Draft decision

CITIPOWER'S AND POWERCOR'S PROPOSED SECURITY FEE SCHEME

21 December 2010

Request for submissions

This document sets out the Australian Energy Regulator's (AER) draft decision on CitiPower's and Powercor's proposed security fee scheme.

Interested parties are invited to make written submissions regarding this draft decision to the AER by Friday, 4 February 2011. The AER will deal with all information it receives in accordance with the ACCC/AER information policy. The policy is available at www.aer.gov.au.

Submissions can be sent electronically to AERinquiry@aer.gov.au.

Alternatively, submissions can be mailed to:

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GPO Box 520
Melbourne Victoria 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.

All non-confidential submissions will be placed on the AER website, www.aer.gov.au.

Inquiries about the draft decision or about lodging submissions should be directed to the Network Regulation South Branch on (03) 9290 1436 or alternatively emailed to AERinquiry@aer.gov.au.

Contents

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
EDL	Electricity distribution licence
WACC	Weighted average cost of capital
NPV	Net present value

1 Introduction

Victorian distribution network service providers (DNSPs) are required to make formal offers to customers who request to be connected to a distribution network. This responsibility is set out in clause 6.1 of the DNSPs' electricity distribution licenses (EDL). 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 powers relating to compliance monitoring and enforcement of DNSPs' obligations under their respective distribution licenses and the ESCV's codes and guidelines.

In situations where a DNSP determines that there is a high level of risk associated with a customer requested new connection, the DNSP may request a security fee from the customer under the ESCV's *Electricity Industry Guideline 14* (Guideline 14). Guideline 14 outlines the obligations of Victorian DNSPs if and when they choose to implement a security fee scheme. It also outlines the responsibility of the AER to approve the interest rate on the amount of a security fee that is to be paid to a customer, and the terms and conditions of that interest rate payment.

CitiPower and Powercor have sought approval from the AER for their proposed interest rate payment. CitiPower and Powercor are the first of the Victorian DNSPs to draft and submit a security fee scheme to the AER.

The AER issued a consultation paper on 28 June 2010 which requested submissions relating to CitiPower's and Powercor's security fee scheme proposals by 26 July 2010. In response to the consultation paper, the AER received one submission, which was from CitiPower and Powercor.

1.1 Purpose of a security fee

Guideline 14 requires Victorian DNSPs to 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.

When making a connection offer, a DNSP must estimate the incremental revenue it will receive from the offer. The incremental revenue component of a new connection offer reduces the overall customer contribution received by a DNSP.

A security fee acts to insure a DNSP against the risk of failing to collect the full incremental revenue estimated. If the actual incremental revenue from the new connection is below the estimated incremental revenue, then a security fee, or a portion of it, is retained and forms part of the customer's capital contribution. However, if the estimated incremental revenue of the connection offer is realised, then the security fee is refunded with interest.

In the absence of a security fee scheme, if the DNSP does not collect the full estimated incremental revenue, then the shortfall would eventually be recovered through higher network tariffs to all other network users. Thus, the security fee reduces the risks to existing customers from bearing inefficient connection costs attributable to certain new connecting customers.

1.2 Requirement for security fee

Under clause 3.5.1 of Guideline 14, Victorian DNSPs may request security fees from customers if a DNSP determines that there is a high risk they may not earn the estimated incremental revenue in relation to a connection offer.

Clause 3.5.2 of Guideline 14 requires that the value of the security fee must not be greater than the portion of the estimated incremental revenue which the DNSPs believe has a high risk of not being recovered. The security fee also cannot be higher than the net present value (NPV) of the incremental cost that a DNSP will incur.

Under clause 3.5.3 of Guideline 14, DNSPs must pay customers interest on the security fee using an interest rate and terms and conditions of the interest rate which have been approved by the AER.

Clause 3.5.4 requires DNSPs to rebate the amount of the security fee together with interest earned as the DNSP receives incremental revenue. The rebate must be paid at least once per calendar year, beginning after the calendar year in which the connection services are provided.

The ESCV's Guideline 14 can be found at www.esc.vic.gov.au.

1.3 Role of the AER

Clause 3.5.3 of Guideline 14 requires the AER to approve the interest on the amount of a security fee to be paid to a DNSP's customer including the rate and the terms and conditions of the interest payment.

In addition, the AER has functions regarding other terms and conditions of a security fee scheme should a question of the fairness and reasonableness of them arise. Under the 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 based on the AER's opinion of what is fair and reasonable. This responsibility is set out in clause 11.4 of the EDL.

Furthermore, should a question arise, the AER is to determine the fairness and reasonableness of a DNSP's estimate with regards to clause 3.5.1 and 3.5.2 of Guideline 14. The AER must use its opinion of what is fair and reasonable in the circumstances. This responsibility is set out in clause 7 of Guideline 14.

1.4 Purpose of this draft decision likely approach

This paper will outline the AER’s:

1. draft decision regarding the interest rate on the security fee to be paid by the DNSPs to a customer and the terms and conditions of that payment for the purposes of clause 3.5.3 of Guideline 14

2. indicative views as to the fairness and reasonableness of other terms and conditions of the security fee scheme. These views may inform the AER’s approach in the event of a dispute but will not be binding on the AER in relation to any particular dispute.

This paper will also outline the submission to the consultation paper from CitiPower and Powercor, which included an amendment to the methodology of calculating security fees.

The AER welcomes submissions to this draft decision and its likely approach to the assessment of other terms and conditions. The AER will consider all submissions before the publication of a final decision.

2 The proposed security fee scheme and submissions

The AER released a consultation paper on 28 June 2010 which outlined CitiPower's and Powercor's proposed security fee scheme. The paper also invited submissions regarding the schemes':

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

One submission was received in response to the consultation paper. The submission was from CitiPower and Powercor. Both DNSPs proposed an amended methodology for the calculation of the security fee and explained the rationale behind the other terms and conditions of the proposed scheme in the submission.

2.1 The security fee scheme

CitiPower's and Powercor's proposed security fee scheme is attached in Appendix A. According to CitiPower and Powercor, their proposed security fee scheme will only apply to customers who's NPV of the incremental revenue component of the connection is greater than $750,000.

The proposed scheme calculates the amount of a security fee via a two stage process which assesses the customer's risk against three risk factors.

2.1.1 Location, industry, and customer diversity risk factors

CitiPower and Powercor proposed that the average of the risk criteria 'Location' and 'Industry', which are each given a rating from 0 to 5 in accordance with the criteria outlined in table 2.1, is obtained to gain a prima facie assessment of whether the location of the project and broad industry characteristics indicate that risks to realising the estimated incremental revenue are high.

If the average of these two risk factor is 'high' (a risk rating of 4) or 'very high' (a risk rating of 5), a subsequent assessment is made of the number of end customers at the site and their estimated contribution to the estimated incremental revenues. This third risk factor, called 'Customer diversity', has been designed to ascertain if the number of customer at each connection site mitigates risk.

If the customer diversity score is not classified as at least 'high', a security fee is deemed not applicable to the connection. If the score for diversity is classified as high or above, the average of the three risk factors is used to determine the amount of a customer's security fee.

In the AER's consultation paper, the AER invited stakeholder submissions on the fairness and reasonableness of CitiPower's and Powercor's proposed risk factors. CitiPower's and Powercor's submission provided no further information regarding the risk factors previously included in their proposal.

2.1.2 Amount of the security fee

CitiPower and Powercor initially proposed that if the overall risk rating is classified as at least 'high', being the average of the three risk factors, the security fee is calculated as the product of the risk rating, and five years' incremental revenue divided by five.

In the their submission, CitiPower and Powercor proposed an amended methodology for the calculation of the security fee, whereby the amount of the security fee would be one third of the 15 year NPV of the estimated incremental revenue multiplied by the average risk factor divided by five, rather than five years' estimated incremental revenue as outlined in the initial proposal.[1] The change results in eligible customers paying a lower security fee, and has regard to the time value of money which was previously omitted.

Applying CitiPower's and Powercor's modified approach, 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 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 a 15-year NPV of incremental revenue of $1,600,370 / 3 = $533,457 * (4.67/5) = $497,893.[2]

2.1.3 Interest rate

CitiPower and Powercor proposed to pay interest on any amount of the security fee which was refunded to the connecting customer—this occurs when the estimated incremental revenue is realised—at a rate equal to the 90 day Bank Accepted Bill rate published by the Reserve Bank of Australia. The consultation paper suggested that the regulated weighted average cost of capital (WACC) could be an alternative rate for the calculation of interest repayments. The paper also sought stakeholder comment regarding the appropriateness of CitiPower's and Powercor's proposed security fee interest rate at the 90 day Bank Bill rate.

CitiPower and Powercor submitted that using the WACC would be an inappropriate basis for the calculation of interest on security fees, as the security fees are effectively held in trust until such a time as they are repaid or retained. Therefore, the DNSPs noted that the security fee is not available for investment in the business. In addition, they stated that paying interest at the WACC would impose an economic cost and would create a disincentive to charge security fees. [3] CitiPower and Powercor reiterated that the payment of interest at the 90 day bank bill rate is consistent with the interest payable on refundable advances set out in clause 8.3(a) of the Energy Retail Code.

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[1] This equated to approximately 50 per cent of the estimated incremental revenue using CitiPower's and Powercor's real WACC of 6.4 and 6.3 per cent respectively for the 2006–10 regulatory period.

[2] CitiPower and Powercor intend to use the WACC to calculate the 15 year NPV.

[3] CitiPower and Powercor submission, *CitiPower's and Powercor's Proposed Security Fee Scheme*, 27 July 2010.

CitiPower and Powercor proposed an administration charge for the security fee to be paid by the connecting customer as a 0.25 per cent reduction to the proposed interest rate. As noted in the AER's consultation paper, the AER considers that the administration charge is a term and condition expressed as part of the interest rate. This is because CitiPower and Powercor proposed that the administration charge be calculated as a 0.25 per cent reduction in the interest rate paid on the balance of the security fee held. The AER sought submissions as to the appropriateness of the administration charge.

CitiPower and Powercor submitted that the administration charge equates to only a fraction of the interest rate to be paid on the security fee and that no administration charge will be applied if the security fee is not refunded. [4] CitiPower and Powercor also believed that the charge would not be material in the context of the security fee scheme and that expressing the charge as a percentage of the security fee is easier to administer than an upfront handling charge.

2.1.4 Other terms and conditions

The proposed scheme sought to refund any security fee or part thereof to the connecting customer over a five year period. In the AER's consultation paper, the AER sought comments on the fairness and reasonableness of refunding security fees or part thereof over a five year period.

In CitiPower's and Powercor's submission, they reiterated their initial proposal that that the amount of risk associated with a new connection decreases over time. CitiPower and Powercor believe that the greatest uncertainty with regards to the incremental revenue for a connection exists in the first five years. They submitted that a longer period was not adopted because the benefits did not outweigh the administration costs, and a shorter period was not adopted because it can take a new customer several years to achieve full load.

Guideline 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 initial proposals outlined 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 will not be collected. The AER's consultation paper sought submissions on whether the proposal was fair and reasonable. CitiPower's and Powercor's submission provided no further information to what was initially included in their proposal.

In the consultation paper, the AER sought submissions as to whether stakeholders considered that under the risk factor approach, the amount of the security fee would not be greater than the amount of incremental revenue which the DNSP fairly and reasonably assessed the risk as high, as prescribed by Guideline No. 14.

CitiPower and Powercor submitted that the classification of high risk is encapsulated in the risk factors and is supported by not requiring more than one third of the net present value of the estimated incremental revenue as a security fee.

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[4] CitiPower and Powercor submission, *CitiPower's and Powercor's Proposed Security Fee Scheme*, 27 July 2010.

The DNSPs also reiterated that they believed that the greatest uncertainty with regard to the incremental revenue of a connection offer exists in the first five year period. CitiPower and Powercor submitted that their revised methodology for collecting security fees aligns with this belief.[5]

A shortfall of incremental revenue followed by above estimated incremental revenue

CitiPower and Powercor do not intend that a shortfall of incremental revenue—resulting in the retention of a portion of the security fee—in a given year, to be offset by above estimated incremental revenue received in other years.

The AER's consultation paper requested submissions regarding this aspect of the proposed security fee scheme. CitiPower's and Powercor's submission explained that, as the security fee scheme only applies to large connections, in the event the incremental revenue is higher than anticipated it would be likely that the load on the system would be higher than anticipated. CitiPower and Powercor contended that as a result, the incremental costs, such as the initial capital cost, operational and maintenance costs and the marginal reinforcement costs, could be higher than estimated. In addition, they submitted that the proposed method is simpler to administer. [6]

The acceptable realm of balance between the interests of new and existing customers

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 its existing customer base. CitiPower's and Powercor's initial proposed scheme required 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 sought submissions on whether this amount was within the acceptable realm of balance between the interests of new and existing customers.

In CitiPower's and Powercor's submission, they outlined a modified approach that collected not more than one third of the NPV of the incremental revenue as a security fee. CitiPower and Powercor also reiterated their initial proposal that collecting a security fee over a five year period (or one third of the NPV incremental revenue[7]) also represents a balance between mitigating as much risk as possible whilst minimising the customer impacts and administration costs.[8]

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[5] The modified methodology calculates the security fee as five years of the NPV of the estimated incremental revenue. CitiPower and Powercor submission, *CitiPower's and Powercor's Proposed Security Fee Scheme*, 27 July 2010.

[6] CitiPower and Powercor submission, *CitiPower's and Powercor's Proposed Security Fee Scheme*, 27 July 2010.

[7] Under Guideline 14, a business customer is assumed to have a connection life of 15 years.

[8] CitiPower and Powercor submission, *CitiPower's and Powercor's Proposed Security Fee Scheme*, 27 July 2010.

Table 2.1: Risk assessment criteria and ratings proposed by CitiPower and Powercor

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 (i.e isolated areas)	Mining	1

3 Issues and AER considerations

This section outlines the AER's draft decision on CitiPower's and Powercor's proposed security fee interest rate, and terms and conditions which must be approved by the AER.

Additionally, this section includes the AER's indicative views on the fairness and reasonableness of other proposed terms and conditions and its likely approach to assessing those terms and conditions in the event of a dispute.

3.1 Interest rate and administration charge

Under clause 3.5.3 of Guideline 14, DNSPs must pay customers interest on the amount of a security fee at a rate, and on terms and conditions approved by the AER.

As noted in the AER's consultation paper, a security fee and its size balances the interests of new and existing customers. The AER considers that in order to balance these interests, the amount of interest payable should not unduly influence, or provide a strong disincentive, for DNSPs to collect security fees. Therefore, as CitiPower and Powercor have noted that the security fee will be used for short term funding and is not available for investment in the business, the AER considers that the 90 day Bank Bill rate is an appropriate basis for determining the interest payable on the security fee.

In addition, the payment of interest at the 90 day bank bill rate is consistent with the interest payable on refundable advances set out in clause 8.3(a) of the Energy Retail Code.[9]

CitiPower and Powercor proposed a 0.25 per cent reduction in the security fee as an administration charge. The AER considers that CitiPower and Powercor should be able to recover the costs of administering the security fee scheme from the new connecting customer in order to prevent the charges being recovered from the DNSPs' existing customer base.

The AER considers that the costs of administering a security fee scheme are unlikely to vary with the amount of the security fee held. However, as security fees will not be required for new customers who have an estimated incremental revenue under $750,000, the AER considers that the administration charge is unlikely to be excessive in terms of overall project cost.

Noting that there were no other submissions received on the AER's consultation paper proposing an alternative method to calculate the administration charge, or on the likely size of the administration charge, the AER's draft decision is to approve the proposed 0.25 per cent reduction in the interest rate for administration costs on the portion of any security fee refunded to the customer. However, the AER specifically invites further submissions on the proposed administration charge of CitiPower and Powercor.

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[9] ESCV, *Energy Retail Code*, Version 7, February 2010.

The AER's draft decision is to approve CitiPower's and Powercor's interest rate and the 0.25 percent reduction to the interest rate for administration charges.

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

3.2 The AER's indicative view on the fairness and reasonableness of the proposed security fee scheme

Under Guideline 14 and the EDL, in the event of a dispute, any question as to the fairness or reasonableness of a term or condition of the security fee scheme is to be determined by the AER. This section outlines the AER's indicative views on whether those terms and conditions may be fair and reasonable. However the indicative views presented are not binding on the AER in relation to any particular dispute.

Location, Industry, and Customer diversity risk factors

The AER considers that the proposed risk factors and the application of the methodology appear to provide a reasonable framework to assess customer risk. However, the AER notes that as the proposed risk factors do not include an exhaustive list of industries, or specifically defined location assessments, there remains some unavoidable uncertainty in the scheme. In addition, there may be circumstances specific to connecting customers which have not been contemplated by the risk factors. Should a dispute arise between a customer and CitiPower or Powercor in relation to the proposed risk factors, this would require an assessment by the AER of the individual circumstances to determine a fair and reasonable outcome.

The AER's indicative view is that the proposed risk factors would be fair and reasonable.

- The AER seeks stakeholder comment regarding its indicative view that the proposed risk factors would be fair and reasonable.

Other Terms and Conditions

Guideline 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. It also states that the amount of the security fee must not be greater than the amount of estimated incremental revenue which is considered at high risk. The AER considers that the risk factors would fairly and reasonably assess whether there is a risk that a DNSP may not earn the full incremental revenue from a new connecting customer in most cases. In addition, the AER considers that the risk factors, together with only requiring one third of the estimated incremental revenue as a security fee, would mean that the amount of the security fee would not be greater than the amount of incremental revenue which the DNSPs fairly and reasonably assess as high risk.

The AER has considered CitiPower's and Powercor's proposal to refund security fees, or portions of security fees, to the customer over a five year period. The AER considers that CitiPower and Powercor are well placed to comment on the period of greatest uncertainty that a DNSP faces in not earning the estimated incremental revenue from a new connecting customer. The AER is of the view that it appears fair and reasonable for the security fee to be collected or refunded over the first five years of connection.

Therefore, the AER's indicative view is that the proposed scheme would be fair and reasonable regarding:

- the assessment that there is a risk that the DNSPs may not earn the incremental revenue in relation to a connection offer
- the provision that 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.

The AER's indicative view is that the proposal to refund security fees or part thereof over a five year period would be fair and reasonable.

A shortfall of incremental revenue followed by above estimated incremental revenue

The AER considers that the purpose of a security fee scheme is to reduce the risk of the incremental revenue differing from the estimated incremental revenue. Under the proposed scheme, a shortfall of incremental revenue—resulting in the retention of a portion of the security fee—in a given year, will not be offset by above estimated incremental revenue received in other years. The AER considers that whilst this reduces the risk to the DNSP of not collecting the full estimated incremental revenue and hence the DNSP's existing customer base, it places a risk on the new connecting customers of an inaccurate incremental revenue forecast.

As the security fee scheme reduces the risk to a DNSP of not collecting the full estimated incremental revenue, it does not appear appropriate for a new connecting customer to bear the risk of forecasting, which in some cases may result from a DNSP's inaccurate forecast.[10] The proposed scheme places a risk on the new connecting customer of an inaccurate incremental revenue forecast which the AER considers not to be consistent with the basis of requiring a security fee.

In order to remove this risk, any shortfall in incremental revenue—requiring the retention of part of the security fee—should be offset if the new connecting customer has above estimated incremental revenue in another year during which the proposed scheme operates.

In addition, the AER does not consider that CitiPower and Powercor have demonstrated that there is a relationship between the amount of potential higher incremental costs associated with higher than estimated load on the system, and the additional security fee amount that may be retained resulting from below estimated

[10] The AER notes that a forecast which differs from the actual incremental revenue will not, in all cases, result from inaccurate forecasting. A forecast may be accurate based on the information provided by a new connecting customer, however, this does not mean that the estimated incremental revenue will be realised.

incremental revenue in any year and above estimated incremental revenue in another year.

The AER recognises that the proposed methodology is simpler to administer, however, the costs to new connecting customers have the potential to be material.

The AER's indicative view is that the proposed approach, whereby above estimated incremental revenue in any year would not be offset against below estimated incremental revenue in another year, may not result in a fair and reasonable outcome. The AER would also consider the materiality of the issue should a question as to the fairness and reasonableness of this term arise.

- The AER seeks stakeholder comment regarding the AER's indicative view that it may not be fair and reasonable to new customers that above estimated incremental revenue in any year, will not offset below estimated incremental revenue in another year (which results in a part of the security fee being retained).

The acceptable realm of balance between the interests of new and existing customers

The AER recognises that one third of the NPV of the estimated incremental revenue is a significant cost in terms of the overall connection cost and may provide some level of investment impediment for some new customers. However, the AER considers that, given the type of customers which may be required to pay a security fee, this amount is not unreasonable. Security fees are only required for new customers with an estimated incremental revenue greater than $750,000. The type of customers which would have such an estimated incremental revenue are likely to be a larger customers, and therefore they are likely to have the ability to pay such fees. In addition, electricity connection costs are only one component of the total set up costs a new customer is likely to face.

As noted, the AER considers that CitiPower and Powercor are likely, given their access to information, to be well placed to assess what is the period of greatest uncertainty that a DNSP faces in not earning the estimated incremental revenue from a new connection. Therefore, the AER considers that one third of the NPV of the estimated incremental revenue appears to balance the financial risks between both new and existing customers.[11]

The AER's indicative view is that, requiring one third of the NPV of the estimated incremental revenue as a security fee as part of this proposed security fee scheme, would fairly and reasonably balance the risks to new and existing customers.

- The AER seeks stakeholder comment regarding its indicative views on the other terms and conditions of the proposed security fee scheme.

[11] Collecting a security fee over five years is analogous to collecting one third of the estimated incremental revenue because non-domestic customers is are assumed to have a connection life of 15 years under Guideline 14.

4 Conclusion and draft decision

4.1 Conclusion

After consideration of the initial proposal and the submission received the following are the AER's indicative views on the fairness and reasonableness of the proposed security fee scheme. These may inform the AER in the event of a dispute but will not bind the AER. The AER concludes that, with the exception of not refunding an incremental revenue shortfall of one year followed by above estimated revenue in subsequent years:

- the proposed risk factors would be fair and reasonable
- the proposed security fee scheme would fairly and reasonably assess whether there is a risk that a DNSP may not earn the full estimated incremental revenue from a new connecting customer
- the proposed scheme would fairly and reasonably assess whether the amount of the security fee would not be greater than the amount of incremental revenue which the DNSP fairly and reasonably assessed as high risk
- the proposal to refund security fees or part thereof over a five year period would be fair and reasonable
- requiring one third of the NPV of the estimated incremental revenue as a security fee would fairly and reasonably balance the risks to new and existing customers.

The AER considers that it may not be fair and reasonable that above estimated incremental revenue in any year will not offset below estimated incremental revenue in another year (which would result in the retention of a portion of the security fee). The AER proposes that a fair and reasonable scheme may be one in which any shortfall in incremental revenue—requiring the retention of part of the security fee—should be offset, if the new connecting customer has above estimated incremental revenue in another year during which the proposed scheme operates.

4.2 Draft decision

The AER's draft decision is to approve the use of the 90 day Bank Bill rate less a 0.25 per cent administration charge as the interest payable on the amount of a security fee returned to a customer.

A. Appendix: Proposed security fee scheme by CitiPower and Powercor

This appendix outlines CitiPower's and Powercor's revised proposed security fee scheme which was provided in an appendix to its submission. CitiPower's and Powercor's deletions from their original proposed security fee schemes are marked in square brackets. A full copy of CitiPower's and Powercor's submission, including appendix is available at http://www.aer.gov.au/content/index.phtml/itemId/737791.

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’~~] one-third of the present value of the IR applicable to the connection. This [~~The five year IR figure~~] is analogous to classifying 1/3 of the present value 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 = a 15 year NPV of IR of $1,600,370 [~~*~~] / 5 years = $533,457 * 4.67 Risk Rating = [~~$933,400~~] $497,893

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”~~] “Industrial Estate”; 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.~~]

As the Customer Diversity figure is less than 4, the overall risk rating is not classified as 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.