standard control services will be charged according to the AER's decision on the form of control (for example, a price cap or revenue cap). Chapter 5A and the Guideline also provide that for standard control services a distributor may seek a capital contribution from the customer toward the cost of the connection service. ActewAGL may only seek a capital contribution from a customer when the incremental cost of the standard control connection service exceeds the estimated incremental revenue expected to be derived from the standard control connection service. Put simply, if the customer's connection cost exceeds the revenues that will be paid by that customer over time, then the customer will be asked to make a contribution to the connection costs.

ActewAGL is proposing that basic connection services, for example, a new residential property owner having their house connected to the network, should be standard control services.⁴⁸ This basic connection request is common to anyone wanting to connect to the network to use electricity.

Connections over and above the cost of a basic connection may trigger a capital contribution.⁴⁹ For example, a customer may seek a temporary connection to complete renovations to their house, or an upgrade from single phase to three-phase connection. The cost of these types of services is directly attributable to the customer requesting the service. On that basis, we intend to classify these 'non-standard' connection services as alternative control services. This means the customer requesting the service will pay the full cost of the service. This would avoid other customers having to bear the cost of customer specific service requests. The list of relevant services is set out in appendix B.

With the impact of Chapter 5A and the Guideline in mind, we set out our reasons below.

ActewAGL holds the only electricity distribution licence to provide connection services in the ACT. This licensing arrangement results in a high regulatory barrier preventing third parties from providing connection services.⁵⁰ Additionally, we consider the scale and scope of resources available to ActewAGL also prevent the competitive provision of connection services by a third party. We

⁴⁴ NER, chapter 5A.

⁴⁵ NER, cl. 6.2.1 and 6.2.2.

⁴⁶ AER, *Connection charge guidelines for electricity retail customers, under Chapter 5A of the National Electricity Rules*, June 2012.

⁴⁷ AER, *Connection charge guidelines for electricity retail customers, under Chapter 5A of the National Electricity Rules*, June 2012, p. 29.

⁴⁸ ActewAGL, *Response to the AER's preliminary framework and approach paper*, 24 August 2012, p. 14.

⁴⁹ *Ibid.*

⁵⁰ NEL, s. 2F(a).

therefore consider that ActewAGL possesses significant market power in the provision of connection services.⁵¹

For these reasons, we consider that classifying connection services as direct control services is the most appropriate outcome. ActewAGL supported this approach.⁵²

We intend to retain the current classification of connection services as standard control services. We consider that there is no basis to move away from this classification as:

- There is little, if any, prospect for competition in the market for connection services. That is, we are not aware of any ACT Government initiatives to introduce contestability for connection services in the transitional and subsequent regulatory control periods. Therefore, our classification will not influence the potential for competition.
- There would be no material effect on administrative costs to the AER, ActewAGL, users or potential users. This is because classifying connection services as standard control services is consistent with the current regulatory approach.
- We currently regulate connection services in most other NEM jurisdictions under a direct form of control. We do not regulate some New South Wales (NSW) connection services, which are competitively available.
- The nature of basic connection services is that in most instances, the customer requesting the service will benefit from the provision of that service. As such, the costs are directly attributable to identifiable customers. However, the operation of Chapter 5A and the Guideline provide a safety net for the broader customer base. That is, the requirement of the requesting customer to make a capital contribution to a service protects the broader customer base from incurring additional costs for services of no benefit to them.
- The AER classifies standard connection services in Queensland, South Australia and Tasmania as standard control services.⁵³ In Victoria, we classify standard connection services as alternative control services.⁵⁴

We must act on the basis that there should be no departure from a previous classification unless another classification is clearly more appropriate.⁵⁵ We consider the current standard control classification supports the operation of Chapter 5A and the Guideline and provides a framework for consumers to understand where additional contributions may be required. We intend to classify connection services (collectively) as standard control services.

1.3.3 Metering services

All electricity customers have a meter that measures the amount of electricity they use.⁵⁶ However, not all customers have the same type of meter. There are different types of meters which each measure electricity usage in different ways.

⁵¹ NEL, s. 2F(d).

⁵² ActewAGL, *Response to the AER's preliminary framework and approach paper*, 24 August 2012, p. 3.

⁵³ AER, *Final decision, Queensland distribution determination 2010-11 to 2014-15*, May 2010, p. 8; AER, *Final decision, South Australia distribution determination 2010-11 to 2014-15*, May 2012, p. 7; AER, *Final distribution determination Aurora Energy Pty Ltd 2012-13 to 2016-17*, April 2012, p. 9.

⁵⁴ AER, *Final decision, Victorian DNSPs distribution determination 2011-2015*, October 2010, p. 14.

⁵⁵ NER, cl. 6.2.2(d).

⁵⁶ All connections to the network must have a metering installation (NER, cl. 7.3.1A(a)).

ActewAGL is the monopoly provider of type 5 and 6 meters.⁵⁷ These are the default meter types provided to households and other small consumption users. Type 6 meters simply record total electricity usage over a period of time. Type 5 meters can record electricity usage and time of use.⁵⁸

Type 4 meters or 'smart meters' are available from ActewAGL, or alternative providers, competitively and households or other small consumption users may purchase them. These interval meters have a communications capability allowing ActewAGL or a third party to read them remotely. Customers are increasingly seeking smart meters because they offer frequent information about usage. This allows customers to manage their electricity use better.

ActewAGL is also the monopoly provider of type 7 metering services, which are special unmetered connections (for example, public lighting connections).⁵⁹

Currently, ActewAGL's metering services are:

- types 1 to 4— unclassified
- types 5 to 7— alternative control services.

We do not propose changing the above classifications. Our reasons follow.

Types 1 to 4 metering services

Types 1 to 4 metering services are contestable in the ACT.⁶⁰ For this reason, we intend not to classify these services. Consequently, we will not regulate these services. This is consistent with the current regulatory approach.

Types 5 and 6 metering services

The AER intends to classify type 5 and 6 metering services as direct control and further, as alternative control services. We consider type 5 and 6 metering services include:

- a. installation services — which include on site connection of a meter at a customer's premises, and on site connection of an upgraded meter at a customer's premises where the customer initiated the upgrade.
- b. metering provision, maintenance, reading and data services — meter provision refers to the capital cost of purchasing the metering equipment to be installed. Meter maintenance covers works to inspect, test, maintain, repair and replace meters. Meter reading refers to quarterly or other regular reading of a meter. Metering data services involve the collection, processing, storage, delivery and management of metering data in accordance with the Rules.⁶¹

ActewAGL supported our preliminary position to classify types 5 to 7 metering services as alternative control services.⁶²

⁵⁷ ActewAGL is the 'responsible person' for types 5, 6, and 7 metering installations (NER, cl. 7.2.3(a)(2)).

⁵⁸ Interval meters record electricity usage every 30 minutes.

⁵⁹ NER, cl. 7.2.3(a)(2).

⁶⁰ Industrial and large customers may use types 1 to 4 meters. These meters are already open to competition and are not regulated by the AER (NER, cl. 7.2.3(a)(2) and 7.3.1.A(a)).

⁶¹ To avoid doubt, metering data services are defined in cl. 7.11.2 and chapter 10 of the NER. The metering data provider performs these services. The Local Network Service Provider may act as the metering data provider, or engage another party (NER, s. 7.2.5(c1) and s. 7.4.1A).

⁶² ActewAGL, *Response to the AER's preliminary positions paper*, August 2012, p. 11; ActewAGL, *Response to query on classification of metering services*, 21 January 2013, p. 1.

We consider it necessary to classify type 5 and 6 metering services as direct control services because, currently due to legislative requirements,⁶³ there are no real substitutes for type 5 and 6 metering services.⁶⁴ This barrier⁶⁵ provides ActewAGL with significant market power in providing these services.⁶⁶ In fact, ActewAGL is currently the ACT's sole provider of type 5 and 6 meters.⁶⁷ Metering services are subject to a direct form of control in the ACT and other NEM jurisdictions.

By adopting a direct control service classification, we must further classify types 5 and 6 metering services as standard or alternative control services.⁶⁸ We consider that these services should be alternative control services because:

- There is competition potential for type 5 and 6 metering services in the near future. The AER recognises that ActewAGL is currently the monopoly provider of types 5 and 6 metering services.⁶⁹ However, we consider that retaining an alternative control classification will enhance competition should contestability for these services change.⁷⁰ If charges for these services were bundled in distribution charges, any future changes in contestability may be far less effective.

Additionally, our proposed approach is consistent with the AEMC's draft report for its Power of Choice Review. The AEMC's recommendations included that:

- the current metering arrangements need reform to provide investment in better metering technology and provide customer choice
- metering costs should be unbundled from shared network charges.⁷¹

The AEMC also released a Power of Choice supplementary paper on metering services, exploring the arrangements necessary to implement its recommendations.⁷² The AEMC recommended that metering provision be contestable and open to competition among approved service providers. Further, it stated that customers should be able to choose a metering service provider.⁷³ The AEMC designed its recommendations to promote the investment in, and use of, advanced metering infrastructure ('smart' metering). It considers there will be demand management benefits for customers, retailers and distributors.⁷⁴

We consider that keeping type 5 and 6 metering services unbundled from other standard control services will enhance competition for providers of type 4 meters. It will enable alternative providers to compete with ActewAGL on both price and non-price aspects. Additionally:

- There would be no material effect on administrative costs to the AER, ActewAGL, users or potential users. This is because classifying type 5 and 6 metering services as alternative control services is consistent with the current regulatory approach.

⁶³ NER, cl. 7.2.3.

⁶⁴ NEL, ss. 2F(e) and (f).

⁶⁵ NEL, s. 2F(a).

⁶⁶ NEL, s. 2F(d).

⁶⁷ ActewAGL, *Response to query on classification of metering services*, 21 January 2013, p. 1.

⁶⁸ NER, cl. 6.2.2(c).

⁶⁹ NER, cl. 7.2.3(a)(2) provides that a DNSP, as the local network service provider, is the responsible person for all types 5 and 6 metering installations.

⁷⁰ NER, cl. 6.2.2(c)(1) and (c)(6).

⁷¹ AEMC, *Draft report, Power of choice - giving consumers options in the way they use electricity*, 6 September 2012, pp. 47-56.

⁷² AEMC, *Power of choice review draft report, Supplementary paper, Principles for metering arrangements in the NEM to promote installation of DSP metering technology*, 6 September 2012 (AEMC, *Power of choice metering paper*, September 2012).

⁷³ AEMC, *Power of choice metering paper*, September 2012, p. 4.

⁷⁴ AEMC, *Power of choice metering paper*, September 2012, pp. 7-9.

- There is some variation in the classification of metering services across NEM jurisdictions. However, types 5 to 7 metering services in South Australia and Tasmania are alternative control services.⁷⁵ We are also proposing that some type 5 and 6 metering services in NSW be classified as alternative control services.⁷⁶
- The AER considers that an alternative control classification for type 5 and 6 metering services is appropriate, as customers will only pay for services they receive.
- Another relevant factor⁷⁷ we considered is the potential to create a more transparent and accurate way of providing customers with costing information. Directly attributing costs under an alternative control classification allows customers to make informed choices on meter provision, maintenance, reading and data services.

For the above reasons, the AER considers it clearly more appropriate to classify type 5 and 6 metering services as alternative control services.

Type 7 metering services

In its preliminary F&A, the AER proposed to classify type 7 metering services as direct control and further, as alternative control services.⁷⁸ Our position is unchanged.

A type 7 metering service does not measure the flow of electricity. Examples include streetlights or traffic lights. Distributors charge customers, usually councils or government agencies, for unmetered connections by estimating usage using standard data. For example, the distributor estimates streetlight usage using the total time the lights were on, the number of lights in operation and the light bulb wattage. As only ActewAGL estimates usage, only it can bill customers.

ActewAGL is the monopoly provider of type 7 metering services. Notably, ActewAGL does not charge for type 7 meters.⁷⁹ For this reason, an alternative provider has no incentive to enter the market for the provision of type 7 metering services. The AER therefore considers that there is no potential to develop competition in the provision of these metering services.⁸⁰ For this reason, the AER intends to retain the current classification of type 7 metering services as direct control services.

The AER also proposes to classify type 7 metering services as alternative control services. While a standard control classification for this monopoly service may seem more appropriate, we do not consider it worthwhile to alter the classification for a distribution service provided free of charge.⁸¹

Based on the analysis above, our proposed approach is to classify metering services as set out in table 2.

⁷⁵ AER, *Final Decision, South Australia Draft distribution determination 2010-11 to 2014-15*, 25 November 2009, p. xi; AER *Final F&A decision for Aurora Energy Pty Ltd*, November 2012, pp. 15, 24 and 68-69.

⁷⁶ AER, *Stage 1 Final F&A paper for NSW Distributors*, March 2013, p. 14.

⁷⁷ NER, cl. 6.2.2(c)(6).

⁷⁸ AER, *Preliminary position Framework and approach paper, ActewAGL, Regulatory control period commencing 1 July 2014*, June 2012, p. 21.

⁷⁹ ActewAGL, *Response to query on classification of metering services*, 21 January 2013, p. 1.

⁸⁰ NER, cl. 6.2.2(c)(1).

⁸¹ NER, cl. 6.2.2(d)(1).

Table 2: AER's proposed approach to classifying metering services

AER's proposed approach	
Service	Proposed classification
Metering types 1 to 4	Unclassified
Metering types 5 to 6	Alternative control
Type 7 metering	Alternative control

Source: AER

1.3.4 Ancillary network services

In our Preliminary F&A paper we proposed two service groups called 'fee-based services' and 'quoted services'.⁸² Quoted services include 'customer specific services'.⁸³ We now intend to create one service group called ancillary network services, which will replace the fee-based and quoted services groups. The AER no longer considers 'fee based services' and 'quoted services' appropriate service groupings. Rather they describe the basis on which services captured in the ancillary services group are charged. Ancillary network services share the common characteristic of being non-routine services provided to individual customers on an 'as needs' basis. Examples include temporary supply, supply enhancement or after hours service provision.

Our proposed classification of these services as alternative control services remains unchanged. The AER's proposed approach is set out in table 3.

Table 3: AER's proposed classification of ancillary network services

AER's preliminary position		AER's proposed approach	
Service group	Classification	Service group	Classification
Fee based services	Alternative control	Ancillary network services	Alternative control
Quoted services	Alternative control		

Source: AER

Ancillary network services⁸⁴ involve work on, or in relation to, parts of ActewAGL's distribution network. Therefore, as a licensed monopoly provider only ActewAGL can undertake these services.

We consider that, similar to network services, there is a regulatory barrier preventing any party other than ActewAGL providing ancillary network services.⁸⁵ Because of this monopoly position, customers have limited negotiating power in determining the price and other terms and conditions on which

⁸² AER, *Preliminary positions paper, Framework and approach for NSW DNSPs, Regulatory control period commencing 1 July 2014*, June 2012, p. 15.

⁸³ Ibid, p. 31. it is the AER's view, consistent with the Federal Court decision in *Ergon Energy Corporation Ltd v Australian Energy Regulator* [2012] FCA 393, that 'customer specific' services are services provided by the distributor 'in conjunction with' the distribution system.

⁸⁴ Ancillary network services will be charged on either a fee or a quotation basis. A fee will be charged for homogenous services where costs can be estimated with reasonable certainty. A quote will be provided for services of a unique nature where the distributor must assess the task, materials and time involved in performing the service.

⁸⁵ NEL, s. 2F(a).

ActewAGL provides these services. These factors contribute to the view that, like network services, ActewAGL possesses significant market power in providing ancillary network services.⁸⁶

We note that numerous of the current 'miscellaneous services' are subject to a direct form of control in the ACT.⁸⁷ Miscellaneous services appropriately fall within the ancillary network services group. Similar arrangements exist in several NEM jurisdictions.⁸⁸

For the above reasons, we consider that we should classify ancillary network services as direct control services.

Our classification of ancillary network services as alternative control services is because:

- We are currently unaware of competitors willing to provide ancillary services. We are also not aware of any initiatives by the ACT Government to encourage contestability of these services in the next regulatory control periods. Therefore, ActewAGL is performing the majority, if not all, ancillary services.
- There would be a nominal effect on the administrative costs of the AER, ActewAGL, users or potential users. This is because classifying ancillary network services as alternative control services involves the AER regulating them through a similar approach to that we currently use. For example, ActewAGL is currently charging for services where the work involved is more complex or outside business hours.⁸⁹
- We currently regulate services ActewAGL provides on a fee or quotation basis. Queensland and Victorian distributors charge for similar services on a fee or quotation basis. These are alternative control services.⁹⁰ We are currently proposing the same approach to ancillary network services in New South Wales.⁹¹
- The nature of ancillary network services is that the customer requesting the service will benefit from that service. As such, the costs of that ancillary network service are directly attributable to an individual customer.⁹² This results in costs that are more transparent for customers. Additionally, the note to clause 6.2.2(c)(5) of the Rules states that:

In circumstances where a service is provided to a small number of customers on a discretionary or infrequent basis, and costs can be directly attributed to those customers, it may be more appropriate to classify the service as an alternative control service than as a standard control service.

We consider that ancillary network services should be alternative control services as costs are attributable to an individual customer. This is because of the specific nature of the services only benefiting an individual or small sub-set of customers.

⁸⁶ NEL, s. 2F.

⁸⁷ NER, cl. 6.2.1(c)(2) and (3).

⁸⁸ AER, *Final F&A decision for Aurora Energy Pty Ltd*, November 2010, pp. 78-79, 139 and 140; AER, *Final Decision for Victorian DNSPs*, May 2009, pp. XII, LXIV, 54 and 906; AER, *Final Decision, Queensland distribution determination 2010-11 to 2014-15*, May 2010, See Appendices I to K, pp. 352-353, 451-460. We are currently proposing a similar approach to ancillary services in NSW. See AER, *Stage 1 Final F&A paper for NSW distributors*, March 2013, p. 22.

⁸⁹ The fixed fees are charged for services to standard residential or similar installations carried out in normal business hours unless otherwise state. See ActewAGL Electricity Networks Schedule of charges 2011-12: Miscellaneous charges at www.actewagl.com.au/About-us/The-ActewAGL-network/Electricity-network/Electricity-network-prices.aspx for a list of fee-based services.

⁹⁰ AER, *Queensland final distribution determination*, May 2010, pp. 378-384; AER, *Victorian draft distribution determination—Appendices*, June 20210, pp. 2-3.

⁹¹ AER, *Stage 1 Framework and approach for NSW DNSPs, Regulatory control period commencing 2014-15 to 2018-19*, March 2013, p. 33.

⁹² NER, cl. 6.2.2(c)(5).

If we continued to classify ancillary network services as standard control services, ActewAGL would share the cost of the services across all customers. ActewAGL does not support our proposed approach and submitted ancillary network services should remain a standard control service.⁹³

ActewAGL agrees, however, that it should not share the cost of services benefiting specific customers over its broad customer base. Rather, ActewAGL submits that ancillary network services account for 'little revenue'.⁹⁴ As such, it claims that the administrative costs of separately regulating ancillary network services as alternative control services would negate any benefit to its customer base.⁹⁵

Notably, ActewAGL identifies energising and de-energising premises, temporary connections and removing, repositioning or upgrading services at the customer's request as examples of ancillary network services for which it charges the customer a fee. Where the work required is larger or more complex, ActewAGL provides a quote for the service.⁹⁶ These examples clearly demonstrate why these services should be classified as alternative control.

While ActewAGL has indicated that ancillary network services are immaterial to their level of revenue earned, they have not provided any evidence in support of this. The AER, therefore, can only be guided by the factors in the Rules in reaching its proposed approach to classifying these services. Materiality is not a factor within the Rules.

For these reasons, we intend to classify ancillary network services as direct control and further, as alternative control services in the transitional and subsequent regulatory control periods.

1.4 AER's proposed approach to service classification

In summary, the AER intends to group and classify ActewAGL's distribution services as set out in table 4. Appendix B contains a full list of ActewAGL's distribution services.

Table 4: Proposed approach to classification of distribution services in the ACT

AER service group	Proposed classification of distribution services	Proposed classification of direct control services
Network services	Direct control	Standard control
Connection services	Direct control	Standard control
Metering services		
Types 1 to 4	Unclassified	
Types 5 to 6	Direct control	Alternative control
Type 7	Direct control	Alternative control
Ancillary network services	Direct control	Alternative control

Source: AER

⁹³ ActewAGL, *Response to the AER's preliminary positions paper*, August 2012, p. 11.

⁹⁴ ActewAGL, *Response to the AER's preliminary positions paper*, August 2012, p. 11

⁹⁵ ActewAGL, *Classification of electricity distribution services in the ACT and NSW, Response to the AER consultation paper, February 2012*, p. 8.

⁹⁶ ActewAGL, *Classification of electricity distribution services in the ACT and NSW, Response to the AER consultation paper, February 2012*, p. 8.

2 Attachment 2: Control mechanisms

This attachment sets out the control mechanisms the AER will apply to ActewAGL's direct control services for both the transitional regulatory control period (2014–15) and the subsequent regulatory control period (expected to be 2015-19). This attachment also sets out the AER's proposed approach on the formulae to give effect to the control mechanisms for direct control services.

The AER's distribution determination must impose controls over the prices (and/or revenues) of direct control services.⁹⁷ This Stage 1 F&A paper states our decision, together with our reasons, for the form(s) of the control mechanism(s) to apply to direct control services in the distribution determinations for the transitional and subsequent regulatory control periods.⁹⁸ The AER classifies direct control services as standard control services or alternative control services. Different control mechanisms may apply to each of these classifications, or to different services within the same classification.

Attachment 1 of this paper provides the AER's likely classification of ActewAGL's distribution services. Broadly, the AER will classify a service as a direct control service if the distributor is a natural monopoly provider of the service.⁹⁹ Typically, we split direct control services into standard or alternative control services based on the customer base for the service. For example, if ActewAGL provides a service to the broad customer base, we will classify it as standard control. If ActewAGL provides a service to specific customers, or if there is potential for competition to develop in the provision of that service, we will classify it as an alternative control service.

We can only approve the control mechanisms in a distributor's regulatory proposal if they are the same as those set out in the F&A paper.¹⁰⁰ We can also only approve the proposed formulae to give effect to the control mechanism in a distributor's regulatory proposal if the formulae are the same as the formulae set out in this F&A paper, unless we consider that unforeseen circumstances justify departing from the formulae set out in this paper.¹⁰¹

2.1 AER decision

The AER's decision is to apply the following forms of control in the transitional and subsequent regulatory control periods:

- Average revenue cap— for services the AER has classified as standard control services.
- Caps on the prices of individual services— for services the AER has classified as alternative control services.

2.1.1 Standard control services

The AER considers that revenue caps and average revenue caps have positive and negative attributes when assessed against the factors set out in the Rules.¹⁰² Our position is to apply an average revenue cap for standard control services. In determining our position, our key conclusion is that, to date, the theoretical weaknesses of the average revenue cap have not caused substantial detriments to consumers.

⁹⁷ NER, cl. 6.2.5(a).

⁹⁸ NER, cl. 6.8.1(b).

⁹⁹ A natural monopoly is where one firm can supply the entire market demand at a low cost than multiple firms.

¹⁰⁰ NER, cl. 6.12.3(c).

¹⁰¹ NER, cl.6.12.3(c1).

¹⁰² NER, cl. 6.2.5(c).

We consider that the detriments of moving from an average revenue cap to a revenue cap, such as price instability and transitional administration costs, outweigh the benefits for the transitional and subsequent regulatory control periods. However, it is likely the AER may require ActewAGL to move from an average revenue cap form of regulation in the future.

2.1.2 Alternative control services

The AER considers caps on the prices of individual services have greater benefits than other control mechanisms when assessed against the factors set out under clause 6.2.5(d) of the Rules. Our key conclusion is that caps on the prices of individual services will provide benefits in the provision of cost reflective prices.

2.2 Submissions

ActewAGL stated a preference for an average revenue cap for standard control services.¹⁰³

ActewAGL stated a preference for a weighted average price cap for metering services and a light handed approach for non-network services.¹⁰⁴ ActewAGL also requested the AER provide more guidance on the basis of control mechanism for alternative control services.¹⁰⁵

2.3 AER's assessment approach

In the 2009–2014 distribution determination, the transitional Chapter 6 rules required the AER to continue with the control mechanisms from the 2004–2009 distribution determination. That is, an average revenue cap for standard control services and a revenue cap for alternative control services. Those transitional Chapter 6 rules do not apply to the ACT distribution determinations for the transitional or subsequent regulatory control periods.

2.3.1 Available control mechanisms

For each direct control service we will consider the following three matters:

- the control mechanism¹⁰⁶
- the basis of the control mechanism¹⁰⁷
- the formulae that give effect to the control mechanisms.

Clause 6.2.5(b) of the Rules sets out the control mechanisms that may apply to both standard and alternative control services:

- a schedule of fixed prices

A schedule of fixed prices specifies a price for every service a distributor provides. The specified prices are escalated annually by inflation, the X factor and applicable adjustment factors. Distributors comply with the constraint by submitting prices matching the schedule in the first year and then escalated prices in subsequent years.

¹⁰² ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p.18.

¹⁰⁴ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p. 27.

¹⁰⁵ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p. 27.

¹⁰⁶ NER, cl. 6.2.5(b).

¹⁰⁷ NER, cl. 6.2.6(a).

- caps on the prices of individual services¹⁰⁸

Caps on the prices of individual services are the same as a schedule of fixed prices except that a distributor may set prices below the specified prices.

- caps on the revenue to be derived from a particular combination of services (revenue cap)

A revenue cap sets a maximum allowable revenue (MAR) for each year of the regulatory control period. Distributors must then recover revenue equal to or less than the MAR. Distributors comply with the constraint by forecasting sales for the next regulatory year and setting prices so the expected revenue is equal to or less than the MAR. At the end of each regulatory year, the distributor reports its actual revenues to the AER. The AER accounts for differences between the actual revenue the distributor recovers and the MAR in future years. This operation occurs through an 'overs and unders' account, whereby any over-recovery (under-recovery) is deducted from (added to) the MAR in future years.

- tariff basket price control or weighted average price cap (WAPC)

A WAPC is a cap on the average increase in prices from one year to the next. This allows prices for different services to adjust each year by different amounts. For example, some prices may rise while others may fall, subject to the overall WAPC constraint. We use a weighted average to reflect that services may be sold in different quantities. Therefore, a small increase in the price of a frequently provided service must be offset by a large decrease in the price of an infrequently provided service. Distributors comply with the constraint by setting prices so the change in the weighted average price is equal to or less than the CPI-X cap. Importantly, the WAPC places no cap on the revenue recovered by a distributor in any given year. That is, if revenue recovered under the WAPC is greater than (less than) the expected revenue, the distributor keeps (loses) that additional (shortfall) revenue.

- revenue yield control (average revenue cap)

An average revenue cap is a cap on the average revenue per unit of electricity sold that a distributor can recover. The cap is calculated by dividing the MAR by a particular unit (or units) of output, usually kilowatt hours (kWh). The distributor complies with the constraint by setting prices so the average revenue is equal to or less than the MAR per unit of output. Importantly, average revenue caps place no cap on the revenue recovered by a distributor in any given year. That is, if revenue recovered is greater than (less than) the MAR, the distributor keeps (loses) that additional (shortfall) revenue.

- a combination of any of the above (hybrid).¹⁰⁹

A hybrid control mechanism is any combination of the above mechanisms. Typically, hybrid approaches involve a proportion of revenue that is fixed and a proportion that varies according to pre-determined parameters, such as peak demand.

2.3.2 Standard control services

In deciding on a control mechanism to apply to standard control services, we considered the factors in clause 6.2.5(c) of the Rules:

- the need for efficient tariff structures

¹⁰⁸ A price cap and a schedule of fixed prices are largely the same mechanism, with the only difference being that a price cap allows the distributors to charge below the allocated price on some or all of the services.

¹⁰⁹ NER, cl. 6.2.5(b).

- the possible effects of the control mechanism on administrative costs of the AER, the distributor 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)
- any other relevant factor.

The AER proposed in its Preliminary F&A paper to consider three other factors which it considers are relevant to assessing the most appropriate control mechanism:

- volume risk and revenue recovery
- price flexibility and stability
- incentives for demand side management.

The basis of the control mechanism for standard control services must be of the prospective CPI-X form or some incentive-based variant.¹¹⁰

The following subsections outline the factors we have considered in deciding on the form of control for standard control services.

The need for efficient tariff structures

Appendix C outlines some high level considerations about the concept of efficient pricing structures. Broadly, we consider prices are efficient if they reflect the underlying cost of supplying distribution services and take into account customers' willingness to pay.

Efficient pricing is important for several reasons:

- where prices are cost reflective, allocative efficiency is maximised because customers can compare the cost of providing the service to their needs and wants¹¹¹
- where prices are cost reflective, consumers and providers of demand side management face efficient incentives because they can consider the cost of providing the service in decision making
- cost reflective prices allow distributors to make efficient investment decisions. Because customers base consumption decisions on the cost of providing the service compared to their value of consumption, increases and decreases in demand signal the potential need for extra network capacity.

¹¹⁰ NER, cl. 6.2.6(a).

¹¹¹ Allocative efficiency is achieved when the value consumers place on a good or service (reflected in the price they are willing to pay) equals the cost of the resources used up in production. The condition required is that price equals to marginal cost. When this condition is satisfied, total economic welfare is maximised.

Administrative costs

Where possible, a control mechanism should minimise the complexity and administrative burden for the AER, distributors and users. As ActewAGL is a small distributor, changes in control mechanisms are likely to affect administration costs more than in other jurisdictions.

The existing regulatory arrangements

The AER considers that consistency across regulatory periods for similar services is generally desirable.

The desirability for consistency of regulatory arrangements

The AER considers that consistency between regulatory arrangements both within and across jurisdictions for similar services is generally desirable.

Volume risk and Revenue recovery

Our Preliminary F&A paper set out that a control mechanism should give distributors an opportunity to recover efficient costs. Further, that a control mechanism should limit revenue recovery above such costs. Revenue recovery above efficient costs results in higher prices for consumers. Further, distributors recovering additional revenue from pricing above marginal cost reduces allocative efficiency.

Pricing flexibility and stability

Price flexibility enables distributors to restructure existing prices and introduce charges for new services.

The stability and predictability of distribution network prices is important because it affects customers' ability to manage bills and retailers' ability to manage risks incurred from changes to network prices.

Incentives for demand side management

Demand side management refers to non-network solutions implemented to avoid the need to build network infrastructure to meet increases in annual or peak demand.¹¹²

Our view is that we should consider demand side management in determining the form of control. The AEMC states in its Power of Choice Review that the control mechanism (along with other factors inherent in the regulatory determination) can influence distributors' decisions to conduct demand side management.¹¹³ Moreover, the AER¹¹⁴ and previous jurisdictional regulators¹¹⁵ have considered the incentives for demand side management in determining the control mechanism in past decisions.

¹¹² Peak demand is generally referred to as the maximum load on a section of the network over a very short time period.

¹¹³ AEMC, *Power of Choice Review Directions Paper - Supplementary Paper: Demand Side Participation and Profit Incentives for Distribution Network Businesses*, 23 March 2012, pp.19-24.

¹¹⁴ For example, see AER, *Proposed positions - Framework and approach paper - Classification of services and control mechanisms - Energex and Ergon Energy 2010–15*, July 2008, p. 45.

¹¹⁵ For example, see QCA, *Final Determination – Regulation of Electricity Distribution*, May 2001, p. 25.

2.3.3 Alternative control services

In determining the control mechanism to apply to alternative control services, we considered the factors in of the Rules:¹¹⁶

- the potential for the development of competition in the relevant market and how the control mechanism might influence that potential
- the possible effects of the control mechanism on administrative costs of the AER, the distributor, 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)
- any other relevant factor.

The AER considers that the provision of cost reflective prices is another relevant factor.

We must state what the basis of the control mechanism is in our distribution determination.¹¹⁷ This may utilise elements of Part C of chapter 6 of the Rules with or without modification. For example, the control mechanism may use a building block approach or incorporate a pass-through mechanism.¹¹⁸

2.4 Reasons for decision — control mechanism and formulae to give effect to control mechanism for standard control services

2.4.1 Efficient tariff structures

The AER considered in its Preliminary F&A paper that the average revenue cap does not provide an incentive for distributors to set efficient tariffs. Because revenue increases when kWh sales increase, distributors face an incentive to set tariffs which promote additional kWh sales instead of reflecting the cost of providing the service.

Distributors' incentives for setting prices under an average revenue cap include:

- reducing the price of price sensitive kWh services. Setting marginal prices (kWh distribution) below marginal cost for price sensitive services will increase consumption of such services. This increases profits where the incremental cost of providing the service is low. This is the case even if the marginal benefit to customers is less than the marginal cost of providing the service.
- reducing the availability of capacity management tariffs. The distributor has an incentive not to provide capacity management tariffs where the revenue from additional sales is greater than the marginal cost of providing the additional capacity. The incentive not to provide capacity management also exists where the benefits to customers of the additional units sold are less than the cost of providing them.

ActewAGL submitted that factors outside the control mechanism influence ActewAGL's pricing incentives to a greater degree than the average revenue cap.¹¹⁹ ActewAGL submitted we should have

¹¹⁶ NER, cl. 6.2.5(d).

¹¹⁷ NER, cl. 6.2.6(b).

¹¹⁸ NER, cl. 6.2.6(c).

regard to the actual outcomes of ActewAGL's pricing rather than the incentives provided by the average revenue cap. Consistent with the Preliminary F&A paper, we consider the underlying incentives provided by the control mechanism are important. However, we agree with ActewAGL that actual pricing outcomes should be taken into account when assessing pricing efficiency. Appendix C sets out our assessment of ActewAGL's pricing behaviour. Broadly, we consider ActewAGL has not responded to the incentives to set inefficient tariffs created by the average revenue cap. The AER considers that:

- ActewAGL has not reduced the price of price sensitive kWh services below marginal cost
- ActewAGL has not reduced the availability of capacity management tariffs.

While the incentives the average revenue cap provides have not had a material impact, ActewAGL's pricing exhibits the weaknesses displayed by distributors under other control mechanisms. In particular, Appendix C demonstrates that throughout the period more than fifty per cent of ActewAGL's revenue was derived from inefficient charging parameters. That is, charges that bear little or no relation to the costs of providing distribution services. We therefore consider that a new set of pricing principles that provide an incentive to set cost reflective prices should accompany the average revenue cap. The AER supports the AEMC's proposed review of the pricing principles.¹²⁰

The AER maintains its position from the Preliminary F&A paper that the revenue cap in isolation provides limited incentive for distributors to set efficient prices. No submissions disagreed with this position.

2.4.2 Administrative costs

ActewAGL submitted that a revenue cap imposes additional administration costs on it and the AER.¹²¹ ActewAGL submitted that annual forecasting requirements and compliance with the unders and overs account under a revenue cap will increase administration costs relative to the average revenue cap. We consider that revenue caps and average revenue caps generally have similar administration costs. However, in ActewAGL's case we agree that the revenue cap is likely to create higher administration costs. We consider ActewAGL's small size and limited annual forecasting processes mean the annual forecasting requirements under a revenue cap is likely to increase its administrative costs.

2.4.3 The existing regulatory arrangements

The AER maintains its preliminary view that consistency across regulatory control periods is generally desirable but should not be a primary consideration. We consider how consistency across regulatory control periods affects the other factors under the Rules.¹²² The AER considers this appropriate because consistency in and of itself has no direct affect on distributors, customers or the AER.¹²³

2.4.4 The desirability of consistency between regulatory arrangements

The AER maintains its preliminary view that consistency between regulatory arrangements, both within and beyond the relevant NEM jurisdiction, is generally desirable but should not be a primary consideration. Further, similar to consistency across regulatory control periods, the AER considers it

¹¹⁹ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p. 22.

¹²⁰ AEMC, *Power of Choice Review – giving consumers choice in the way they use electricity*, Final Report, 30 November 2012, p. 185.

¹²¹ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p. 24.

¹²² NER, cl. 6.2.5(c).

¹²³ AER, *Preliminary Positions F&A paper*, June 2012, p. 61.

should take into account the impact of consistency across jurisdictions on the other factors in the Rules.¹²⁴

2.4.5 Volume risk and revenue recovery

Revenue recovery

The AER maintains its preliminary position that average revenue caps provide a low likelihood of distributor's recovering efficient costs. The AER considers the majority of distributor's costs are fixed and correlated to peak demand, while a large proportion of revenue is recovered from energy sales. Therefore, if the actual volume of energy sales varies from that forecast, distributors' revenue will vary from cost.

The variability of revenue and profit under the average revenue cap creates incentives for distributors in price setting and demand forecasting. Distributors face incentives to:

- understate sales forecasts in regulatory proposals because higher than forecast sales will increase profit.¹²⁵
- adjust tariffs to increase sales volumes. Where additional revenue is attained through price adjustments that do not reflect changes in the costs of providing the service, distributors can make windfall gains.

ActewAGL submitted evidence in response to the Preliminary F&A demonstrating that variances from forecast revenue under the average revenue cap have been minor.¹²⁶ Furthermore, ActewAGL provided evidence that the variances were from non-systematic errors in CPI and volume forecasts. Appendix D provides analysis of ActewAGL's submission. Broadly, we consider that revenue variances have not resulted from forecasting or the pricing behaviour of ActewAGL.

The AER maintains its preliminary position that a revenue cap provides a high likelihood of recovery of efficient costs.¹²⁷ Under a revenue cap, revenue recovery is fixed and unrelated to energy sales. Because costs for distributors are largely fixed and unrelated to energy sales, a revenue cap is likely to lead to efficient cost recovery. Differences from forecast peak demand and customers may cause differences in costs for distributors and variations from efficient cost recovery under the revenue cap may result. If a revenue cap was preferred we consider adjustment mechanisms are available (hybrid control mechanisms) to alter the revenue cap for variations from forecast peak demand and customer numbers.

Volume risk

A revenue cap fixes revenue regardless of the volume of services provided by the distributor. If the distributor recovers above the MAR in one year, it must decrease the price of its services in the following year. Similarly, if the distributor recovers below the MAR in one year, it can increase the price of its services in the following years. In both cases, the consumer bears the volume risk through price changes within the regulatory control period. ActewAGL submitted that the distributor should

¹²⁴ NER, cl. 6.2.5(c).

¹²⁵ While we rigorously test the forecasts proposed by distributors, we are concerned with the accuracy of sales volume forecasts.

¹²⁶ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p. 35.

¹²⁷ AER, *Preliminary F&A paper*, June 2012, p. 42.

bear volume risk and not the consumer because distributors are best placed to manage such risk.¹²⁸ The AER agrees with ActewAGL.

2.4.6 Price flexibility and stability

Price flexibility

The AER maintains its preliminary view that price flexibility is similar for all forms of control. We considered that price flexibility is primarily influenced by the side constraints and the pricing principles in the Rules.¹²⁹ No submissions disagreed with this view.

Price stability

The AER maintains its preliminary view that price instability can occur under a revenue cap and an average revenue cap. This is because the Rules require various annual price adjustments regardless of the control mechanism.¹³⁰

However, the AER agrees with ActewAGL's point that there is a greater likelihood of price instability within a regulatory control period under a revenue cap.¹³¹ Under a revenue cap, distributors must adjust prices during the regulatory control period to account for differences between forecast and actual sales volumes. While tolerance limits on the unders and overs account can limit price adjustments, we consider this added price instability a negative feature of revenue caps.

2.4.7 Incentives for demand side management

Consistent with our Preliminary F&A paper, we consider that a revenue cap provides an incentive to undertake demand side management, at least in the short run. On the other hand, an average revenue cap provides a disincentive to undertake demand side management in the short and long run.¹³²

The AER discussed these incentives in the Preliminary F&A paper.¹³³ In summary:

- Under a revenue cap – distributors' revenue is fixed over the regulatory control period and therefore it is possible to maximise profits by reducing costs. Distributors therefore have an incentive to undertake energy efficiency and demand side management projects to reduce demand and consequently the need to incur capital costs associated with building network infrastructure.¹³⁴ While the distributor benefits within the regulatory period through higher profits from reduced costs, consumers benefit in future regulatory periods through lower charges from a lower RAB.

¹²⁸ ActewAGL, *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, p. 7.

¹²⁹ AER, *Preliminary F&A paper*, June 2012, p. 58.

¹³⁰ These include cost pass throughs, jurisdictional scheme obligations, tribunal decisions and transmission prices passed on to the distributors from the Transmission Network Service Providers (TNSPs).

¹³¹ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p. 20.

¹³² In the long run, regardless of the form of control, distributors have a diminished incentive to undertake demand side management. This is because under the building block framework, a distributor may have an incentive to increase the size of the regulated asset base if it is confident that the allowed return exceeds actual funding costs.

¹³³ AER, *Preliminary F&A paper*, June 2012, pp. 46–48.

¹³⁴ Some submissions considered a revenue cap could lead distributors undertaking excessive demand side management (in order to cut costs). However, the AER considered that the risk of distributors undertaking excessive demand side management (in order to cut costs) under a revenue cap is not significant. This is because the risk can be mitigated by implementing an incentive scheme such as the Service Target Performance Incentive Scheme.

- Under an average revenue cap – distributors' profits are directly linked to the actual volumes of electricity distributed. As a result, distributors' profits increase with sales if the marginal revenue is greater than the marginal cost of providing services. Demand side management may not be attractive for distributors if such projects result in less revenue because of falling demand.

The Office of the Regulator-General and the Independent Pricing and Regulatory Tribunal (ACT) previously discussed the incentives under an average revenue cap. ActewAGL submitted the average revenue cap these regulators commented on is based on slightly different formulae to the one applied to ActewAGL's standard control services.¹³⁵ We consider these regulators' comments apply equally to ActewAGL's average revenue cap. The different formulations of the average revenue cap do not affect the relationship between revenue and actual energy sales which drives the disincentive to undertake demand side management.

We agree with ActewAGL that the form of control mechanism is not the only factor that affects the incentive for demand side management. The AEMC has reviewed the profit incentives for distributors to pursue demand side management under the current regulatory framework. Broadly, the AEMC considered the form of control mechanism was one of the most significant factors impacting profit incentives.¹³⁶ Importantly, the AEMC also considered that a control mechanism linking profits to volumes distributed is likely to provide low incentives for demand side management.¹³⁷

When a network business develops tariffs which are based on consumption volumes, its profits could depend upon the level of actual volumes. With such a tariff structure, the business may have no incentive to pursue any form of demand side participation project (or energy efficiency project) which decreases volumes.

Disincentives for demand side management are a drawback of an average revenue cap. However, when weighing this along with the other factors we have considered, our position remains that a change in ActewAGL's control mechanism for standard control services is not necessary in the transitional or subsequent regulatory control periods.

2.4.8 Formulae for standard control services

The AER is required to set out its proposed approach to the formulae that give effect to the control mechanisms for standard control services in the Stage 1 F&A paper.¹³⁸ The AER must include the proposed formulae in its distribution determination, unless it considers that unforeseen circumstances justify departing from the formulae as set out in that paper.¹³⁹

On 15 February 2013, the AER consulted on the proposed formulae. The AER received one submission from ActewAGL supporting the average revenue cap and proposing minor amendments to the proposed formulae.¹⁴⁰

We propose to apply the following formulae to standard control services. We consider that the formula gives effect to the average revenue cap.

¹³⁵ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p. 16. ActewAGL stated that the comments made by the jurisdictional regulators were in relation to an average revenue cap that is based on forecast volumes. In contrast, the average revenue cap applied to ActewAGL uses the actual volume in the most recent calendar year.

¹³⁶ One of the factors identified by the AEMC is the different treatment of costs under the regulatory framework.

¹³⁷ AEMC, *Final Report: Power of choice review - giving consumers options in the way they use electricity*, 30 November 2012, p. 214.

¹³⁸ NER, cl. 6.8.1(b)(2)(ii).

¹³⁹ NER, cl. 6.12.3(c1).

¹⁴⁰ ActewAGL, *Submissions on control mechanism formulae*, 20 February 2013.

$$(1) MAAR_t \geq \frac{(\sum_{i=1}^n \sum_{j=1}^m p_{ij}^t q_{ij}^{t-2})}{kWhtransported_{t-2}} \quad i=1,\dots,n \text{ and } j=1,\dots,m \text{ and } t=1,\dots,5$$

$$(2) MAAR_t = AAR_t + \frac{(I_t + T_t + B_t)}{kWhtransported_{t*}}$$

$$(3) AAR_t = AAR_{t-1}(1 + CPI_t)(1 - X_t)$$

Where:

$MAAR_t$ is the maximum allowable average revenue in year t.

p_{ij}^t is the price of component i of tariff j in year t.

q_{ij}^t is the quantity of component i of tariff j in year t-2.

AAR_t is the average allowable revenue in year t.

$kWhtransported_{t-2}$ is the total kWh in year t-2.

$kWhtransported_{t*}$ is the forecast total kWh in year t

I_t is the sum of incentive scheme adjustments in year t. To be decided in the final decision.

T_t is the sum of transitional adjustments in year t. To be decided in the final decision.

B_t is the sum of annual adjustments in year t. To be decided in the final decision.

CPI_t is the percentage increase in the consumer price index in year t. To be decided in the final decision.

X_t is the X-factor in year t. To be decided in the final decision.

AAR_1 is the average allowable revenue in year one. To be decided in the final decision.

ActewAGL's submission sought clarification of the use of financial year data in the $kWhtransported_{t-2}$ term in equation (1). In the 2009-14 distribution determination, this term utilised calendar year data. We consider the change to financial year data is appropriate because it provides consistent use of financial year data throughout the control mechanism.

ActewAGL submitted that forecast year t data is appropriate for the $kWhtransported_{t*}$ term in equation (2). We agree with this view and have changed the term.

2.5 Reasons for decision— control mechanism and formulae to give effect to control mechanism for alternative control services

The AER has decided to apply caps on the prices of individual alternative control services in the transitional and subsequent regulatory control periods. Our main consideration is that caps on the prices of individual services will result in cost reflective prices. We consider this benefit outweighs any detriment from an increase in transitional administrative costs. The following services are classified as alternative control services:

- types 5 to 7 metering services
- ancillary network services.

Through the distribution determination process, we will confirm the basis of the control mechanism for alternative control services.¹⁴¹ That is, whether we will set prices using a building block approach or another method. Prices for certain ancillary network services will be determined on a quoted basis. ActewAGL will propose the approach to determining quoted prices, which we will consider in our distribution determination. Typically, prices for quoted services are based on quantities of labour and materials with the quantities dependent on the particular task. Ancillary network services to be offered on a quotation basis include:

- upgrade services
- covering low voltage mains/tiger matting
- de-energising wires.¹⁴²

The AER's consideration of the relevant factors is set out below.

2.5.1 The influence on the potential for development of competition

The AER maintains its view from the Preliminary F&A paper that the control mechanism for alternative control services will not have a significant impact on the potential development of competition. We consider the primary influence on competition development will be the classification of services as alternative control services. Attachment 1 discusses this classification. In addition, we consider that competition for alternative control services is currently limited. Where competition may develop, we consider caps on the prices of individual services will enhance competition. This is because transparent and cost reflective prices will enable competitors to assess prices and make informed market entry decisions.

2.5.2 Administrative costs

The AER considers administrative costs will be influenced primarily by the classification of services and the basis of the form of control mechanism. ActewAGL submitted major administrative changes would result for it from the AER's change to the control mechanism.¹⁴³ We recognise that our proposed control mechanism change may result in some additional administrative costs. However, we

¹⁴¹ The basis of the control mechanism is the method used to calculate the revenue to be recovered or prices to be set for a group of services. Clause 6.2.6(b) of the Rules states that for alternative control services, the control mechanism must have a basis stated in the distribution determination. The AER is able to apply a control mechanism to a distributor's alternative control services as set out under chapter 6, Part C of the Rules. This involves applying the building block approach, although the AER may only apply certain elements of the building block approach. Alternatively, the AER may implement a control mechanism that does not use the building block approach.

¹⁴² Appendix B lists ancillary network services and relevant descriptions.

¹⁴³ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, pp. 25–27.

consider that these costs will be minor, and will only be incurred transitioning to the new control mechanism. The control mechanism changes will create more cost reflective charges for these services, and more appropriate charges for end users in a user-pays environment. We consider that these benefits will outweigh any additional short term administrative costs.

2.5.3 The existing regulatory arrangements

The AER considers that consistency across regulatory control periods is generally desirable. However, we consider the pursuit of consistency across regulatory control periods should not be the primary consideration in determining a control mechanism. We assess each jurisdiction on a case-by-case basis and apply the most appropriate control mechanism based on this assessment. We have therefore placed more weight on the other factors in clause 6.2.5(d) of the Rules. Further, we are proposing to reclassify ancillary network services and some metering services, as discussed in attachment 1. This means there will be a change in regulatory arrangements regardless of the control mechanism we determine.

2.5.4 The desirability for consistency between regulatory arrangements

The AER considers that consistency within and across jurisdictions is generally desirable. However, we consider the pursuit of consistency in control mechanisms across jurisdictions should not be the primary consideration in determining a control mechanism. We assess each jurisdiction on a case-by-case basis and apply the most appropriate control mechanism based on this assessment. We have therefore placed more weight on the other factors in clause 6.2.5(d) of the Rules.

Different classification and control mechanisms are applied across NEM jurisdictions. For example, in Victoria, non-contestable excluded services are regulated through a price cap.¹⁴⁴ In NSW and Queensland, a variant of a schedule of fixed prices is applied to these services. The AER considers that while different control mechanisms are applied across the NEM, each jurisdiction has applied consistent control mechanisms to similar services within the regulatory control period.

2.5.5 Cost reflective prices

We consider that another relevant factor to a choice of control mechanism is the provision of cost reflective prices.

We maintain our preliminary position that caps on the prices of individual services will deliver greater cost reflectivity than other control mechanisms.¹⁴⁵ Under caps on the prices of individual services, we will estimate the cost of each service and set the cap at that cost. If competition develops within the period on some or all services, ActewAGL can compete by charging below the price cap. Importantly, if ActewAGL chooses to reduce the price below the cap on competitive services, such reductions will not be offset by increases to the price of non-competitive services. Caps on the prices of individual services will therefore enhance cost reflectivity on both competitive and non-competitive services.

ActewAGL's preferred approach is to set a price cap for a basket of metering services rather than separate price caps for each service.¹⁴⁶ This is a WAPC approach. We consider that a WAPC would reduce cost reflectivity compared to caps on the prices of individual services. Under a WAPC, if ActewAGL reduces the price on services that become competitive, it will be able to increase the price

¹⁴⁴ AER, *Final Framework and approach paper for Victorian electricity distribution regulation – Citpower, Powercor, Jemema, SP AusNet and United Energy – Regulatory control period commencing 1 January 2011*, May 2009, p. 68

¹⁴⁵ AER, *Preliminary F&A paper*, June 2012, p. 53

¹⁴⁶ ActewAGL, *Response to the Australian Energy Regulator's Preliminary Positions paper - Framework and Approach for the 2014-19 ACT electricity network determination*, August 2012, p. 27.

on non-competitive services. This will result in reductions in cost reflectivity on non-competitive services.

2.5.6 Formulae for alternative control services

The AER is required to set out its proposed approach to the formulae that give effect to the control mechanisms for alternative control services in the F&A paper.¹⁴⁷ The AER must include the proposed formulae in its distribution determination, unless it considers that unforeseen circumstances justify departing from the formulae as set out in that paper.¹⁴⁸

On 15 February 2013, the AER consulted on the proposed formulae. The AER received one submission from ActewAGL. ActewAGL did not provide any comments on the formulae to apply to alternative control services. Instead, ActewAGL submitted that a WAPC would be preferable to the proposed cap on the prices of individual services. Section 2.5 details our consideration of the choice of control mechanism.

¹⁴⁷ NER, cl. 6.8.1(b)(2)(ii).

¹⁴⁸ NER, cl. 6.12.3(c1).

Services currently classified as alternative control services and which continue to be classified as alternative control services

We propose to apply the following formulae to alternative control services. We consider that the formula gives effect to the caps on the prices of individual services.

$$\bar{p}_i^t \geq p_i^t \quad i=1,\dots,n \text{ and } t=1,\dots,4,$$

$$\bar{p}_i^t = \bar{p}_i^{t-1}(1 + CPI_t)(1 - X_i^t)$$

Where:

\bar{p}_i^t is the cap on the price of service i in year t.

p_i^t is the price of service i in year t.

CPI_t is the percentage increase in the consumer price index. To be decided in the final decision.

X_i^t is the X-factor for service i in year t. To be decided in the final decision.

\bar{p}_i^1 is the cap on the price of service i in the first year of the subsequent regulatory control period. To be decided in the final decision.

Services currently classified as standard control services which may be reclassified as alternative control services

We propose to apply the following formulae to alternative control services. We consider that the formula gives effect to the caps on the prices of individual services.

$$\bar{p}_i^t \geq p_i^t \quad i=1,\dots,n \text{ and } t=1,\dots,5$$

$$\bar{p}_i^t = \bar{p}_i^{t-1}(1 + CPI_t)(1 - X_i^t)$$

Where:

\bar{p}_i^t is the cap on the price of service i in year t.

p_i^t is the price of service i in year t.

CPI_t is the percentage increase in the consumer price index. To be decided in the final decision.

X_i^t is the X-factor for service i in year t. To be decided in the final decision.

\bar{p}_i^1 is the cap on the price of service i in the transitional regulatory control period.

3 Attachment 3: Dual function assets

Dual function assets are high voltage transmission assets forming part of a distribution network. Transmission network service providers (TNSPs) usually operate such assets. Considering transmission assets as part of a distribution determination avoids need for a separate transmission proposal. The Rules, by allowing this, save time and money for network service providers and the AER. These savings ultimately benefit electricity consumers and taxpayers.

The AER must set prices for use of dual function assets under either transmission or distribution rules. We make our pricing decisions during the distribution determination process. Before that, however, we must decide whether transmission or distribution pricing rules will apply. The Rules require us to set out our pricing approach decision in this Stage 1 F&A paper.

Under the new Rules' transitional provisions, our dual function asset decisions set out here relate only to 4 years, rather than the usual 5 years. The current dual function asset pricing approach continues over the transitional regulatory control period—1 July 2014 to 30 June 2015.¹⁴⁹ Our decisions set out in this attachment, therefore, relate to the subsequent regulatory control period—1 July 2015 to 30 June 2019.

This is our first dual function asset decision for ActewAGL, as the relevant assets are new. Our decision to apply transmission pricing reflects dual function asset materiality compared to total assets. It also allows cost reflective pricing for customers benefitting, or potentially benefitting, from the assets. Also, our decision is consistent with our preliminary approach and with ActewAGL's preference. However, ActewAGL's transmission provider, Transgrid,¹⁵⁰ does not support our decision.

3.1 AER decision

The AER's decision is final and binding on ActewAGL throughout the subsequent regulatory control period. The AER decided that ActewAGL's dual function asset services will be subject to transmission pricing.¹⁵¹

The AER determines under clause 6.25(b) that Part J of chapter 6A (transmission pricing) of the Rules will apply to relevant standard control services provided by ActewAGL's dual function assets in the subsequent regulatory control period.

¹⁴⁹ NER, cl. 11.56.3(g).

¹⁵⁰ Transgrid is the largest transmission network service provider (TNSP) operating in NSW, also supplying ActewAGL's distribution network. The Australian Capital Territory (ACT), of which ActewAGL is the sole electricity distributor, has no large scale electricity generation assets and must import almost all its electricity from NSW.

¹⁵¹ Relevant services conform to the definition under cl. 6.24.2 of the Rules.

Table 5: ActewAGL dual function assets and pricing approach

Dual function assets (\$m)	\$45.6
Proportion of distribution Regulatory Asset Base (%)	6.3
Current period pricing	N/A
Service provider preference	Transmission
AER preliminary position	Transmission
AER determination	Transmission

Source: AER

3.2 Distributor view

ActewAGL supported the AER's preliminary position to apply transmission pricing.¹⁵²

3.3 AER's assessment approach

Dual function asset rules make transmission pricing the default approach where the assets form a material proportion of the distributor's regulatory asset base (RAB). The Rules require the AER, in deciding pricing approaches, to consider impacts on distribution prices, consumption, production and investment.¹⁵³ We may also account for other factors we consider relevant.¹⁵⁴

The AER's decision on dual function assets incorporates two main stages. First, we must be satisfied that relevant assets conform to the Rules' definition.¹⁵⁵ On this, we gave weight to distributor information and statements and a late submission from Transgrid. Having satisfied ourselves on this first issue, we then considered alternative pricing approaches.

Distribution and transmission pricing represent different ways of recovering service costs. Under transmission pricing, distributors may allocate dual function asset costs to both a TNSP's broader customer base and the distributor's customers. However, under distribution pricing rules, distributors with dual function assets may not allocate costs to a TNSP.

Electricity supply costs transfer along the supply chain, or downstream, onto the next service provider in the process. Hence, generators pass generation costs to retailers who pass them to customers. In the same way, TNSPs pass their costs to distributors, who in turn pass those costs to retailers and then to customers. Service providers may not pass costs back up the supply chain from distributors to TNSPs, except under transmission pricing rules.¹⁵⁶ Therefore, under distribution pricing rules, a distributor's own customers pay the full cost of dual function assets.

¹⁵² When the AER finalised its preliminary F&A paper ActewAGL had not informed the AER whether it owns, operates or controls any dual function assets. Therefore, we could not set out a dual function asset position. After finalising our preliminary F&A paper, ActewAGL provided dual function asset information. We published this information on our website with a statement that our preliminary position was to apply transmission pricing rules. We sought submissions on this preliminary position.

¹⁵³ NER, cl. 6.25(c)(1) and (2).

¹⁵⁴ NER, cl. 6.25(c)(3).

¹⁵⁵ NER, cl. 6.24.2.

¹⁵⁶ Under transmission pricing rules, TNSPs allocate fifty per cent of costs to transmission customers on a locational basis. This means that transmission customers in a specific region will bear at least half the dual function asset transmission service costs in that region. TNSPs allocate the remaining fifty per cent of costs across their total transmission customer

Because transmission networks are upstream of distribution networks, they usually service larger numbers of electricity consumers than distribution networks. Therefore, where TNSPs recover the same service costs, transmission pricing usually provides for lower per unit prices than distribution pricing. The AER notes that this is not necessarily an appropriate outcome. The Rules require us to determine efficient service costs.¹⁵⁷ In principle, electricity customers who stand to benefit from dual function assets should pay for those services.

In some cases, the potential transmission and distribution customer bases for cost recovery purposes may be the same. In such cases, network service providers would recover dual function asset costs from the same number of customers. The AER expects that in such cases price impacts for individual customers under both pricing approaches would be equivalent. In this instance, they are not the same. The distribution region is confined to the Australian Capital Territory whereas the transmission service area also includes New South Wales.

The AER applied a three part test to determine application of either transmission or distribution pricing rules. Firstly, we considered the value of dual function assets as a proportion of the distributor's RAB.¹⁵⁸ Secondly, we considered whether regulating prices under distribution rules rather than transmission would:¹⁵⁹

- result in materially different prices for distribution customers
- impact on future consumption, production and investment decisions.

Thirdly, we took into account other matters we considered relevant. Specifically, we considered cost reflectivity, or who does and may benefit from the assets. Customers benefiting, or potentially benefiting, from dual function assets should contribute to their cost recovery. The Rules define dual function assets as supporting the higher voltage transmission network.¹⁶⁰ Therefore, our default assumption is that a broader customer set than just the distributor's customers are benefiting from shared assets.

As part of our analysis, we took into account submissions that commented on dual function assets.¹⁶¹

3.4 Reasons for AER's position

For the following reasons the AER decided that transmission pricing will apply to ActewAGL's dual function assets. Firstly, we accept that ActewAGL owns assets complying with the Rules' definition of dual function assets. ActewAGL reported that it owns dual function assets and Transgrid supports this view. Having satisfied ourselves that assets conform to the Rules' definition, we then consider the alternative pricing approaches. ActewAGL reported that its dual function assets represent 6.3 per cent of its RAB. Because of its likely price impact, we consider this a material proportion of ActewAGL's RAB, justifying application of transmission pricing. Further, applying distribution pricing would materially impact ActewAGL's distribution customers and affect consumption, production and investment. In terms of cost reflectivity, ActewAGL's dual function assets support Transgrid's transmission network. As such, they benefit a broader set of customers than just ActewAGL's distribution customer base. We therefore consider transmission pricing is appropriate.

base. The TNSP bills its costs to its customers as fixed and variable charges, with variable charges dependant on electricity demand in specific regions.

¹⁵⁷ NEL, s. 7.

¹⁵⁸ NER, cl. 6.25(b).

¹⁵⁹ NER, cl. 6.25(c).

¹⁶⁰ NER, cl. 6.24.2(a).

¹⁶¹ NER, cl. 6.25(d).

The AER and industry expect electricity predominantly to flow into the ACT over these assets. However, electricity will flow into NSW when an alternative transmission route is closed. Additionally, future transmission flows are difficult to predict. Should flows into the ACT be larger than foreseen, applying distribution pricing would not be cost reflective. This is because under distribution pricing Transgrid may not be charged for *any* related asset costs. We consider this a significant risk of materially inefficient pricing. Transgrid would benefit significantly from ActewAGL's dual function assets, but ActewAGL would have no capacity to recover costs from Transgrid.

Further, even as reserve capacity for Transgrid, ActewAGL's dual function assets provide some benefit to Transgrid's customers. Should Transgrid's other service to the Cooma region of NSW, south of the ACT, be interrupted, the southern ACT interconnector will maintain supply. Such interruptions may be for further planned works, but may also be unplanned. The new interconnector in the ACT's south therefore provides a back-up service to Transgrid's other Cooma service. We consider it appropriate that Transgrid's customers provide support for ActewAGL's dual function assets.

In light of the above, we also note transmission pricing's impact on Transgrid customers is negligible. The dual function asset costs would be spread across a relatively large customer base—all customers connected to Transgrid's network. For ActewAGL's customers, a relatively small customer base, the price impact of distribution pricing would be considerable.

The remainder of this section sets out background information and details of the AER's decision.

3.4.1 Background— second ACT supply point

ActewAGL's dual function assets form a second interconnector between the ACT and NSW. This new interconnection is in the ACT's south and is in addition to an existing northern interconnection that Transgrid owns. The ACT Government decided to establish the second supply point, obliging ActewAGL¹⁶² and Transgrid¹⁶³ to give effect to this decision. The assets have operated since March 2012.

ActewAGL and Transgrid broadly agree on the nature of services ActewAGL's dual function assets provide.¹⁶⁴ The AER and industry expect electricity predominantly to run from NSW into the ACT. In other words, from Transgrid to ActewAGL. Therefore, these assets will predominantly provide services to ActewAGL's distribution customers. There are, however, important exceptions.

As part of the new ActewAGL interconnector project, Transgrid is upgrading its existing assets servicing the Cooma region of NSW. ActewAGL and Transgrid expect electricity to flow from the ACT into NSW while Transgrid undertakes these upgrade works. To provide continuous supply to Cooma, Transgrid will take electricity from the ACT, through ActewAGL's dual function assets. Transgrid expects its upgrade project to take around five months to complete. After Transgrid's upgrade project is complete, electricity would then usually flow into the ACT over ActewAGL's dual function assets. ActewAGL's dual function assets would, however, be available to Transgrid as stand-by, or reserve capacity, into the future. The assets will once again service Transgrid should Transgrid's other service to Cooma again be interrupted.

¹⁶² ActewAGL is 50 per cent owned by Actew Corporation, which is 100 per cent owned by the ACT Government.

¹⁶³ The ACT Government established Transgrid's requirement to provide a second ACT electricity supply point in the *ACT Utilities exemption 2006 (No 1) - Disallowable instrument DI2006-47*, made under the Utilities Act 2000.

¹⁶⁴ Transgrid, submission *ActewAGL dual function assets*, 21 September 2012; ActewAGL, letter *Advice to the AER on dual function assets*, 30 June 2012.

Transgrid and ActewAGL further agree the ACT Government's policy to establish a second supply point drives Transgrid's upgrade project. Without this decision, Transgrid's pre-existing assets are sufficient to service its Cooma area customers, at least for the present time. The service providers expect ActewAGL customers to benefit most from ActewAGL's dual function assets. However, Transgrid's NSW customers will also benefit. Transgrid will receive upgraded assets and some additional reserve transmission capacity.

ActewAGL valued its dual function assets at \$45.6 million as at 1 July 2012.¹⁶⁵ This equates to 6.3 per cent of its RAB.¹⁶⁶ ActewAGL further submitted that by 1 July 2014 its dual function assets will represent 7.1 per cent of its RAB.¹⁶⁷ However, ActewAGL must register with the Australian Energy Market Operator as a TNSP because it owns dual function assets. At time of writing, ActewAGL is confirming whether it must invest in additional metering assets because of its TNSP registration. If required, ActewAGL advises it expects the necessary volume meters to cost between one and two million dollars in total. This would marginally increase dual function assets' proportion of ActewAGL's RAB.

AER position — details

The AER decided that transmission pricing will apply to ActewAGL's dual function assets. This is consistent with our preliminary position.¹⁶⁸

ActewAGL operates assets conforming to the Rules' dual function asset definition. We reached this view, firstly, because ActewAGL reported that it owns assets conforming to the Rules' definition. As there are significant penalties for reporting incorrect information, we gave weight to ActewAGL's reported information. Secondly, Transgrid's submission and other statements supported ActewAGL's information in most respects.

The AER then considered whether the dual function assets were a material proportion of ActewAGL's RAB. At 6.3 per cent, ActewAGL's dual function assets are a material proportion of its RAB. The Rules do not define 'material' in the context of dual function assets. We therefore applied its common meaning and considered the consumer price implications of this asset proportion.¹⁶⁹ On face value, we consider 6.3 per cent to be a significant or important portion of ActewAGL's RAB. However, without a Rules' materiality definition, we further considered the asset proportion in terms of customer price impacts. ActewAGL reported that under distribution pricing its customers would face tariffs 1.9 per cent higher than if priced as transmission assets. However, this percentage impact is answering a different question.

To determine how material ActewAGL's dual function assets are, we considered the price impact of removing those assets completely. ActewAGL's 1.9 per cent estimate incorporates costs ActewAGL's customers face even under transmission pricing. Therefore, we consider 1.9 per cent a lower bound estimate of ActewAGL's dual function assets' raw price impact. The actual raw price impact would be a marginally higher percentage. We also note ActewAGL expects that its dual function asset value may increase to 1 July 2014 due to additional metering requirements.

We then considered whether the likely raw price impact is material. Again, the Rules do not define materiality for dual function assets. Therefore, we again applied its common meaning. We also gave

¹⁶⁵ ActewAGL, letter to AER, 30 June 2012.

¹⁶⁶ ActewAGL, *Responses AER questions on DFA 22 August 2012*, response to question 1, emailed to AER on 3 September 2012.

¹⁶⁷ Ibid.

¹⁶⁸ The AER's dual function asset preliminary position was published on our website, separate to our *Preliminary Framework and Approach*: www.aer.gov.au/node/11482.

¹⁶⁹ The Oxford Dictionary notes 'material' is equivalent to 'significant' and 'important'.

weight to the Rules' materiality definition for cost pass through applications. That is, one per cent of the distributor's annual revenue requirement for that regulatory year.¹⁷⁰ We consider a price change of a specific proportion would be equivalent to a revenue change of the same proportion. At marginally higher than 1.9 per cent, the raw price impact would likely double the Rules' cost pass through materiality threshold. In terms of materiality's common meaning, we consider the amount significant in the context of providing electricity network services. In turn, we conclude that ActewAGL's dual function assets are important or significant and therefore material. This justifies applying transmission pricing.

Transgrid submitted that ActewAGL's dual function assets are not material. We consider, however, that the information available does not support Transgrid's position. Transgrid has not challenged ActewAGL's reported asset values or proportions. As such, for the reasons set out above, we maintain the view that ActewAGL's dual function assets are a material proportion of its RAB.

The AER then considered the materiality of the alternative pricing approaches to distribution customers. Under distribution pricing rules, ActewAGL's distribution customers would pay 100 per cent of its shared asset costs. Transgrid's other transmission customers would pay none. Because ActewAGL's customer base is relatively small, we expect the price impact to be relatively large. As noted above, ActewAGL estimated a 1.9 per cent price impact from pricing its dual function assets under distribution rules instead of transmission.

The Rules require us also to consider customer price impacts for other distributors, not just ActewAGL. In addition to ActewAGL, Transgrid services NSW distributors Essential Energy, Endeavour Energy and Ausgrid. There would be negligible impact on these distributors' customers from pricing ActewAGL's shared assets under transmission rules. This is because transmission pricing would allocate the asset costs across a relatively large customer base. We therefore conclude that to minimise distribution customer price impacts, we should price ActewAGL's shared assets under transmission pricing rules.

Finally, we consider that uncertainty over future electricity flows through ActewAGL's dual function assets also supports transmission pricing. We consider that forecasting electricity flows through interconnector assets over long time periods is subject to substantial uncertainty. This uncertainty raises concern that a distribution pricing determination would inappropriately rule out Transgrid paying anything for the relevant assets. In contrast, a transmission pricing determination allows ActewAGL distribution customers and Transgrid to share costs.

Late submission

On 15 February 2013, the AER received a late submission from Transgrid, proposing that the majority of ActewAGL's dual function assets are distribution assets.¹⁷¹ Transgrid considers the assets will be used primarily for distribution, rather than transmission services. We consider, however, that the primary purpose of these assets is not in doubt and is not relevant.

The AER agrees that ActewAGL's proposed dual function assets will rarely provide electricity to Transgrid's customer base south of the ACT. Neither ActewAGL nor Transgrid dispute this. The likelihood that the assets will provide this service is, however, greater than zero. Transgrid acknowledges the assets have been used recently to provide this service.¹⁷² Also, the Rules define dual function assets as providing support to a higher voltage transmission network. The ACT second

¹⁷⁰ NER, chapter 10, glossary — *materially*.

¹⁷¹ Transgrid, letter to AER: *ActewAGL framework and approach paper - determination on dual function assets*, 15 February 2013.

¹⁷² *Ibid.*, p. 2.

interconnector project provides support to Transgrid's network, even if this will predominantly be potential support rather than active support in future. We note also that ActewAGL was required to register as a TNSP in relation to the assets in question. Clearly, the Rules and the Australian Energy Market Operator both consider these transmission assets.

Transgrid further proposes that ActewAGL's actual transmission assets would not comprise a material proportion of its RAB, nor pose material price impacts. Transgrid estimates the total value of ActewAGL's dual function assets as \$12 million, with a price impact of 0.76 per cent. Transgrid submits that these metrics do not justify application of transmission pricing.

In considering Transgrid's submission, we accept that there may be some uncertainty regarding one, relatively small, element of ActewAGL's proposed dual function assets. Namely, upgrade of the existing Gilmore to Theodore 132 kV line. To provide a sense of scale, this is around 5 kilometres of existing line to be upgraded, or enhanced. By comparison, the Theodore to Williamsdale component is around 20 kilometres of new line, with additional line upgrades, protection and metering equipment all making up the full project. The upgraded Gilmore to Theodore line will be capable of supplying Canberra's full electricity demand from Transgrid's network south of the ACT.

Even if we were to accept that the Gilmore to Theodore element were not properly defined as part of a dual function asset, this would not impact our pricing determination. This is because it is not included in the amount claimed by ActewAGL. Subsequent to Transgrid's submission, ActewAGL submitted that it did not include this element in its 2012 price impact estimate of 6.3 per cent.¹⁷³ As it is, we consider there is only a level of doubt about this component of the project not meeting the Rules' dual function asset definition. At best, we consider this arguable.

For the above reasons, we do not accept the propositions in Transgrid's late submission and maintain our determination that transmission pricing will apply to ActewAGL's dual function assets in the subsequent regulatory control period.

¹⁷³ ActewAGL, letter to the AER: *ACT part 1 framework and approach paper - dual function assets*, 25 February 2013.

Appendix A: Rule requirements for classification

The AER must have regard to four factors when classifying distribution services.¹⁷⁴

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)
 - the extent to which there is information available to a prospective network service user or network service user, and whether that information is adequate, 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.¹⁷⁵
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)¹⁷⁶
3. the desirability of consistency in the form of regulation for similar services (both within and beyond the relevant jurisdiction)¹⁷⁷
4. any other relevant factor.¹⁷⁸

The Rules specify additional requirements for services the AER has regulated before.¹⁷⁹ They are:

1. There should be no departure from a previous classification (if the services have been previously classified); and
2. If there has been no previous classification - the classification should be consistent with the previously applicable regulatory approach.

¹⁷⁴ NER, cl. 6.2.1(c).

¹⁷⁵ NEL, s. 2F.

¹⁷⁶ NER, cl. 6.2.1(c)(2).

¹⁷⁷ NER, cl. 6.2.1(c)(3).

¹⁷⁸ NER, cl. 6.2.1(c).

¹⁷⁹ NER, cl. 6.2.1(d).

The AER must have regard to six factors when classifying direct control services as either standard control or alternative control services.¹⁸⁰

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.¹⁸¹

In classifying direct control services that have previously been subject to regulation under the present or earlier legislation, the AER must also follow the requirements of clause 6.2.2(d) of the NER.

¹⁸⁰ NER, cl. 6.2.2(c).

¹⁸¹ NER, cl. 6.2.2(c).

Appendix B: ActewAGL's distribution services

Table B.1: Proposed classification of distribution services - ActewAGL

AER service group/Activities included in service group	Further description (if any)	AER proposed classification 2014-19	Current classification 2009-14
Network services	Constructing the network; Maintaining the network; Operating the network for DNSP purposes; Planning the network; Designing the network; Emergency response; Administrative support	Standard control	Standard control
Metering services (types 5 to 7)	Commissioning of metering and load control equipment; provision of types 5 to 7 meters; types 5 to 7 metering data services (metering data services involve the collection, processing, storage and delivery of metering data and the management of relevant NMI Standing Data in accordance with the Rules); scheduled meter read; Maintaining and repairing meters and load control equipment; meter test during business hours (refunded if meter proves to be faulty); special meter reading or check read (refunded if original reading was incorrect); install interval meter at customer's request; replace meter to facilitate renewable energy installation	Alternative control	Alternative control
Connection services	<p>Connection services include:</p> <p>Premises connections - additions or changes to the connection assets located on the customer's premises (Note: excludes all metering services)</p> <p>Extensions - new assets, other than shared network assets, required to connect a power line or facility outside the present boundaries of the transmission or distribution network owned or operated by a Network Service Provider.</p> <p>Augmentations - any shared network enlargement/enhancement undertaken by a distributor which is not an extension</p>	Standard control	Standard control

AER service group/Activities included in service group	Further description (if any)	AER proposed classification 2014-19	Current classification 2009-14
AER Service group— Ancillary network services			
Re-energise or de-energise a site	Visit to re-energise or de-energise a site - business hours - re-energise	Alternative control	Standard control *Alternative control
	Visit to re-energise or de-energise a site - after hours - re-energise		
	Visit to re-energise or de-energise a site - business hours - de-energise		
	De-energise a site for non-payment* De-energise a site for non-payment - field visit only*		
Temporary connection	Temporary connection - overhead*	Alternative control	*Alternative control
	Temporary connection - standard underground		Standard control
	Temporary connection - free-standing underground		
Remove, reposition or disconnect service	Includes overhead or underground	Alternative control	Standard control
Upgrade services	Upgrade service from single to three phase at customer's request where load does not justify three phase - overhead	Alternative control	Standard control
	Upgrade service from single to three phase at customer's request where load does not justify three phase - underground - service cable replacement not required		
	Upgrade service from single to three phase at customer's request where load does not justify three phase - underground - service cable replacement required		
Rescheduled visit	Rescheduled visit (applied where a revisit to a site is necessitated by obstructed access, non-compliance with the Service and Installation Rules or the client is not ready for the scheduled work)	Alternative control	Standard control
Issues of copies of electrical drawings		Alternative control	Standard control
Covering low voltage mains/Tiger matting		Alternative control	Standard control

AER service group/Activities included in service group	Further description (if any)	AER proposed classification 2014-19	Current classification 2009-14
Specification and design enquiry charges		Alternative control	Standard control
Non-standard data services (types 5 to 7 metering)		Alternative control	Standard control
De-energising wires (to allow safe approach, for example, for tree pruning, plant operation, oversize loads, construction activities)		Alternative control	Standard control

Appendix C: Efficient pricing

This Appendix provides some high level considerations about efficient pricing structures and analyses pricing efficiency under the average revenue cap in the current and previous regulatory period.

Broadly, we consider that efficient prices will incorporate two key characteristics:

- the underlying cost of supply
- customers willingness to pay

While there are a variety of methods of incorporating these characteristics, we consider that the resulting prices from each will include many of the same features. Firstly, because the majority of DNSPs cost of supply are fixed or related to peak demand, efficient prices will be structured around fixed or peak prices.¹⁸² Secondly, because customers' willingness to pay for connection to the network is generally higher than for electricity consumption, where the price must be set above the cost of supply the largest margin is likely to be applied to fixed (connection) prices.

Our analysis of pricing efficiency under the average revenue cap is divided into two parts:

- revenue recovered under efficient charging parameters relative to inefficient charging parameters at the beginning and end of the current and previous regulatory control periods
- analysis of ActewAGL's most utilised tariffs in the current regulatory period

The AER considers this analysis demonstrates that ActewAGL:

- has not responded to the incentives to set inefficient prices under the average revenue cap. Either through reduction of kWh service prices to increase sales volumes or through a reduction in the availability or importance of capacity/demand tariffs.
- does not currently face a strong incentive to set tariffs efficiently. ActewAGL has set tariffs, and recovers a large proportion of its revenue from inefficient charging parameters which have little or no relation to the cost of providing the service.

Charging parameter revenue recovery

Broadly, we consider that efficient pricing would match prices to cost drivers. Therefore, energy based charges that are unrelated to the networks peak periods and capacity are generally not efficient. Charges for peak usage, peak demand/capacity and fixed charges generally are generally efficient.

On this basis, we consider that an increase in pricing efficiency would be represented by a higher proportion of distributors' revenues being accrued from peak usage, peak demand/capacity and fixed charges. While a lower proportion would be derived from flat, inclining block and off peak charges (other energy charges).

Charts C.1 to C.3 provide ActewAGL's revenue recovered by tariff type in 2004-05, 2008-09 and 2011-12. If ActewAGL was setting prices in line with the incentives provided by the average revenue cap, the likely changes throughout the period would be:

- a decrease in the proportion of revenue recovered from capacity/demand tariffs

¹⁸² Peak prices include peak energy, demand and capacity prices.

- a decrease in the proportion of revenue recovered from energy based charges
- a substantial increase in the proportion of revenue derived from fixed charges.

Chart C.1: ActewAGL revenue by tariff type 2004-05

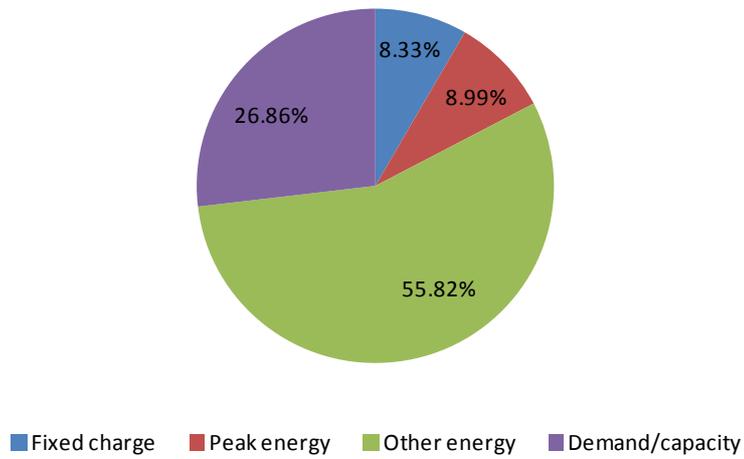


Chart C.2: ActewAGL revenue by tariff type 2008-09

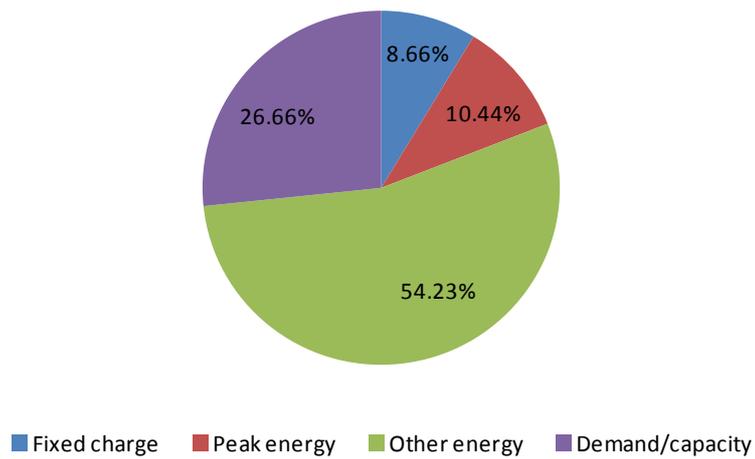
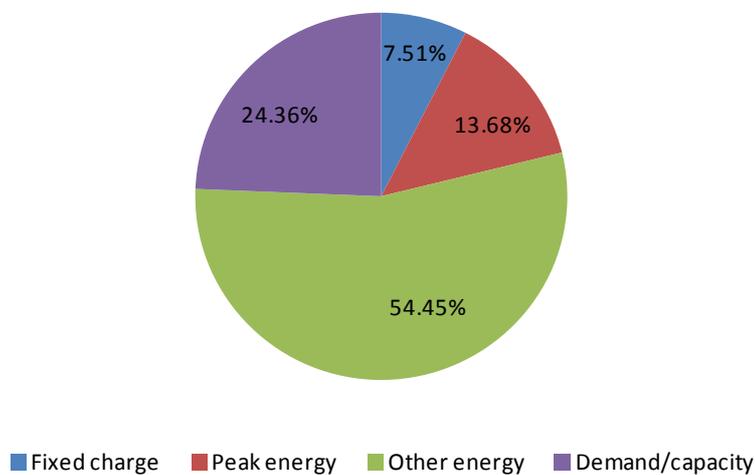


Chart C.3: ActewAGL revenue by tariff type 2011-12



Charts C.1 to C.3 show that the main change in the proportion of revenue recovered over the period is an increase in revenue from peak energy charges. Peak energy charges increased from 8.99 per cent to 13.68 per cent from 2004-05 to 2011-12. There have been small drops in the proportion of revenue derived from all of the other charging types over the period.

We consider the decrease in revenue from fixed charges and the increase in revenue from peak energy charges demonstrate that ActewAGL is not setting prices in line with the incentive to set inefficient prices under the average revenue cap. Further, we consider that the increasing use of peak energy charges represents an increase in pricing efficiency over the period. However, the AER notes that ActewAGL recovered more than 50 per cent of its revenue from other energy charges throughout the period. We consider that other energy charges are not efficient charges as they are not capable of reflecting the cost drivers of the network.

ActewAGL's most important tariffs

This section analyses ActewAGL's most important tariffs. The tariff structure, relative size of prices, and movements within the period are considered.

The residential basic network charge is ActewAGL's standard residential customer tariff:

- The tariff structure has remained the same throughout the period. That is, a two-part tariff consisting of a fixed charge and an energy usage charge.
- The relative size of the fixed and usage charges has also remained relatively constant throughout the period, largely increasing with the average revenue cap constraint.

Table C.1 Residential basic network

	Fixed (\$ per year)	Fixed (% increase)	Usage (c/kWh)	Usage (% increase)
2009-10	47.34		4.47	
2010-11	51.14	8.02%	4.70	5.29%
2011-12	55.66	8.85%	5.03	7.08%
2012-13	61.85	11.12%	5.36	6.55%

Source: AER analysis

Note: DUOS charges not inclusive of cost pass throughs

The general network tariff is ActewAGL's standard small business customer tariff:

- The tariff structure has remained the same throughout the period. That is, a two block inclining block tariff.
- The relative size of the fixed and usage charges has also remained relatively constant throughout the period, largely increasing with the average revenue cap constraint.

Table C.2 General network

	fixed (\$ per year)	fixed (% change)	block one usage (c/kWh)	block one usage (% change)	block two usage (c/kWh)	block two usage(% change)
2009-10	94.90		7.02		9.62	
2010-11	100.96	6.38%	7.41	5.61%	10.13	5.32%
2011-12	112.09	11.03%	8.01	8.05%	10.97	8.24%
2012-13	122.99	9.72%	8.56	6.89%	11.78	7.36%

Source: AER analysis

Note: DUOS charges not inclusive of cost pass throughs

The LV TOU kVA demand network tariff applies to commercial customers with stable loads:

- The tariff structure has remained the same throughout the period. That is, a fixed charge combined with time of use energy charges and a demand charge.
- The relative size of the fixed and usage charges has also remained relatively constant throughout the period, largely increasing with the average revenue cap constraint.

Table C.3 LV TOU kVA demand

	fixed (\$ per year)	fixed (% change)	peak usage (c/kWh)	peak usage (% change)	shoulder usage (c/kWh)	shoulder usage (% change)	off-peak usage (c/kWh)	off-peak usage (% change)	Demand (c/kVA /day)	Demand (% change)
2009-10	116.80		3.16		2.12		0.90		30.99	
2010-11	127.75	9.38%	3.48	10.09%	2.08	-2.26%	0.76	-14.64%	32.99	6.45%
2011-12	131.40	2.86%	3.73	7.33%	2.24	7.95%	0.82	6.86%	34.81	5.52%
2012-13	146.64	11.60%	4.37	16.89%	2.60	16.22%	0.98	20.63%	37.50	7.72%

Source: AER analysis

Note: DUOS charges not inclusive of cost pass throughs

The HV TOU demand network tariff is appropriate for large commercial users taking supply at high voltage:

- The tariff structure has remained the same throughout the period. That is, a fixed charge combined with time of use energy charges and demand/capacity charges.
- The relative size of the fixed and usage charges has also remained relatively constant throughout the period, largely increasing with the average revenue cap constraint.

Table C.4 HV TOU demand

	fixed per year	(\$ peak usage (c/kWh)	shoulder usage (c/kWh)	off-peak usage (c/kWh)	Demand (c/kVA/day)	Capacity (c/kVA/day)
2009-10	4380.00	2.55	1.55	0.64	12.01	12.01
2010-11	4745.00	2.63	1.39	0.48	13.21	13.21
2011-12	4745.00	2.72	1.45	0.51	13.91	13.91
2012-13	5263.97	3.06	1.61	0.60	14.38	14.38

Source: AER analysis

Note: DUOS charges not inclusive of cost pass throughs

Table C.5 HV TOU demand (percentage change)

	fixed per year	(\$ peak usage (c/kWh)	shoulder usage (c/kWh)	off-peak usage (c/kWh)	Demand (c/kVA/day)	Capacity (c/kVA/day)
2009-10						
2010-11	8.33%	3.46%	-10.28%	-25.35%	9.99%	9.99%
2011-12	0.00%	3.09%	4.40%	6.09%	5.30%	5.30%
2012-13	10.94%	12.86%	10.83%	18.75%	3.40%	3.40%

Source: AER analysis

Note: DUOS charges not inclusive of cost pass throughs

The AER considers that there has been little change in ActewAGL's most important tariffs throughout the period. The tariffs structure, relative magnitude and importance have remained stable. We therefore consider that ActewAGL has not responded to the incentives to set efficient tariffs under the average revenue cap.

Appendix D: Revenue recovery

The AER considers that revenue recovery above efficient costs results in higher bills for consumers. Further, where higher revenue is recovered from inefficient charging parameters it is likely to result in reductions in allocative efficiency.

ActewAGL submitted that variations from forecast revenue in the current and previous regulatory period have been minor. Furthermore, ActewAGL consider that where variations have occurred they have been caused by cost pass throughs and random forecasting errors in energy delivered and CPI. Table D.1 presents ActewAGL's forecast and actual revenue recovered.

Table D.1 Forecast and actual revenue recovery

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	Total
Load (GWh)									
Forecast	2,615.30	2,654.50	2,693.80	2,733.00	2,772.20	2,932.86	2,916.01	2,907.58	22,225.30
Actual	2,641.63	2,777.95	2,819.82	2,830.05	2,872.92	2,895.88	2,910.93	2,889.16	22,638.30
Revenue (\$ m)									
Forecast cap	95.07	98.22	102.26	106.86	111.11	139.97	148.31	157.60	959.39
Actual	98.72	102.91	108.95	119.30	121.36	141.32	149.27	158.07	999.91
Pass throughs	0.00	0.00	0.00	5.57	4.15	0.00	0.00	2.18	11.90
Actual	98.72	102.91	108.95	113.73	117.21	141.32	149.27	155.90	988.00
Difference: (actual less forecast)									
(\$ m)	3.66	4.69	6.70	6.87	6.10	1.35	0.96	-1.70	28.62
(percent)	3.80	4.80	6.50	6.40	5.50	1.00	0.60	-1.10	3.00
Difference due to CPI									
(\$ m)	1.07	1.65	1.78	2.43	2.33	2.57	1.77	2.46	16.06
(percent)	1.10	1.70	1.70	2.30	2.10	1.80	1.20	1.60	1.70
Difference due to load									
(\$ m)	0.96	4.57	4.78	3.79	4.04	-1.77	-0.26	-1.00	15.12
(percent)	1.00	4.70	4.70	3.60	3.60	-1.30	-0.20	-0.60	1.60
Difference due to other factors									
(\$ m)	1.63	-1.52	0.14	0.64	-0.27	0.54	-0.55	-3.16	-2.56
(percent)	1.70	-1.60	0.10	0.60	-0.20	0.40	-0.40	-2.00	-0.30

Source: ActewAGL submission to the Preliminary F&A

We consider that table D.1 demonstrates that the majority of differences between forecast and actual revenue have been caused by cost pass throughs, CPI forecasting errors and consumption load forecasting errors. We also note that load was generally under forecast in the previous regulatory control period and over forecast in the current regulatory control period. This resulted in higher than expected recovery in the previous regulatory control period and lower than expected recovery in the current period. We consider the last two rows, 'difference due to other factors', which include variations from changes in ActewAGL's prices, are consistent with the outcomes provided in appendix C. That is, the variation from forecast is random because ActewAGL has not altered its pricing to attain additional revenue through the average revenue cap.