Consultation paper

CITIPOWER'S AND POWERCOR'S PROPOSED SECURITY FEE SCHEME

28 June 2010

AUSTRALIAN ENERGY REGULATOR

Request for submissions

Interested parties are invited to make written submissions to the Australian Energy Regulator (AER) regarding this consultation paper by the close of business on 26 July 2010.

Submissions can be sent electronically to: aerinquiry@aer.gov.au

Alternatively, submissions can be sent to:

> Mr Chris Pattas
> General Manager
> Network Regulation South
> Australian Energy Regulator
> GPO Box 520
> Melbourne VIC 3001

The AER prefers that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information are requested to:

- clearly identify the information that is the subject of the confidentiality claim
- provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential submissions will be placed on the AER's website at http://www.aer.gov.au. For further information regarding the AER's use and disclosure of information provided to it, see the *ACCC/AER Information Policy*, October 2008 also available on the AER's website.

Enquiries about this paper, or about lodging submissions, should be directed to the Network Regulation South branch of the AER on (03) 9290 1446.

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Glossary

AER	Australian Energy Regulator
ESCV	Essential Services Commission of Victoria
Guideline No. 14	Essential Services Commission of Victoria, *Electricity Industry Guideline No. 14 – Provision of Services by Electricity Distributors*
DNSP	Distribution network service provider

1 BACKGROUND

All Victorian electricity distribution network service providers (DNSPs) are required to make an offer to connect new customers to the distribution network. The Australian Energy Regulator (AER) is responsible for exercising certain powers and functions previously undertaken by the Essential Services Commission of Victoria (ESCV). This includes compliance with any Acts or Guidelines under the Victorian regulatory framework. Under clause 3.5.3 of the ESCV's *Electricity Industry Guideline No. 14 – Provision of Services by Electricity Distributors* (Guideline No. 14), the AER is responsible for approving the rate and terms and conditions of security fee interest that may be required by a DNSP as part of the terms and conditions for connecting certain new customers to the distribution network.[1] Under clause 3.5.1 of Guideline No. 14, a DNSP may require a security fee where it fairly and reasonably considers there to be a risk that it will not recover the incremental revenue in relation to a connection offer.

CitiPower and Powercor provided to the AER a proposed security fee scheme for charging certain groups of new customers a security fee and the terms and conditions for such charges. They sought approval from the AER of the interest rate, and interest terms and conditions associated with their proposed schemes.

1.1 Purpose of a security fee

Guideline No. 14 requires that a DNSP must calculate the maximum amount of a customer's capital contribution for new works and augmentation in association with a connection offer, as follows:

CC = [IC – IR] + SF

Where:

- CC is the maximum amount of the customer's capital contribution
- IC is the amount of incremental cost in relation to the connection offer
- IR is the amount of incremental revenue in relation to the connection offer
- SF is the amount of any security fee under the connection offer.

The incremental revenue component of a new connection offer reduces the overall customer contribution received by a DNSP. As such, a security fee acts to insure a

[1] As part of the transition to national regulation of energy markets, the AER is now responsible for exercising certain powers and functions previously undertaken by the ESCV. The new responsibilities are conferred on the AER by the operation of the *National Electricity (Victoria) Act 2005* (NEVA) in accordance with the *Trade Practices Act 1974* and the Australian Energy Market Agreement. The NEVA specifically confers economic regulatory functions, powers and duties on the AER. This includes the powers to approve distributors proposed security fee rate and terms and conditions pursuant to Guideline No. 14.

DNSP against the risk of failing to collect the full incremental revenue it estimates. The level of security fee, if deemed necessary, does not directly impact on the calculation of the customer’s capital contribution.

Under clause 3.5.1 of Guideline No. 14, if a DNSP fairly and reasonably assesses that there is a risk that it may not receive the incremental revenue in relation to a connection offer as estimated by the DNSP, the DNSP may, under the connection offer, require a security fee. Situations where a DNSP does not receive the full estimated incremental revenue may arise when a business customer fails shortly after connection, or, a customer’s consumption is significantly below the forecast.

Without a security fee, the above situations will result in the DNSP being unable to recover the new works and augmentation costs from new customers. The shortfall will eventually be recovered through higher network fees to all other network users.

Under clause 3.5.2 of Guideline No. 14, the amount of the security fee must not be greater than the amount of the estimated incremental revenue for which the DNSP fairly and reasonably assesses as high risk. In addition, in no case may the amount exceed the present value of the incremental cost the DNSP will incur in undertaking any relevant new works and augmentations.

1.2 Role of the AER

Guideline No. 14 provides that, under clause 3.5.3, a DNSP must pay to a customer interest on the amount of a security fee at a rate, and on terms and conditions as approved by the AER.

Under the Electricity Distribution Licence (EDL), any question as to the fairness and reasonableness of a term or condition of an offer made by a licensee under clause 6—obligation to offer connection services and supply to a customer—is to be decided by the AER on the basis of the AER’s opinion of the fairness and reasonableness of a term or condition.

Additionally, when a question arises as to the fairness and reasonableness of a DNSP’s estimate with regards to clause 3.5.1 and 3.5.2 of Guideline No. 14, it is to be determined by the AER on the basis of the AER’s opinion on what is fair and reasonable in the circumstances under clause 7 of Guideline No. 14.

1.3 Purpose of this consultation

This paper seeks to consult on:

1. The rate and terms and conditions of interest proposed by CitiPower and Powercor, which must be approved by the AER under clause 3.5.3 of Guideline No. 14.
2. The fairness and reasonableness of the terms and conditions of CitiPower’s and Powercor’s security fee set out in section 3 of this paper.

Under the EDL and Guideline No. 14, any question as to the fairness and reasonableness of the terms and conditions of CitiPower’s and Powercor’s security fee will be determined by the AER on its opinion of what is fair and reasonable in the circumstances. This paper seeks submissions to inform the AER on its likely approach to assess the fairness and reasonableness of CitiPower's and Powercor's security fee scheme should a dispute be submitted to the AER.

The AER's likely approach will be presented in its final decision paper. However, it should be noted that, at the conclusion of this consultation process, the AER's likely approach to assessing such terms stated in the final decision of this consultation process will not be binding on the AER in relation to any particular dispute.

2 CitiPower's and Powercor's proposed terms and conditions for charging security fees

CitiPower and Powercor proposed identical security fee schemes. CitiPower's proposed security fee scheme is outlined at appendix A.

The proposed security fee schemes are a risk-based approach which provides some protection to DNSPs and existing customers against the cost of network augmentation, if a new connecting customer's load is insufficient for the DNSP to receive the estimated incremental revenue in order to recover the augmentation cost.

The risk factors used to assess whether a security fee will be required, and the amount of any such security fee in the proposed scheme are, a connecting customer's 'location', 'industry' and 'customer diversity'—which is the number of customers at each connection site. The risk assessment will only be applied when the net present value of the incremental revenue component of a connection is greater than $750,000, as can occur in sectors such as rural mining and forestry.

The proposed schemes calculate the amount of a security fee from the average of the three risk factors which are each given a rating from 0 to 5 in accordance with the criteria outlined at table 2.1. If the overall risk factor is 'high' (a risk rating of 4) or 'very high' (a risk rating of 5), the security fee is calculated as the product of the risk rating and five years' incremental revenue divided by five. For example, if a customer is situated in a rural area (risk factor 4), is in the mining industry (risk factor 5) and there is only one customer involved (risk factor 5), the overall risk rating is calculated as (4+5+5)/3 = 4.67. This overall risk rating is classified as 'high', hence a security fee will be required. Assuming the incremental revenue is $200,000 per annum then the security fee over a five year period is calculated as $200,000 * 5 years * (4.67/5) = $934,000.

If the average of the location and industry risk factors is not classified as at least high (4 or more), then no security fee will be required regardless of the customer diversity risk factor.

It should be noted that, for CitiPower and Powercor, five years of incremental revenue represents approximately 50 per cent of the net present value of the total incremental revenue based on a 15 year connection life for business customers as specified in Guideline No. 14.[2]

[2] The calculation uses CitiPower's and Powercor's real weighted average cost of capital (WACC) of 6.4 and 6.3 per cent respectively for the current 2006–10 regulatory control period.

Table 2.1 Criteria Ratings

Risk Rating Factor	Location	Industry	Customer Diversity (largest customer's share of IR)
0		Essential Services	
1 Very Low	CBD—Melbourne CBD	Residential (low/high density) Public Admin/education	<25%
2 Low	Urban—Melbourne metropolitan area	Accommodation/ food services Commercial/residential occupancy Health care/social assistance Wholesale/retail trade	>=25% <50%
3 Medium	Regional—Large Regional Provincial Centres (e.g. Ballarat, Bendigo, Geelong, Mildura and Shepparton	Industrial estate Telecomm/information media Transport, postal/warehousing Other	>= 50% < 75%
4 High	Rural—Settled areas outside of above	Agriculture, forestry/fishing Manufacturing	>= 75% < 100%
5 Very High	Remote Rural— All other areas outside of above (i.e. isolated areas)	Mining	=100%

As outlined in the proposals, CitiPower and Powercor will rebate to the connecting customer the full security fee over five years with interest if the full estimated incremental revenue is received. If only part of the incremental revenue is recovered in a year, they will rebate one fifth of the security fee adjusted pro rata for the incremental revenue not recovered and the relevant interest. It should be noted that CitiPower and Powercor do not intend a shortfall in incremental revenue in a given year to be offset by above estimated incremental revenue received in other years.

CitiPower and Powercor sought approval to pay interest on any security fee at the 90 day Bank Accepted Bill rate published by the Reserve Bank of Australia less 0.25 per cent for administration costs. Interest is paid annually but not on any portion of the security fee which is retained by CitiPower and Powercor. Hence, the non-refunded amount becomes a customer funded asset which reduces the regulated asset base on which distribution tariffs are calculated, rather than revenue to CitiPower’s and Powercor’s shareholders.

3 Considerations and consultation

This section seeks submissions on CitiPower's and Powercor's proposed security fee interest rate, and interest terms and conditions, which must be approved by the AER. In addition, this section outlines the terms and conditions of CitiPower's and Powercor's security fee scheme, which the AER seeks to consult on to inform the AER's opinion on what can be considered fair and reasonable should a dispute arise. The key elements of the proposals presented are the:

- interest rate and administration charge
- location risk factor
- industry risk factor
- other terms and conditions.

3.1 Interest rate and administration charge

Under Guideline No. 14, DNSPs must pay to a customer interest on the amount of a security fee at a rate, and on terms and conditions approved by the AER.

CitiPower and Powercor proposed that the interest payable on a security fee be calculated at the 90 day Bank Bill rate. As noted by CitiPower and Powercor, this is consistent with the interest rate set out in the Energy Retail Code of the ESCV.

Clause 8.3(a)	A retailer must pay to a customer interest on the amount of a refundable advance at the bank bill rate. Interest is to accrue daily and is to be capitalised (if not paid) every 90 days.

According to CitiPower and Powercor, one of the reasons for proposing the 90 day Bank Bill rate is that they intend to treat the security fee as short term funding before it is refunded or retained. By contrast, CitiPower's and Powercor's regulated rate of return is the DNSPs' weighted average cost of capital (WACC). The AER notes the WACC is used for calculating the net present value of the incremental revenue of the customers' connection offer. Therefore, a possible alternative rate, at which interest is paid, is the WACC of the DNSPs.

CitiPower and Powercor have proposed an administration charge rate at 0.25 per cent of the security fee in the form of a reduction of the security fee interest rate by the same percentage. The AER considers the administration charge to be a term of the security fee scheme expressed as a part of the interest rate. In the proposals, CitiPower and Powercor submitted that an adjustment to the interest rate expressed as a percentage of any security fee required is easier to administer than an up-front handling charge.

- The AER seeks stakeholder comment regarding the appropriateness of CitiPower's and Powercor's proposed security fee interest rate at the 90 day Bank Bill rate less 0.25% administration charge.

3.2 Location risk factor

CitiPower and Powercor outlined that a location risk factor should be used to assess the riskiness of new connecting customers. They contended that:

> The more remote the location the less likely that a site vacancy will be quickly filled, therefore the higher the risk that incremental revenue will be less than expected. The risk of a site vacancy in the CBD is comparatively lower than in the urban areas.

- The AER seeks stakeholder comment regarding whether CitiPower's and Powercor's proposed location risk factors appear fair and reasonable.

3.3 Industry risk factor

CitiPower and Powercor proposed industry risk factor criteria as outlined in table 2.1.

They submitted that:

> Some industries are inherently more risky than others. This criterion is used to help assess the risk that the customer will experience financial difficulties due to changes in industry conditions, which in turn may result in changed usage patterns. For instance, government and residential sectors are considered low risk, and high tech and mining sectors are considered high risk.

- The AER seeks stakeholder comment regarding whether CitiPower's and Powercor's proposed industry risk factors appear fair and reasonable.

3.4 Other terms and conditions

Guideline No. 14 provides that a DNSP may only collect a security fee, if it fairly and reasonably assesses that there is a risk that it may not earn the incremental revenue in relation to a connection offer. CitiPower's and Powercor's proposals outline that a security fee is only collected if there is considered to be a high, or very high risk, based on the criteria ratings that the estimated incremental revenue is not collected. The AER seeks submissions whether stakeholders consider that this term is fair and reasonable as required.

CitiPower and Powercor use the product of the risk rating (maximum value of 5) divided by five, and five years' incremental revenue to calculate the security fee amount. The AER seeks submissions as to whether stakeholders consider that under this condition, the amount of the security fee will not be greater than the amount of incremental revenue which the DNSP fairly and reasonably assesses that risk as high, as prescribed by Guideline No. 14.

CitiPower and Powercor stated in their proposals that, the greatest uncertainty regarding recovering the incremental revenue exists in the first five years of connection. The AER seeks comments on the fairness and reasonableness of the refunding security fees or part thereof over a five year period as outlined in the proposals.

CitiPower and Powercor do not intend that a shortfall of incremental revenue in a given year to be offset by above estimated incremental revenue received in other years. The AER seeks submissions on whether stakeholders consider this to be fair and reasonable.

With a security fee scheme in operation, if a DNSP is unable to recover the full estimated incremental revenue from a new customer, it will retain the shortfall from the security fee. If the security fee does not cover the full shortfall, the remainder will be recovered by the DNSP from existing customers. CitiPower's and Powercor's proposed scheme requires about 50 per cent of the total projected network revenue (depending on the risk rating) of the more risky businesses in net present value terms to be payable as a security fee. The AER seeks submissions on whether this amount is within the acceptable realm of balance between the interests new and existing customers.

In accordance with Guideline No. 14, CitiPower and Powercor noted that the maximum security fee charged is the lesser of:

- five times the annual incremental revenue
- the incremental cost incurred by the DNSP.

Under the proposed scheme, a rebate of any security fee and interest is payable annually which is in accordance with Guideline No. 14.

- The AER seeks stakeholder comment regarding whether CitiPower's and Powercor's other terms and conditions are fair and reasonable.

4 Consultation

The AER considers that the proposed security fee will represent some level of investment impediment for some customers. However, this impediment needs to be balanced by the risk of a DNSP's existing customers subsidising certain risky business ventures that result in stranded assets.

The AER seeks submissions on CitiPower's and Powercor's interest rate, interest terms and conditions, and security fee scheme terms and conditions. Specifically whether:

- CitiPower's and Powercor's proposed security fee interest rate at the 90 day Bank Bill rate is appropriate and is consistent with the DNSPs' recognition of the interest as short term funding
- a 0.25 per cent administration charge is appropriate
- the location risk factors appear to be fair and reasonable
- the industry risk factors appear to be fair and reasonable
- the other terms and conditions appear to be fair and reasonable.

Submissions to this consultation paper must be lodged with the AER by 26 July 2010 and will be published on the AER website in accordance with the *ACCC/AER Information Policy*, October 2008.

Appendix A: CitiPower's proposed security fee scheme

What is a security fee?

Some projects may require a security fee to be paid. The Security Fee is applied to manage the risk associated with CitiPower not receiving the distribution revenue amount that was assumed when the connection offer was prepared. Subject to the required load being achieved the security fee is refundable with interest. The customer's load is assessed from the customer's weighted average maximum billed demand for the preceding 12 months.

Risk Factors

Incremental revenue may be less than expected due to:

- Site vacancy: There is a risk that a site will be vacant for part of the period of time that revenue is assumed to accrue for the purpose of determining customer contribution (15 years for non-residential and 30 years for residential). A vacancy may occur for a number of reasons, including customer insolvency or changing business conditions.
- Energy intensity: The energy consumption of the customer may change over time.

Risk criteria are assessed to determine the overall level of risk applicable to a customer connection. If the risk score is high a security fee may be required.

The risk criteria used are as follows:

- Location: This criterion is used to help assess the probable duration of the vacancy, should the site become vacant for whatever reason. The more remote the location the less likely that a site vacancy will be quickly filled, therefore the higher the risk that incremental revenue will be less than expected. The risk of a site vacancy in the CBD is comparatively lower than in the urban areas.
- Industry: Some industries are inherently more risky than others. This criterion is used to help assess the risk that the customer will experience financial difficulties due to changes in industry conditions, which in turn may result in changed usage patterns. For instance, government and residential sectors are considered low risk, and high tech and mining sectors are considered high risk.
- Customer diversity: This criterion is determined by the number of customers at the connection site. The larger a single customer's share of IR, the greater the risk

Please see Table 1 below for criteria ratings.

Table 1 Criteria Ratings

Risk Rating Factor	Location	Industry	Customer Diversity (largest customer's share of IR)
0		Essential Services	
1 Very Low	CBD	Residential (low/high density) Public Admin/education	<25%
2 Low	Urban	Accommodation/ food services Commercial/residential occupancy Health care/social assistance Wholesale/retail trade	>=25% <50%
3 Medium	Regional	Industrial estate Telecomm/information media Transport, postal/warehousing other	>= 50% < 75%
4 High	Rural	Agriculture, forestry/fishing Manufacturing	>= 75% < 100%
5 Very High	Remote Rural	Mining	=100%

When will a Security Fee be required?

A security fee may be required where it is assessed that there is a high risk that CitiPower will not receive the distribution revenue.

Assessment will only apply where the NPV of the incremental revenue (IR) calculated for the purposes of determining the connection charge is greater than $750k. (The NPV of the IR is calculated over 30 years for residential and 15 years for other customer types in accordance with Guideline No.14)

If the connection project triggers the revenue threshold above then an assessment is carried out to determine the risk. If the risk to CitiPower is assessed as being high, a security fee will be required.

In assessing whether a security fee is required, CitiPower considers three risk factors, location, industry type, and customer diversity. The weighted average of the risk criteria "industry type" and "location" is assessed to gain a prima facie assessment of whether broad industry characteristics and the location of the project indicate that risks to IR realization are high. The risk is assessed on a scale of 0 to 5 and ratings of 4 or 5 are regarded as high risk. If the risk is classified as high on the basis of “industry type” and ‘location” then a further assessment is made of the number of end customers at the site and their estimated contribution to the predicted revenues to ascertain if “customer diversity” mitigates risks. If the score for “diversity” is also classified as high then the average of the three risk criteria is calculated to determine the risk factor, otherwise no security fee is required.

The security fee is calculated from the product of the risk factor and five years’ IR. The five year IR figure is analogous to classifying 1/3 of the forecasted revenue used to calculate the connection charge as high risk and is viewed as a conservative assumption.

This revised methodology more accurately assesses risk levels and security fee amounts, and ensures that risk assessments can be conducted quickly and easily.

The Security Fee will be calculated by CitiPower and included in the offer for connection services.

The following examples are provided to demonstrate the risk assessment and calculation of the security fee.

Example 1:

> Consider a mining enterprise in a rural location, only one customer involved and annual revenue of $200,000
>
> Location = “Rural”; Risk Rating = 4
>
> Industry = “Mining”; Risk Rating = 5
>
> Average risk rating for “Location and Industry” = 4.5 therefore assess for third criteria, “Customer Diversity”. Only single customer therefore Risk Rating = 5
>
> Overall Risk Rating = (4 + 5 + 5) / 3 = 4.67
>
> Therefore Security Fee = $200,000 per annum * 5 years * 4.67 Risk Rating = $933,400

Example 2:

> Consider an Industrial estate in a regional location, with 10 customers with the largest one being 30% of the total load and the annual revenue is $200,000
>
> Location = “Regional”; Risk Rating = 3
>
> Industry = “Mining”; Risk Rating = 3
>
> Average risk rating for “Location and Industry” = 3, not high risk therefore no further assessment and no Security Fee required.

Example 3:

> Consider a forestry enterprise in a rural location, consisting of two customers, the largest one being 55% of the total load and the annual revenue is $200,000
>
> Location = “Rural”; Risk Rating = 4

Industry = “Forestry”; Risk Rating = 4

Average risk rating for “Location and Industry” = 4 therefore assess for third criteria, “Customer Diversity”. Largest customer = 55% therefore Risk Rating = 3

Overall Risk Rating = (4 + 4 + 3) / 3 = 3.67

Overall Risk Rating less than 4 (High) therefore no Security Fee required.

Security Fee Refunds

CitiPower will allow an annual rebate of the Security Fee over a five year period. CitiPower will compare the weighted average maximum billed demand against the estimate used for that year in calculating the customers capital contribution incorporated into the connection offer. In each of the five years CitiPower will refund to the customer a sum equal to one fifth of the initial Security Fee adjusted pro rata if the weighted average maximum billed demand was less than the estimated maximum demand, with interest.

In other words if there is a shortfall in the weighted average maximum billed demand for that year the rebate will be reduced by the shortfall expressed as a fraction of the estimated maximum demand. Any shortfall for any year may not be off-set against additional revenue received for any other year or vice versa.

The first qualifying year of the rebate period commences on the date of completion of the works. Subsequent rebate periods will follow at successive 12 month intervals from the first period.

Interest is paid on the annual rebate. Interest is not payable on the amount of the reduction of any rebate. The interest rate is based on the average monthly 90 day Bank Accepted Bill rate published by the Reserve Bank of Australia, less 0.25%, from the date CitiPower receives the security fee.

Any security fees which are not refunded will be recognised as a customer contribution to the network augmentation. This assessment commences 12 months after the date of completion of works, and is performed annually for a five year period.

Why is a security fee required?

The purpose of collecting a security fee is to afford some protection to the distributor and its existing customers against the intending customer failing to take up the electrical load advised to the distributor and included in the calculation of their incremental revenue. To the extent that anticipated revenue is not realised, a financial cost is incurred. This cost will flow to the distributor during the current regulatory period and other customers in subsequent regulatory periods.

This approach helps to ensure that other customers and the distributor aren’t required to subsidise inefficient costs.

Administration Fee

The administration costs will be recovered by an adjustment to the interest rate. The adjustment to the interest rate is easier to administer than an up-front handling charge, expressed as a percentage of any security fee required. Administrative costs are incurred whether or not a refund is made.

Period

A five year period has been proposed for the following reasons:

- The greatest uncertainty with regards to the incremental revenue for a connection exists in the first five year period, with the risk generally reducing over the remainder of the 15 year economic life of a non-residential connection;
- A shorter period was not adopted because it can take several years for a customer to achieve full load. This period includes the construction period which can be up to 18 months from the time of the connection;
- A longer period was not adopted because the benefits of a longer period didn't outweigh the additional administration costs; and
- A five year period represents a balance between mitigating as much risk as possible whilst minimising customer impacts and administration costs.

Ownership changes

The original contracting party would be paid any refund, unless there was adequate evidence to indicate that the Distributor's contractual obligation had been novated to another party.