

21 April 2017

Mr Moston Neck
Director Network Regulation
Australian Energy Regulatory
PO Box 12241, George Street Post Shop
Brisbane Qld 4003

By electronic submission: moston.neck@aer.gov.au

Dear Mr Neck

Endeavour Energy response to the AER's preliminary Framework and Approach paper for the next regulatory control period

Endeavour Energy welcomes the opportunity to provide feedback on the AER's preliminary Framework and Approach (F&A) paper for the next regulatory control period. The preliminary F&A paper follows a request from Endeavour Energy, and other Distribution Network Service Providers (DNSPs) to review and update the existing F&A paper that applies for the current regulatory control period, 1 July 2014 to 30 June 2019.

The F&A is the first step in the determination process for the next regulatory control period, 1 July 2019 to 30 June 2024. The preliminary F&A paper sets out the AER's views on a number of matters which will enable Endeavour Energy to prepare and submit a regulatory proposal for the 2019-24 period in January 2018. These matters primarily relate to which services the AER will regulate and how. Our views on the positions outlined in the preliminary F&A paper are summarised below:

- **Service classification:** broadly we support the AER's preliminary service listing and definitions which are largely similar to the 2014-19 classification table. We support the AER's objective of rationalising the listing to improve its readability and consistency across jurisdictions. Our more detailed comments and points of clarification are attached.
- **Form of control:** we support the AER's preliminary position to maintain the existing forms of control; revenue cap for standard control services and price cap for alternative control services.
- **Formulae to give effect to the form of control:** we support the AER's preliminary position.
- **Incentive schemes:** we support the AER's preliminary position to apply all four incentive schemes. We consider improvements could be made to some of these schemes, however we accept this is an issue separate to the F&A process.
- **Forecast Expenditure Assessment (FEA) Guideline:** we accept the AER's preliminary decision to apply the FEA guideline. However, we consider this guideline should be amended to provide more detail on the assessment methods (particularly benchmarking) the AER intend to rely upon, the relative strengths and weaknesses of the available methods and how they will be applied in assessing and/or substituting expenditure forecasts.
- **Depreciation approach:** we support the AER's preliminary position to use forecast depreciation to establish the opening regulatory asset bases (RABs) for the upcoming regulatory control period. This maintains incentives to reduce capex in combination with the Capital Expenditure Sharing Scheme (CESS).
- **Dual function assets (DFAs):** we support the AER's preliminary position to regulate Endeavour Energy's DFAs as distribution assets for pricing purposes given a change to transmission pricing would have no impact on the current pricing outcome.

In addition to the issues above we also wish to note our intention to submit a Cost Allocation Methodology (CAM) to apply for the 2019-24 period. This is to better clarify the operation of our existing CAM following discussions with the AER. As this CAM is simply intended to clarify the operation of our existing CAM we do not consider it will materially impact our reported or forecast standard control service expenditure.

Our more detailed comments on the AER's preliminary F&A paper are attached to this letter. If you have any queries or wish to discuss this matter further please contact Jon Hocking, Manager Network Regulation on (02) 9583 4386 or alternatively via email at jon.hocking@endeavourenergy.com.au.

Yours sincerely



Rod Howard
Acting Chief Executive Officer

Attachment A:

Endeavour Energy's views on the AER's preliminary F&A paper

1. Service Classification

We support the AER's assessment approach outlined in section 1.2 of the preliminary F&A paper. This section provides a useful overview of the classification framework and process to stakeholders. We consider a service based approach to classification (rather than asset based) is practical and ensures regulation is applied on a targeted, accurate basis.

Further, we support the AER's approach to group similar services to avoid the need to develop a prescriptive, repetitive listing that seeks to identify every possible iteration of a service. A simplified listing will be more accessible and flexible and allow more detailed specification as part of the determination process when prices are set.

Our more detailed comments and questions are included in Attachment B. An overview of our position on key issues is provided below.

Ring-fencing

We also note the preliminary F&A explains the ring-fencing guideline and its relationship to the service classification process. We consider further clarification may be beneficial for stakeholders unfamiliar with the service classification process. Specifically, to ensure that stakeholders understand that terms such as 'not classified' or 'unclassified' are synonymous with 'unregulated distribution services' and not 'non-distribution services' as different ring-fencing obligations apply for these respective services. Similarly, we ask that the AER clarify a statement made in the preliminary F&A¹:

*In some situations we may remove regulation altogether—unregulated distribution services must be provided through a **separate affiliate to the distributor** following the introduction of our Ring-Fencing Guideline. [emphasis added]*

Our understanding of the ring-fencing guideline is that non-distribution services are subject to both functional and legal separation while unregulated distribution services are subject to functional separation and not legal separation (although it may be logical for DNSPs to separate these services along with non-distribution).

Emergency recoverable works

We support the AER's preliminary position that emergency recoverable works are part of the common distribution services group and therefore a standard control service. As noted by the AER however, a (small) portion of the cost of these works may be recovered under common law in some circumstances.

To avoid double-counting the AER suggest²:

If a distributor is successful in recovering the cost of the emergency repairs from a third party, this payment or revenue, would be netted off the regulatory asset base and treated like a capital contribution.

¹ AER, Preliminary framework and approach paper: Ausgrid, Endeavour Energy and Essential Energy – Regulatory control period commencing 1 July 2019, March 2017, p.10

² Ibid, p. 21

We support the need to ensure DNSPs do not recover the cost of this standard control service twice. However, we do not consider the method above would achieve this outcome. Emergency recoverable works is an operating expense and therefore not a capital contribution, meaning there is no asset class for it to be netted off against. This would penalise DNSPs by removing an asset value from the RAB and the associated return on and of the asset over its remaining life.

Instead, consistent with the ex-ante regulatory framework, we suggest that DNSPs be required to provide an estimate, at the time of a determination, of the expected portion of emergency recoverable works opex that will be recovered directly from third parties. This expectation could be based on the average recovery proportion of the last five years for instance. Ultimately this issue can be resolved as part of the determination rather than the F&A paper. It may therefore be appropriate for the F&A paper to not specify the method for avoiding double-counting but rather note the need to develop an approach.

Metering

On 1 December 2017, the AEMC's metering contestability final rule will come into full effect with the establishment of a competitive market for metering services in the NEM (with the exception of Victoria). The metering contestability rule change establishes a new market participant, a Metering Co-ordinator, which will be responsible for a customer's metering as well as clarifying the roles of existing participants.

All new meters from 1 December 2017 will be competitively provided and classified as a type 1-4 metering service (an unregulated distribution service). We consider the roles and functions of participants providing and supporting these competitively provided meters will also be contestable and therefore unregulated distribution services (or potentially non-distribution).

However, the final metering contestability rule provides for a transition for existing customers in the NEM. An existing customer's metering will only be converted to a type 4 meter by mutual agreement with their retailer or if the meter requires replacement. The AEMC has therefore created a transitional metering service for type 5 and 6 meters. DNSPs will be obligated to exclusively provide initial Metering Co-ordinator services for these meters until a competitive meter is installed. As noted by the AEMC in the final rule determination³:

In response to questions in submissions, the Commission's view is that when a competitive Metering Coordinator is appointed at a connection point for an existing type 5 or 6 metering installation, the metering service will cease to be regulated by the AER, even if the LNSP is retained as the Metering Provider and/or Metering Data Provider at the connection point. Where the LNSP is retained as the Metering Provider and/or Metering Data Provider it would not be performing a regulated distribution service in this scenario as the Metering Coordinator would be ultimately responsible for providing these services.

We therefore support the AER's preliminary classification listing in Appendix B of the preliminary F&A paper. The listing provides for the capital recovery of type 5 and 6 meters installed before 1 July 2015 and replaced between 1 July 2015 and 1 December 2017 and the operating costs a DNSP will incur in providing transitional metering services to type 5 and 6 customers beyond 1 December 2017. This, in combination with the unclassified type 1-4 metering services and contestable metering support roles supports the AEMC's position outlined above.

³ AEMC, Final Rule Determination: National Electricity Amendment (Expanding competition in metering and related services) Rule 2015, 26 November 2015, p. 131

However, we seek clarification that this is the AER's preliminary position as the explanation provided in the paper is contrary to the listing in Appendix B. The explanation provided in section 1.3.2 of the paper suggests type 5 and 6 metering services will become redundant as at 1 December 2017 rather than become redundant over an extended period time. Given the transition may take several years we support the AER's position in Appendix B of the F&A preliminary paper rather than the position outlined in section 1.3.2.

Public Lighting

We support the AER's preliminary decision to classify public lighting services in NSW as an alternative control service rather than a negotiated service. In arriving at this conclusion the AER referenced submissions from the 2014-19 determination that suggest NSW DNSPs lacked commercial incentives to engage meaningfully with public lighting customers.

We wish to note that during the 2014-19 determination Endeavour Energy delivered a pricing outcome of no real price increases while maintaining service levels at the NSW Public Lighting Code. Endeavour Energy also meets regularly (quarterly) with councils to discuss public lighting services and issues. We are confident that we engage positively and proactively with our public lighting customers.

This is evidenced by the 2014-19 determination, in the AER's draft decision it noted a general level of satisfaction of Endeavour Energy's public lighting customers. Further, over 50 submissions were made regarding public lighting to the AER following the NSW DNSPs public lighting proposals, only four of which related to Endeavour Energy.

We consider Endeavour Energy does devote time to engaging with public lighting customers and responding to their needs. However, we accept the AER's decision and the need for a consistent classification of this service in NSW.

Nightwatch

The AER's preliminary F&A position is to classify private security and floodlighting services (known as "Nightwatch" services in Endeavour Energy's network area) as an alternative control service, specifically as part of the "network safety" ancillary network service.

Services can be classified as alternative control services where there is the potential for that service to be provided on a contestable basis in the future. This classification provides for transparency and price discovery for potential market entrants while protecting customers in the absence of functional competition with price control.

To date, Nightwatch services have been provided to customers on an unregulated basis in NSW. We consider the existing arrangement is appropriate. We understand that several DNSPs raised concerns with ring-fencing this service if it were to remain unregulated. Rather than reclassifying the service we consider it would be more appropriate for this service to remain unregulated and for DNSPs to apply for a ring-fencing waiver if required.

Unregulated and Non-distribution services

As noted by the AER, developing a comprehensive list of all unregulated distribution services will be challenging given its large scope. In the Appendix B service listing the AER include distribution asset rentals and contestable metering support roles as common examples of unregulated distribution services. The AER direct DNSPs to the ring-fencing guideline in assessing the services it intends to provide.

We support a flexible approach where DNSPs examine the contestable services they intend to provide against the AER's ring-fencing guideline. It would be impractical for the AER to develop a speculative and exhaustive listing of what contestable services DNSPs may provide. We have conducted this assessment as part of our transition to complying with the ring-fencing guideline by January 2018 as required. We intend to engage with the AER throughout the 2017 calendar year to ensure our understanding of the ring-fencing guideline is correct and our intended approach to compliance is appropriate.

2. Dual Function Assets

We submitted evidence in requesting an update to the 2014-19 F&A demonstrating that Endeavour Energy's DFAs are an immaterial proportion of our overall RAB and are "exit assets" i.e. wholly dedicated to the Endeavour Energy distribution network. This would mean that separately pricing our DFAs as transmission assets would have no impact on our distribution prices (i.e. no benefit) and only create additional administrative costs.

We therefore support the AER's preliminary position that Endeavour Energy's DFAs continue to be regulated as distribution assets for pricing purposes.

3. Form of Control

We support the AER's decision to maintain the existing form of control for both standard and alternative control services. Standard control services will be subject to a revenue cap while alternative control services will be subject to a price cap.

4. Formulae to give effect to the form of control

We support the proposed formulae to give effect to the form of control for both standard and alternative control services.

5. Incentive Schemes

Overall we consider incentive regulation is best practice and should continue to apply. We therefore support the AER's preliminary position that all four incentive schemes continue to apply.

Efficiency Benefit Sharing Scheme (EBSS)

We support the AER's position to apply the EBSS for the 2019-24 regulatory control period. We consider the EBSS provides a strong incentive for DNSPs to efficiently reduce their costs on a continual, incremental basis. This underpins the revealed cost regulatory framework and obviates the need for prescriptive regulatory allowances and the associated risks of regulatory forecasting error.

We also support the AER's preliminary position that the EBSS is complementary to the revealed cost method and therefore contingent to it applying. Where a revealed cost method is not used to set forecast opex we agree that it would be inappropriate to apply the EBSS. However, in setting out its approach to deciding whether to apply the EBSS the AER states⁴:

we would only apply the EBSS if we use a revealed cost forecasting approach to forecast opex for the 2024–29 regulatory control period.

⁴ AER, Preliminary framework and approach paper: Ausgrid, Endeavour Energy and Essential Energy – Regulatory control period commencing 1 July 2019, March 2017, p.61

We wish to clarify whether the decision to apply the EBSS is linked to the 2024-29 regulatory control period as suggested in the preliminary F&A paper, or the 2019-24 regulatory control period. In our view, it is appropriate to apply the EBSS for the 2019-24 period if a revealed cost forecasting approach is used to set the opex allowance for the 2019-24 period. We do not consider it is necessary for the AER to form a view on how forecast opex will be set for the subsequent regulatory control period (2024-29 in this instance).

We therefore consider the preliminary F&A should be amended to couple the EBSS decision with the opex forecasting method adopted for the next regulatory control period rather than coupling it with the AER's intention for the subsequent forecasting period.

CESS

We support the AER's preliminary position to continue to apply the CESS in the manner described in the TransGrid F&A.

We also note the concerns raised by Ausgrid in its request to replace the 2014-19 F&A regarding the incentivisation of deferrals. Asset management practices are often improved through incremental improvements which may result in deferrals from one regulatory control period to the next. It is unclear in what circumstances the AER would adjust the CESS for such deferrals or how in the absence of approving a ten year capital program at a project by project level at the time of a determination. We consider any efficient deferral of capex to be in the long term interests of customers and therefore incentivised by the CESS. However, we accept that this is an issue that would best be addressed by an amendment to the CESS guideline rather than via this F&A paper.

Demand Management Incentive Scheme (DMIS)

We support the AER's preliminary position to apply both the DMIS and DMIA which are currently being developed by the AER.

However, we note that the new DMIS and DMIA will not be completed until later this year. We will make further comment on the application of the schemes as part of the F&A or determination process, depending on the timing, when the final version of the new DMIS and DMIA are published.

Service Target Performance Incentive Scheme (STPIS)

We support the AER's preliminary position to apply the STPIS except for the GSL component of the STPIS in light of the jurisdictional GSL arrangements in NSW. Similar to the DMIS and DMIA the STPIS is currently being review by the AER. We will make further comment on the application of the STPIS following the outcomes of its review.

6 Expenditure Forecast Assessment Guidelines

We accept the AER's preliminary position to apply the EFA guideline.

However, we maintain our position that the EFA guideline itself should be separately reviewed and amended to clarify the AER's intended approach for assessing forecast expenditure. The existing guideline is largely silent on the specific benchmarking method and tools the AER intends to use and how these will be applied. While we appreciate the need for flexibility we consider a full and frank assessment of the available benchmarking techniques available to the AER would help facilitate an ongoing dialogue on the issue of benchmarking to improve its usefulness and accuracy.

We also wish to clarify the AER's expectation that⁵:

The NER require NSW electricity distributors to advise us by 30 November 2017 of the methodology they propose to use to prepare their forecasts.

Our understanding of the cl 6.8.1A(b)(1) of the NER is that we are required to submit our forecasting methodology statement to the AER in June 2017 (24 months prior to expiry of the current regulatory control period). However, we also note cl 6.8.1A(b)(2) that states in the absence of a distribution determination a DNSP is required to submit its statement within three months of being required to do so by the AER. Currently, there is no distribution determination in place for the NSW DNSPs following the outcomes of the merits review of the 2014-19 distribution determination (which is currently subject to judicial appeal). However, we consider cl 6.8.1A(b)(2) was intended for a scenario where a DNSP has not previously been subject to economic regulation by the AER.

We seek clarification from the AER as to when the AER expects the NSW DNSPs to submit a forecasting methodology statement for the 2019-24 regulatory control period. We are currently working towards submitting a forecasting methodology statement by 30 June 2017.

7 Depreciation Approach

We support the AER's preliminary position to use forecast depreciation to establish the opening RAB commencing 1 July 2019. This is consistent with the application of the CESS applied to Endeavour Energy in the current regulatory control period.

8 Cost Allocation Methodology

Whilst not required as part of the F&A process, the Cost Allocation Methodology (CAM) is another aspect of a determination process that needs to be finalised prior to the submission of a regulatory proposal (and the accompanying Regulatory Information Notice).

Initially, Endeavour Energy indicated that we do not intend to propose a new CAM for the 2019-24 period. However, following discussions with the AER we consider our existing CAM should be amended to better clarify its intended operation. We therefore intend to submit a CAM to the AER. As this CAM is simply intended to clarify the operation of our existing CAM we do not consider it will materially impact our reported or forecast standard control service expenditure.

⁵ AER, Preliminary framework and approach paper: Ausgrid, Endeavour Energy and Essential Energy – Regulatory control period commencing 1 July 2019, March 2017, p.73