

# Submission: Preliminary positions on replacement framework and approach (for consultation)

## Form of Price Control for Standard Control Services

DSDBI notes that the AER is proposing to move from applying a Weighted Average Price Cap (WAPC) form of price control for standard control services to the Victorian electricity distributors to applying a revenue cap for the regulatory control period commencing on 1 January 2016.

The AER states that it considers a revenue cap will best meet the factors, as defined under the National Electricity Rules (NER), which must be considered when determining the form of price control for standard control services. In particular, it considers that a revenue cap will result in benefits to consumers through a higher likelihood of revenue recovery at efficient cost, better incentives for demand side management, less reliance on energy forecasts and better alignment with the introduction of efficient prices. While acknowledging the deficiencies of a revenue cap – namely pricing instability within a regulatory control period and weak pricing incentives – the AER believes that these can be ameliorated.<sup>1</sup>

DSDBI recognises that there are advantages and disadvantages associated with both the WAPC and revenue cap forms of price control. It is not a clear cut decision to use one form of price control over another. The form of price control needs to consider the specific market and regulatory conditions that will apply within a jurisdiction.

The AER's proposal to move to a revenue cap appears to be largely based on a comparison of tariffs in Queensland operating under a revenue cap, and tariffs in NSW operating under a WAPC. The AER concludes that more efficient tariffs have been introduced in Queensland than in NSW despite the theoretically stronger incentives towards efficiency under a WAPC. The AER attributes the failure of the WAPC to result in efficient tariffs to a number of technological and regulatory barriers, most notably metering technology and regulatory pricing constraints.<sup>2</sup>

In making its decision on the form of price control for standard control services, the AER needs to consider the market and regulatory conditions that will apply in Victoria during the next regulatory control period. Importantly, these conditions differ significantly from the jurisdictions on which the AER has based its analysis. Indeed the very factors to which the AER refer to acting as a barrier towards the adoption of more efficient pricing under a WAPC have been or are in the process of being addressed in the Victorian market.

With the introduction of smart meters and the prior deregulation of retail tariffs, Victoria has moved further along the path of a establishing the regulatory and technological conditions that are favourable to the functioning of efficient tariff structures. As the AER notes, Victoria now has a high penetration of smart meters and is therefore uniquely well positioned to implement efficient pricing

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<sup>1</sup> Australian Energy Regulator (AER), *Preliminary positions on replacement framework and approach (for consultation) for the regulatory period commencing 1 January 2016*, Australian Competition and Consumer Commission (ACCC), 2014, p.44

<sup>2</sup> AER, *Stage 1 NSW framework and approach Ausgrid, Endeavour Energy and Essential Energy, 1 July 2014-30 June 2019*, ACCC, 2013, p. 48

structures.<sup>3</sup> With the technological barrier to introducing more efficient pricing structures addressed through the near universal roll out of smart meters in Victoria, the form of price control must support the implementation of more efficient pricing structures by the electricity distributors.

In its inquiry into network regulatory frameworks, the Productivity Commission agrees with the AER that there has been little historical evidence of more efficient pricing under a WAPC. However, it posits that this may largely be attributed to the lack of smart meters along with the influence of the state government on NSW distributor pricing proposals.<sup>4</sup>

While electricity distributors in NSW and Queensland are government-owned, electricity distributors in Victoria have been privately owned for nearly twenty years. The Victorian Government has sought to ensure the transition to more cost reflective tariffs has transpired in a manner that is consistent with consumer interests (by initially preventing the automatic re-assignment of customers to time-of-use network tariffs<sup>5</sup> and then introducing a regime of retail choice of network tariff). The Government has not, however, inhibited distributors from setting profit motivated prices.

DSDBI would request that the AER in forming its view on the appropriate form of price control for Victorian distributors take a forward view of the developing market structure unique to Victoria rather than relying on retrospective analyses of jurisdictions with quite different market and policy contexts.

Notwithstanding these comments, if the AER proceeds with its proposal to apply a revenue cap form of price control to the Victorian electricity distributors for the next regulatory control period, there are three issues that the AER needs to consider:

1. **Adjustment mechanisms for variations from forecast peaks demand and customers numbers.** The AER has recognised that, if a revenue cap is introduced, variations from efficient cost recovery may result. “Differences from forecast peak demand and customer numbers may cause differences in distributors’ costs”<sup>6</sup>. The AER has indicated that it has considered adjustment mechanisms (hybrid control mechanisms) to the revenue cap for variations from forecast peak demand and customer numbers. However, it is unclear from the Preliminary Positions paper what adjustment mechanisms are being proposed to apply in Victoria for the next regulatory control period.
2. **Monitoring compliance with pricing principles.** The AER has recognised that “a revenue cap in itself provides limited incentive for distributors to set efficient prices”. It appears that the AER is moving towards a regime where compliance with more prescriptive pricing principles will be the primary means to move towards more efficient pricing structures.<sup>7</sup> Under this

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<sup>3</sup> *ibid.*, p.45

<sup>4</sup> Productivity Commission, *Electricity Network Regulatory Frameworks – Inquiry Report*, 2013, Volume 2, p.471

<sup>5</sup> This agreement is commonly referred to as a ‘moratorium’ on time-of-use tariffs.

<sup>6</sup> *op. cit.*, AER, *Preliminary positions on replacement framework and approach*, p. 47

<sup>7</sup> As the AER states, “We expect that a review of the pricing principles in the Rules providing a more prescriptive set of pricing principles is likely in the near future. It is more likely that efficient pricing will eventuate if a revenue cap is applied in combination with more prescriptive pricing principles, rather than relying on a WAPC. That is, distributors will be obliged to set efficient prices under more prescriptive pricing principles and a revenue cap will reduce the risks distributors will face when implementing such prices”. *Stage*

approach, the AER will need to be equipped with the appropriate resources to scrutinise the distributor's annual pricing proposals for compliance with the pricing principles.

3. **Uncertainty as to the final set of pricing principles.** A further risk that the AER should be mindful of is that the AEMC does not anticipate making a draft determination on the SCER and IPART request for a rule change (amending the pricing principles inter alia) until 31 August 2014 with a final determination in November 2014. This means that the proposal to apply a revenue cap is based on an assumption of what the final set of pricing principles will be, including whether they will be more prescriptive and address the limited incentives that exist under revenue caps for distributors to set efficient prices.

### **Control mechanism and formulae for alternative control services**

DSDBI supports the application of price caps on the prices of individual services. DSDBI would query AER's concerns regarding the additional administrative costs associated with the change in control mechanism for type 5 and 6 and smart metering services. It would be expected that the administrative costs would be less over the regulatory control period than continuing with the existing arrangements for regulating these metering service charges.

### **Classification of connection services**

The Department notes and supports the AER's preliminary position on the classification of connection services based on the current regulatory framework for connection services contained in the Essential Services Commission's Guidelines 14 and 15.

While there is potential for Victoria to adopt the National Energy Customer Framework (NECF) within the next regulatory period and therefore the connections framework contained in Chapter 5A of the NER, the Victorian Government has not made a final decision about its adoption in Victoria. Adoption of the NECF in Victoria would require a package of jurisdictional legislative amendments which will take time to prepare and implement, and cannot be assumed to be in place before October 2015. The Victorian Government will advise the AER of any developments at the earliest opportunity.

In the event that Victoria adopts the NECF, then the AER's Connection Charge Guidelines under Chapter 5A of the National Electricity Rules would apply. Routine connections should continue to be classified as direct control alternative control services. New connections requiring augmentation should continue to be classified as direct control and standard control services because, as is the case under Guideline 14, there may be instances where the cost incurred by a distributor in undertaking a connection requiring augmentation may be greater than the revenue recovered from the customer's capital contribution.

It is noted that there is considerable scope to extend the scope for the competitive provision of network connection services in Victoria. Increasing the scope for competitive connection services would provide a rationale for a broader reclassification of connection services with some services becoming unclassified. Again however, such a reform would require time to implement, and would

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*1 NSW framework and approach Ausgrid, Endeavour Energy and Essential Energy, 1 July 2014 - 30 June 2019, ACCC, 2013, p. 49*

be unlikely to be in place prior to the commencement of the next regulatory control period. The AER should consider how reforms of this nature can be handled under the revenue determination.

#### Inspection of PV installation site

The AER has sought comment on whether the service to inspect a PV installation site should be a quoted service or a fee based service. DSDBI is limited in the response it can make as the AER has not articulated the principles for assessing whether an alternative control service should be a quoted service or a fee based service. DSDBI understands from discussion in other sections of the paper that one of the principles to be applied is that a service should be a quoted service if the service can only be costed once the scope of work is known.<sup>8</sup>

This implies that, if the scope of works for inspecting a PV installation site is reasonably consistent for each service provided, and therefore the variability in the costs incurred in providing that service is relatively low, then the service can be a fee based service. Conversely, if the scope of works for inspecting a PV installation site varies from site to site, and therefore the variability in the costs incurred in providing that service is relatively high, then the service will need to be a quoted service.

The distributors are best placed to comment on the variability of the scope of works, and therefore the variability in the costs.

#### Pre-approval fees

Victorian electricity distributors have introduced a requirement that certain proposed distributed generation systems obtain technical pre-approval before connection to the network may proceed. This approval is based on an assessment of the network's technical capacity to allow for new distributed generation connections. Despite the limited prospect for the competitive provision of the connection approval assessment, it is not currently a regulated service leading to a lack of transparency around the manner in which fees are set.

DSDBI requests that the AER consider classifying these services as direct control and alternative control on the basis that there is limited potential for contestable provision of this service and the costs of this service are attributable to a specific user.

#### **Metering services**

DSDBI supports the AER's proposal to classify type 5 and 6 and smart metering services as a direct control and alternative control services. The costs for these services are attributable to specific customers and this proposal is consistent with the current treatment of these services.

DSDBI also supports the separation of the charges for meter provision and maintenance from meter reading and data services. Metering data service charges have been unbundled from distribution use of system charges in Victoria since 2001, and meter provision charges have been unbundled from distribution use of system charges in Victoria since 2006<sup>9</sup>. If Victoria becomes subject to the contestable metering provisions that are proposed for the national framework, the separation of

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<sup>8</sup> op. cit., AER, *Preliminary positions on replacement framework and approach*, p.51

<sup>9</sup> Essential Services Commission, *Electricity Distribution Price Review 2006-10, Final Decision Volume 1: Statement of Purpose and Reasons*, October 2005, pages 509-512

these charges will allow the development of contestability for meter provision and maintenance at a different rate to the development of contestability for meter reading and data services.

#### Exit fee

In regards to the AER's call for comments on the form and scope of an exit fee, DSDBI would support an exit fee which is consistent with the way an exit fee is determined by clause 7 of the AMI Cost Recovery Order in Council (CROIC). This clause was included in the CROIC in anticipation of expiry of distributors' exclusive responsibility for metering installations for small customer sites. The clause requires a retailer to pay to the distributor an exit fee where the retailer becomes the responsible person in respect of a metering installation for a small customer who has a distributor installed smart meter. The fee must be approved by the AER and recover in a lump sum (in summary) the:

- Reasonable and efficient costs of removing the metering installation;
- The unavoidable costs that a prudent distributor has incurred or would incur as a result of the metering installation being removed.

#### Type 7 metering services

DSDBI notes an inconsistency in the way in which the AER proposes to classify Type 7 metering services. While attachment 1 suggests that AER proposes to classify type 7 metering services as standard control services, appendix B lists type 7 metering services as an alternative control service.

DSDBI supports the classification of type 7 metering services as a direct control and alternative control service, rather than a standard control service. This is consistent with the approach that has been adopted in Victoria since 2001<sup>10</sup>, and the service, and therefore the costs, are attributable to specific customers.

#### Classification of services under AMI CROIC

DSDBI would seek to clarify a point in the AER's discussion of the AMI CROIC and the requirements the NER establishes on the AER in regard to the classification of AMI services. The AER interprets clause 11.17.6(b) of the NER as requiring that the AER "regulate smart meters and associated equipment in the next regulatory control period on the same basis as the [CROIC] and to classify the service these meters provide as an alternative control service".

This appears to misinterpret clause 11.17.6(b). What that clause actually provides is that "services to which exit fees under clause 7" and "services to which restoration fees... under clause 8" of the CROIC apply are to be regulated by the AER on the same basis as applied under the CROIC in the regulatory control period 2016 – 2020.

This drafting of clause 11.17.6(b) reflected three things: that the derogation formerly contained in clause 9.9B of the NER expired on 31 December 2013 (the new derogation in clause 9.9C expires on 31 December 2016); the date for completion of the roll-out of AMI was also 31 December 2013, which has not been met; and that the CROIC would in general cease to apply after 31 December 2015. Thus what the clause was intended to ensure is that after the ending of exclusivity on 31 December 2013 and throughout the regulatory control period 2016-20, the AER would provide for

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<sup>10</sup> Ibid.

exit fees and restoration fees as alternative control services. It was not intended that the AER continue to regulate all metering services on the basis that the CROIC continues to apply in that regulatory control period.

### **Public lighting**

DSDBI understands that some councils have been advocating for an extended period of time for greater contestability for public lighting services and by implication for them to be classified as a negotiated service, rather than as a direct control and alternative control service. As a result, greenfield sites and/or emerging technologies have been classified as a negotiated service as there is a greater potential for contestability in the provision of these services. DSDBI supports the continuation of classifying greenfield sites and/or emerging technologies as negotiated services.

Further DSDBI supports the AER's position that a monopoly position exists to some extent over public lighting services, other than greenfield sites and/or emerging technologies, due to the ownership and control of the assets, and the safety restrictions. Therefore the Department supports the continued classification of these services as direct control and alternative control services.

It is noted that some stakeholders argue for these services to be classified as negotiated services. The classification of these services as an alternative control service represents the partial monopoly nature of this service for the majority of public lighting customers and the AER should ensure that its decision considers the interests of all public lighting customers.

### **Incentive schemes**

#### Service target performance incentive scheme

DSDBI notes that the AER does not propose to apply the Guaranteed Service Level (GSL) component if the Victorian distributors remain subject to a jurisdictional GSL scheme. DSDBI would prefer that a national GSL scheme be applied to the Victorian distributors. However, given the concerns that DSDBI has previously raised with the current national GSL scheme, the previous jurisdictional GSL scheme has been retained.

In summary DSDBI's previous concerns in relation to the national GSL scheme include:

- The need for the AER to consider whether the GSL payment thresholds should be amended to ensure that the reliability-based GSL payments continue to be made to Victoria's worst served 1 per cent of customers, consistent with the principle underpinning the design of the jurisdictional GSL scheme.<sup>11</sup>
- The need for the AER to consider whether the level of GSL reliability payments should be amended to reflect the latest values of customer reliability.
- The appropriateness of the national GSL parameters given that it excludes the Momentary Average Interruption Frequency Index (MAIFI) (MAIFI was included in the jurisdictional GSL scheme in 2006 recognising the trade-off between System Average Interruption Frequency

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<sup>11</sup> Essential Services Commission, *Electricity Distribution Price Review 2006-10, Final Decision Volume 1: Statement of Purpose and Reasons*, October 2005, pp 105, 107

Index and MAIFI, and noting stakeholder concerns regarding plant outages caused by short term outages and voltage dips).<sup>12</sup>

If the AER was to address these concerns, then DSDBI would consider recommending the removal of the jurisdictional GSL scheme.

#### Capital expenditure sharing scheme

The Victorian Government's concerns in relation to the capital expenditure sharing scheme are set out in its submission in response to the Australian Energy Market Commission's (AEMC's) Consultation Paper, Consolidated Rule Request – Economic Regulation of Network Service Providers.<sup>13</sup> In summary, the Victorian Government is concerned that reductions in capital expenditure (capex) below forecast can be the result of any, or a combination of: efficiency gains; deferral of capital expenditure projects between regulatory control periods; changes in external expenditure drivers (for example, lower than anticipated peak demand); or overstatement of expenditure requirements as part of the revenue determination process for the regulatory control period.

The AER has indicated in the Framework and Approach Preliminary Positions paper that it can make further adjustments to account for deferral of capex and ex post exclusions of capex from the regulatory asset base (RAB).

The AER has recognised that “consumers may not share in the benefits where capex is deferred from one regulatory control period to the next regulatory control period”.<sup>14</sup> The AER further states that it will make an adjustment to the Capital Expenditure Sharing Scheme (CESS) payments where a distributor has deferred capex in the current regulatory control period and:

- the amount of the deferred capex in the current regulatory control period is material, and
- the amount of the estimated underspend in capex in the current regulatory control period is material, and
- total approved forecast capex in the next regulatory control period is materially higher than it is likely to have been if a material amount of capex was not deferred in the current regulatory control period.<sup>15</sup>

The distributors generally undertake a large number of small projects and, on occasions, a very small number of large projects. Other than the very small number of large projects, the specific projects are generally not identified in the regulatory proposal as the lead time for the small projects is generally short relative to the regulatory control period. It is therefore unclear how the AER will identify the amount of the deferred capex.

If this deferred capex cannot be identified, then there may be no benefit to customers of the CESS (as when a similar scheme was last implemented in Victoria for the 2001-05 regulatory control

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<sup>12</sup> Ibid., page 107

<sup>13</sup> Available at <http://www.aemc.gov.au/getattachment/2b4f4e05-6680-4484-b71c-b6adfdb25256/Victorian-Department-of-Primary-Industries.aspx>

<sup>14</sup> AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p.8

<sup>15</sup> Ibid., p.32

period). In designing and implementing the CESS, the AER should be aware of the risks of the potential for the CESS to muddy the fundamental efficiency incentive of the CPI-X revenue path.

### **Expenditure forecast assessment guideline**

DSDBI generally supports the AER applying all the tools for assessing expenditure as set out in its expenditure forecast assessment guideline.

However, DSDBI notes that some of these methodologies rely on the efficient costs revealed by the distributors. For example, the AER states that “for recurrent expenditure, [it] prefer[s] to use revealed (past actual) costs as the starting point for assessing and determining efficient forecasts”.<sup>16</sup>

Prior to using past actual costs, the AER needs to review in detail the actual costs as disclosed in the distributors’ regulatory accounting statements, to ensure that these accurately reflect the costs that have been incurred by the distributors in providing distribution services to Victorian electricity consumers.

### **Depreciation**

DSDBI supports the use of forecast depreciation in rolling forward the RAB to the 2021-25 regulatory control period. The Victorian Government’s support for the use of forecast depreciation rather than actual depreciation is set out in its submission in response to AEMC’s Consultation Paper, Consolidated Rule Request – Economic Regulation of Network Service Providers.<sup>17</sup>

However, DSDBI has concerns with establishing the opening RAB for the 2016-20 period on the basis of actual depreciation, a decision that was made as part of the 2011-15 revenue determination. As the distributors have some discretion in the way that assets are depreciated over the regulatory control period, the AER must review the way in which actual depreciation has been calculated during the regulatory control period to ensure that it has been calculated on a consistent basis with the regulatory proposals submitted as part of the 2011-15 revenue determination.

If the actual depreciation is materially less than forecast depreciation, then Victorian electricity consumers will pay more for electricity than they would otherwise in future regulatory control periods, potentially with no additional benefit.

### **F-factor scheme**

DSDBI notes the AER’s positions to maintain the incentive rate of \$25,000 per fire for the f-factor scheme in the forthcoming regulatory control period. As the AER would be aware, the Victorian Government is implementing the Powerline Bushfire Safety Program (PBSP), which will deliver a decisive step change in powerline bushfire safety over the course of its 10-year life.

In the wake of the PBSP, it will be necessary to ensure that these safety gains are retained, and built on, through an enduring regulatory framework. DSDBI intends to review the f-factor in 2014-15 to determine how the incentive has performed in delivering efficient improvements to powerline

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<sup>16</sup> AER, *Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p. 8

<sup>17</sup> Available at <http://www.aemc.gov.au/getattachment/2b4f4e05-6680-4484-b71c-b6adfdb25256/Victorian-Department-of-Primary-Industries.aspx>



bushfire safety. This review will take into account the role of the PBSP program in also delivering powerline bushfire safety improvements. Until such time as this review is completed, DSDBI intends to retain the existing scheme parameters.