



ATTACHMENT 9.01

**Application and compliance with the control mechanism
for standard control services**

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1.0 Introduction and Summary

This attachment provides Endeavour Energy's response to Attachment 14 Control Mechanisms of the AER's draft decision. Endeavour Energy broadly agrees with the approach put forward in the AER's draft determination with respect to the application of and compliance with the control mechanisms. However, we have some specific concerns that we wish for the AER to address in the final decision, as summarised in the table below.

Table 1: Overview of Endeavour Energy's response to the AER's Draft Decision on Control Mechanism for Standard Control Services

AER Decision	Endeavour Energy Response	Brief Description of Response
Revenue Cap Control Mechanism for Standard Control Services is revenue cap.	Accept as rules require that Control Mechanism be the same as that specified in the AER's Framework and Approach paper.	
Application of Revenue Cap. Revenue cap comprised of Annual Revenue Requirement (ARR) for standard control services calculated in accordance with revenue cap formulas in Figures 14-1.	In principle accept formula, but will seek further consideration of some elements of the formula.	Endeavour Energy request that the determination expressly provide that the "Price" component for year t in the Revenue Cap Formula includes the unders and overs adjustment.
Side Constraints Side Constraints apply to price movements for each tariff class must be consistent with formula in Figure 14-2.	Endeavour Energy disagrees with the formula in Figure 14-2 on the grounds that it is inconsistent with 6.18.6(c) of the Rules which requires the side constraint be the greater of the CPI-X limitation on any increase in the DNSP's expected weighted average revenue between the two regulatory years plus 2% or CPI plus 2%. Endeavour Energy has proposed an alternative formula that addresses our concerns and corrects for this error in the formula in Figure 14-2.	Endeavour Energy objects to the formula and proposes that the permissible percentage in the formula be expressed as the greater of a CPI-X plus 2% or CPI plus 2%. Endeavour Energy also notes that there is an unintended error in formula in Figure 14-2 where the AER has expressed the price change as being both less than or equal to (\leq) and equal to ($=$).
DUOS Unders and Overs Accounts Endeavour Energy must demonstrate compliance with the control mechanism for standard control services in accordance with Appendix A, of the AER's draft decision.	Endeavour Energy disagrees with aspects of Appendix A which addresses the DUOS unders and overs account.	Endeavour Energy objects to the AER's draft decision not to apply interest to the opening balance and the under/over recovery balance for the regulatory year in year "t"
"TUOS" Under/ Over Recovery Endeavour Energy must submit as part of its annual pricing proposal, a record of the amount of revenue recovered from TUOS charges and associated payments in accordance with Appendix B, of the AER's draft decision.	Appendix B addresses Transmission Use of System "TUOS" unders and overs account but should address "Designated Pricing Proposal Charges Unders and Overs Account.	Endeavour Energy objects to the AER's draft decision not to apply interest to the opening balance and the under/over recovery balance for the regulatory year in year "t"
Jurisdictional Schemes Reporting Endeavour Energy must report to the AER its jurisdiction scheme amounts recovered in accordance with Appendices C, of the AER's draft decision.	The AER has accepted Endeavour Energy's proposed approach, except in respect to the inclusion of interest in year t.	Endeavour Energy objects to the AER's draft decision not to apply interest to the opening balance and the under/over recovery balance for the regulatory year in year "t"
Application of Tolerance Limit	Endeavour Energy disagrees with the AER's approach to tolerance limits	Endeavour Energy seeks reconsideration of the AER's rejection of our proposed approach to tolerance, particularly in respect to imposing a limit on the recoupment of residual metering asset costs.

2.0 Application of the Control Mechanism Formula

The AER draft decision requires Endeavour Energy to submit to the AER proposed DUOS tariffs and charging parameters as part of its annual pricing process that comply with the following control mechanism formula¹:

$$1. \quad ARR_t = \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij} \quad i=1, \dots, n \text{ and } j=1, \dots, m \text{ and } t=2, \dots, 5$$

Endeavour Energy considers that this formula is not workable as it implicitly assumes that the DUOS tariffs (p_t^{ij}) are set to recover the Annual Revenue Requirement (ARR_t) only. However the DUOS tariffs need to be set to include any balance in the DUOS unders and overs account. To assist the AER to address this issue and to provide for greater transparency over the treatment of the DUOS unders and overs account, Endeavour Energy's revised proposal includes the following control mechanism formulae:

2. $DUOS_t \leq R_t$
3. $DUOS_t = \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij}$
4. $R_t = ARR_t \pm U \& O_t$
5. $ARR_t = AR_t \pm B_t$
6. $AR_t = AR_{t-1}(1 + \Delta CPI_t)(1 - X_t)(1 - S_t)$
7. $B_t = MC_t \pm PT_t$

Where:

$DUOS_t$ is the expected DUOS revenue from tariffs in year t .

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

q_t^{ij} is the forecast quantity of component i of tariff j in year t .

R_t is the total DUOS revenue entitlement in year t .

ARR_t is annual distribution revenue requirement in year t .

$U \& O_t$ is the adjustment to the ARR in year t required to return the DUOS unders and overs account to a value compliant with the applicable tolerance limit in year t

AR_t is the annual smoothed distribution revenue requirement for year t .

B_t is the adjustment factor relating to residual metering costs and AER approved pass-through events.

PT_t is the AER approved pass through amount (positive or negative) in regulatory year t .

MC_t is the residual metering costs in year t .

$$\Delta CPI_t = \left[\frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} \right] - 1$$

CPI means the all groups index number for the weighted average of eight capital cities as published by the ABS, or if the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best estimate of the index.

¹ Note that Endeavour Energy is also required to demonstrate that its proposed DUOS tariffs comply with the side constraint mechanism

- X_t is smoothing factor apply to year t calculated in accordance with the PTRM as approved in the AER's final decision, revised for the updated return on debt.
- S_t is the STPIS factor sum of the raw s-factors for all reliability of supply and customer service parameters (as applicable) to be applied in year t.

2.1 CPI Definition

The AER's draft decision adopts Endeavour Energy's proposed CPI formula in the revenue cap control mechanism for distribution standard control services, as expressed in the formula below:

$$\Delta CPI_t = \left[\frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} \right] - 1$$

Where

CPI means the all groups index number for the weighted average of eight capital cities as published by the ABS, or if the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best estimate of the index.

2.2 STPIS Incentive and Transitional Adjustment

Endeavour Energy notes and accepts the AER's position that adjustments be included in the control mechanism for STPIS and Approved Pass Through Amounts, and that a transitional adjustment is no longer required to account for the difference in the notional revenue for the 2014-15 regulatory year and the placeholder revenue in the transitional decision as the AER has taken into account this difference as part of the true-up in establishing the smoothed total revenues over the 2015-19 period.

2.3 Annual Adjustment (B-Factor)

Endeavour Energy notes that the AER has agreed that any adjustment for Approved Pass Through amounts should be through the B-Factor and that residual metering asset costs should be recovered as a standard control service and through the B-Factor. This approach is broadly acceptable to Endeavour Energy.

Endeavour Energy also notes that the AER have applied tolerance limits to the recovery of residual metering asset costs. Endeavour Energy does not agree with the AER on this matter because Endeavour Energy believes that the tolerance limit should be applied to the DUOS overs and unders account, rather than the recoupment of residual metering asset costs. Endeavour Energy's approach will ensure that customers are protected for potential price shocks without unnecessarily restricting Endeavour Energy's recoupment of residual metering asset costs in a given year. This issue is explained in more detail below.

2.4 Treatment of Under and Over Recovery mechanism for DUOS

The AER's draft decision proposes a specific mechanism for the treatment of DUOS under and over recovery that is separated from the B-Factor. Endeavour Energy has no objection dealing with these two issues separately. There are, however, a number of issues with the AER's proposed implementation that should be addressed prior to its finalisation, as explained in the following section.

2.4.1 The application of Tolerance Limits to the DUOS Unders and Overs Account

It appears that the AER have not accepted Endeavour Energy's proposed approach of applying tolerance limits to the DUOS unders and overs account, as reflected in the following quote from the AER's Draft Decision:

"We do not approve this proposal because we consider that Endeavour Energy can smooth prices by working with its customers to smooth its revenue i.e by having a pricing strategy that would smooth out price shocks. Furthermore, a tolerance limit will allow Endeavour Energy to bank revenues that may result in greater price shocks in the future when they are ultimately recovered from customers. Our decision in applying a tolerance limit for Energex in 2010 has had this undesirable result".²

² AER 2014, Draft Decision, Endeavour Energy distribution determination 2015-16 to 2018-19 Attachment 14: Control Mechanisms, Attachment A, p.14-11.

Endeavour Energy strongly disagrees with the AER on this matter and believes it is inappropriate for the AER to dictate pricing strategy in their draft decision to compensate for the shortcomings in their proposed control mechanism. The AER opted for the revenue cap control mechanism in the full knowledge that to move away from the weighted average price cap would pass volume risk from the distributor to the customer in the form of price volatility.

Endeavour Energy’s proposed tolerance limit is a reasoned approach to limit the price shocks that are inherent in the AER’s revenue cap control mechanism without adversely impacting Endeavour Energy’s ability to implement efficient pricing strategy decisions.

The tariff reform process will take many years to complete due to the need to transition network tariffs to cost reflective levels and time taken to replace the existing accumulation metering stock. Given that it will take time for Endeavour Energy to deliver efficient network tariffs, it is important that our customers are shielded from these residual volume risks under the revenue cap in the short to medium-term. Endeavour Energy believes that this outcome can only be achieved by the AER adopting our approach of applying tolerance limits to the DUOS unders and overs account. Endeavour Energy also notes that AER’s draft decision also appears to contradict the above position by applying a tolerance limit to the DUOS overs and unders account, as reflected in the following quote from the AER’s draft decision:

“In proposing variations to the amount and structure of DUOS charges, Endeavour Energy must attempt to achieve an expected zero balance on their DUOS unders and overs accounts in each forecast year in its annual pricing proposals in the 2015-19 regulatory control period, unless it can demonstrate for a given year that such an adjustment exceeds the agreed tolerance limits set out in this decision. In such circumstances, the balance at the end of the regulatory control period will reflect the amount by which the adjustment exceeded the first tolerance limit (that is, the amount by which the under/over adjustment exceeded two per cent of Endeavour Energy’s ARR for year t.)”³

To assist the AER to make a decision on the application of tolerance limits, Endeavour Energy has resolved this contradiction in the AER draft decision by assuming that the AER’s approach involved both general and specific applications of tolerance limits, as discussed below. The following table summarises Endeavour Energy’s interpretation of the AER’s approach to tolerance limits in relation to the DUOS unders and overs account.

Table 2: AER’s draft tolerance limits and actions – general requirement

Tolerance	DNSP Action Required
Less than +/- 2 per cent of the ARR in year t	Endeavour Energy is required to set DUOS tariffs in year t to achieve a zero forecast value of the closing balance of the DUOS unders and overs account in year t.
Greater than +/- 2 per cent of the ARR in year t	Endeavour Energy is required to set DUOS tariffs in year t in a manner that ensures that the forecast closing balance of the DUOS unders and overs account at the end of the regulatory control period is equal to the over/under adjustment in excess of +/-2% of ARR in year t.

Endeavour Energy is concerned that the AER’s approach may only be effective in managing this risk in the situation where the under/over adjustment each year is immaterial. This is because it does not impose an obligation on Endeavour Energy to actively manage a material under or over recovery of DUOS revenue on behalf of customers by developing and implementing a transitional DUOS plan to achieve a zero balance of the DUOS unders and overs account over a reasonable time.

Endeavour Energy believes that the best way to safeguard the long-term interest of consumers from the inherent risk of price shocks under the revenue cap is to design the tolerance limit to ensure that in the event of a material over/under recovery of DUOS revenue that Endeavour Energy has the flexibility to transition DUOS prices to achieve a zero balance of the DUOS unders and overs account over a reasonable time frame. In the case of a very large under/over recovery of DUOS revenue (i.e greater than 5% of the ARR in one year), Endeavour Energy believes that’s it is in the long-term interest of

³ AER 2014, Draft Decision, Endeavour Energy distribution determination 2015-16 to 2018-19 Attachment 14: Control Mechanisms, Attachment A, p.14-17.

customers for transitional DUOS pricing arrangement to extend over more than one regulatory control period as long as our customers have been consulted on the plan to address this issue.

To address the AER’s concerns with the tolerance limit, we have reduced our proposed upper tolerance limit from 10% to 5% as part of our revised proposal and we encourage the AER to adopt the approach to tolerance limits proposed by Endeavour Energy, as shown in the table below:

Table 3: Endeavour Energy’s proposed tolerance limits and actions

Tolerance	DNSP Action Required
Less than +/- 2 per cent	If the audited over/under recovery of DUOS revenue in year t-2 is within +/- 2 per cent of the ARR for year t, the DNSP is required to set DUOS prices for year t to achieve a zero closing balance for the DUOS revenue overs and unders account in year t.
Between +/- 2 per cent and +/- 5 per cent	If the audited over/under recovery of DUOS revenue in year t-2 is greater than +/- 2 per cent of the ARR for year t, but less than +/- 5% of AAR for year t, the DNSP is allowed to set DUOS prices for year t to achieve a non-zero closing balance for the DUOS revenue overs and unders account in year t. The only requirement is that the DNSP sets DUOS prices in year t with the expectation of achieving a zero closing balance of the DUOS revenue overs and unders account in year t+1.
Greater than 5%	If the audited over/under recovery of DUOS revenue in year t-2 is greater than +/- 5 % of the ARR for year t, the DNSP is required to submit to the AER as part of its annual pricing proposal a medium-term plan to address the DUOS revenue overs and unders account.

Endeavour Energy also notes that the AER’s draft decision also requires that Endeavour Energy comply with specific tolerance limits in relation to its recovery of residual metering asset costs via the B-factor, see the table below:

Table 4: AER’s draft tolerance limits and actions – specific requirement

Tolerance	DNSP Action Required
Less than +/- 2 per cent of the ARR in year t	The residual metering asset costs under/over recovery will be cleared within one regulatory year.
Greater than +/- 2 per cent of the ARR in year t	The residual metering asset costs under/over recovery will be recovered in the remainder of the regulatory control period

Endeavour Energy believes that applying a tolerance limit to the recovery of residual metering asset costs defeats the purpose of moving the recovery of these costs from an alternative control services exit fee into standard control services revenue. We understand this change by the AER was to facilitate the recovery of actual asset costs as customers exit our metering service but not specifically charge individual customers. Further, it is also unnecessary for a specific tolerance limit for metering as the general tolerance limit applying to the DUOS unders and overs will safeguard our customers from potential DUOS price shocks under the revenue cap.

2.4.2 Treatment of Interest Charge for year t in the DUOS Unders and Overs Account

The AER draft decision is to not apply interest to the opening balance in year t and the under/over recovery amounts during year t.

Endeavour Energy does not support the AER’s draft decision to exclude the interest calculation in year t from the DUOS unders and overs account because it will result in Endeavour Energy earning more or less than its annual revenue requirement entitlement under the determination in present value terms. In other words the exclusion of interest in year t will result in an outcome that contravenes the following formula:

$$8. \quad PV \text{ of } \sum_{t=1}^z ARR_t = PV \text{ of } \sum_{t=1}^z DUOS_t$$

Where:

$DUOS_t$ is the expected DUOS revenue in year t (calculated in accordance with formula 3 above)

ARR_t is annual distribution revenue requirement in year t. (calculated in accordance with formula 5 above)

To assist the AER to understand our position, Endeavour Energy has provided the following illustrative examples of a DUOS unders and overs account. Table A.4 uses the AER's draft decision methodology to exclude interest in year t of the account. Table A.5 uses Endeavour Energy's proposed methodology that includes interest in year t. Table A.5 demonstrates that Endeavour Energy's proposed methodology is present value neutral while the AER's draft methodology is not.

Table A.4: Illustrative example of AER approach to DUOS Unders and Overs Account (excluding year t interest)

DUOS Unders & Overs Account	Audited Actual Period t-2	Estimate Period t-1	Forecast Period t	Present Value (PV)	Variance in PV
Revenue from DUOS Tariffs ($DUOS_t$)	50.0	100.0	157.7	246.6	
DUOS Revenue Requirement (ARR_t)	100.0	100.0	100.0	248.7	2.1
WACC interest	10%	10%	10%		
Opening Balance	0.0	-52.4	-57.7		
Interest on Opening Balance	0.0	-5.2	0.0		
Forecast over/(under) recovery for financial year	-50.0	0.0	57.7		
Interest charged on over/under recovery for financial year	-2.4	0.0	0.0		
Closing Balance	-52.4	-57.7	0.0		

Table A.5: Illustrative example of AER approach to DUOS Unders and Overs Account (inclusive of year t interest)

DUOS Unders & Overs Account	Audited Actual Period t-2	Estimate Period t-1	Forecast Period t	Present Value (PV)	Variance in PV
Revenue from DUOS Tariffs ($DUOS_t$)	50.0	100.0	160.5	248.7	
DUOS Revenue Requirement (ARR_t)	100.0	100.0	100.0	248.7	0.0
WACC interest	10%	10%	10%		
Opening Balance	0.0	-52.4	-57.7		
Interest on Opening Balance	0.0	-5.2	-5.8		
Forecast over/(under) recovery for financial year	-50.0	0.0	60.5		
Interest charged on over/under recovery for financial year	-2.4	0.0	3.0		
Closing Balance	-52.4	-57.7	0.0		

It is clearly evident from this simple example that the AER approach of excluding interest in year t does not fully compensate the DNSP (customer) for the opportunity costs associated with the under (over) recovery of DUOS revenue in year t-2 given that the DNSP receives its DUOS revenue during the course of year t, rather than the first day of the year t.

Endeavour Energy encourages the AER to reconsider its position on this issue and adjust their final decision to include a calculation of interest for the opening balance in year t and the over/under recovery of forecast revenue during year t for each of the DUOS, Designated Pricing Proposal Charges and Jurisdictional Scheme unders and overs accounts.

2.4.3 Side Constraint

Endeavour Energy notes that the AER's Draft Decision on side constraints is that Endeavour Energy will be required to demonstrate in its annual pricing proposal that proposed DUOS prices for the next year (t) will satisfy the following side constraint formula for each tariff class:

$$9. \frac{(\sum_{t=1}^m d_t^j q_t^j)}{(\sum_{t=1}^m d_{t-1}^j q_t^j)} \leq (1 + \Delta CPI_t)(1 - X_t)(1 + 2\%)(1 + S_t) \pm PT_t \pm DUOS_t$$

Where each tariff class 'j' has up to 'm' components, and where:

d_t^j is the proposed price for component 'j' of the tariff class for year t

d_{t-1}^j is the price charged by the Endeavour Energy for component 'j' of the tariff class in year t-1

q_t^j is the forecast quantity of component 'j' of the tariff class in year t

$$\Delta CPI_t = \left[\frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} \right] - 1$$

CPI_t means the all groups index number for the weighted average of eight capital cities as published by the ABS, or if the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best estimate of the index.

X_t is smoothing factor apply to year t calculated in accordance with the PTRM as approved in the AER's final decision, revised for the updated return on debt.

S_t is the STPIS factor sum of the raw s-factors for all reliability of supply and customer service parameters (as applicable) to be applied in year t.

PT_t is the AER approved pass through amount (positive or negative) in regulatory year t

$DUOS_t$ is an annual adjustment factor related to the balance of the DUOS unders and overs account with respect to regulatory year t.

Endeavour Energy does not support the AER's draft decision on the side constraint mechanism to apply to setting of tariffs for standard control distribution services for the following reasons:

- the permissible percentage is expressed on the basis of a CPI-X limitation plus 2% only. This approach is inconsistent with section 6.18.6(c) of the NER which requires the side constraint to be the maximum of a CPI-X + 2% or CPI + 2% limitation. The AER's draft decision will prevent Endeavour Energy from undertaking efficient tariff reform in an environment of declining allowed revenues and prices;
- The formula does not adjust for both aspects of the B-factor, in that it includes an allowance for approved pass through amounts (PT_t) but does not allow for residual metering costs (MC_t); and
- the AER side constraint formula requires that the proposed % increase in Endeavour Energy's expected weighted average revenue in year t is both "≤" and "=" to the permissible percentage.⁴

To assist the AER to make a decision on the side constraint mechanism to apply to the setting of DUOS tariffs in the next regulatory control period, Endeavour Energy puts forward its preferred approach, as set out in the following formula, below:

$$10. \frac{(\sum_{t=1}^m d_t^j q_t^j)}{(\sum_{t=1}^m d_{t-1}^j q_t^j)} \leq \text{Permissible Percentage}$$

Where each tariff class 'j' has up to 'm' components, and where:

⁴ Note: Endeavour Energy has assumed that the inclusion of "=" is an error given the compliance issues that this contradiction would cause.

d_t^j is the proposed price for component 'j' of the tariff class for year t

d_{t-1}^j is the price charged by the Endeavour Energy for component 'j' of the tariff class in year t-1

q_t^j is the forecast quantity of component 'j' of the tariff class in year t

The Permissible Percentage is the greater of:

11. $(1 + \Delta CPI_t)(1 - X_t)(1 + 2\%)(1 + S_t) \pm B_t \pm U \& O_t$; or

12. $(CPI_t + 2\%)$

Where

X_t is smoothing factor apply to year t calculated in accordance with the PTRM as approved in the AER's final decision, revised for the updated return on debt.

S_t is the STPIS factor sum of the raw s-factors for all reliability of supply and customer service parameters (as applicable) to be applied in year t.

B_t is the adjustment factor relating to residual metering costs and AER approved pass-through events (expressed in a percentage form with respect to regulatory year t).

$U \& O_t$ is the adjustment to the ARR in year t required to return the DUOS unders and overs account to a value compliant with the applicable tolerance limit in year t (expressed in a percentage form with respect to regulatory year t).

$$\Delta CPI_t = \left[\frac{CPI_{Mar,t-2} + CPI_{Jun,t-2} + CPI_{Sep,t-1} + CPI_{Dec,t-1}}{CPI_{Mar,t-3} + CPI_{Jun,t-3} + CPI_{Sep,t-2} + CPI_{Dec,t-2}} \right] - 1$$

CPI_t means the all groups index number for the weighted average of eight capital cities as published by the ABS, or if the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best estimate of the index.

2.4.4 Recovery of D-factor amounts

Endeavour Energy notes that the AER's transitional decision allows distributors to recover the costs and foregone revenues of applicable demand management projects in the 2009-14 regulatory control period in the transitional and subsequent regulatory control periods⁵

Endeavour Energy is concerned the AER's draft decision is silent on the issue of how our entitlements under the D-factor will be recouped from our customers under the revenue cap control mechanism during the regulatory control period.

Endeavour Energy also notes that there are two potential options for the AER to adopt in the final decision to ensure that Endeavour Energy can recoup our entitlements under the D-factor via the revenue cap, as summarised below:

- X-factor approach: to set the X-factor under the revenue cap for distribution standard control services on the basis that an estimate of our entitlement under the D-factor in FY 2014/15 and FY 2015/16 is included in the building block revenue requirement; and
- annual pricing proposal approach: allow Endeavour Energy to include a proposed D-factor amount in its annual pricing proposal for the forthcoming year and to account for this amount in the B-factor under the revenue cap.

⁵ AER 2014, Transitional Distribution Decision 2014-15, page 47