

Essential Energy

8.02 Revenue control mechanisms

January 2023

Attachment summary

- > This section describes our control mechanism for standard control and alternative control services.

Introduction

The Australian Energy Regulator's (AER's) Framework and Approach paper (F&A paper) for the 2024–29 regulatory control period sets out their proposed control mechanisms and associated formulae for standard control services and alternative control services.¹

Essential Energy accepts the proposed control mechanisms and associated formulae. This attachment and other supporting documents demonstrate how we intend to apply them.

National Electricity Rules requirements

In making its draft and final distribution determinations, clauses 6.12.1(11) and (12) of the National Electricity Rules (NER) require the AER to decide on the form of control mechanisms (including the X factor) for standard control services and alternative control services, as well as the formulae that give effect to its chosen mechanisms.

Clause 6.8.2(c)(3) of the NER requires Essential Energy's Regulatory Proposal to include for services classified as alternative control services, a demonstration of the application of the control mechanism, as set out in the F&A paper, and the necessary supporting information.

Australian Energy Regulator's Framework and Approach paper

As noted in its F&A paper, the AER decided to apply the following control mechanisms:

- > an annual revenue cap – for services classified as standard control services
- > annual caps on the prices of individual services – for services classified as alternative control services.

Further to the F&A paper, Paragraph 3 of schedule 1 of the AER's Reset Regulatory Information Notice (RIN) requires Essential Energy to provide the revenues it estimates it will recover by providing direct control services over the forthcoming regulatory control period. This proposed forecast must comprise:

- formulaic expressions for the basis of control mechanisms for standard control services and for alternative control services
- a detailed explanation and justification for each component that makes up the formulaic expression.

Essential Energy must also demonstrate:

- how it considers the control mechanisms are compliant with the F&A paper
- how Essential Energy considers the control mechanisms for its standard control services are compliant with Clause 6.2.6 and Part C of Chapter 6 of the NER.

Compliance with control mechanism for standard control services

The AER determined that the basis of control for standard control services for the 2024–29 regulatory control period should be an annual revenue cap and of the CPI-X form consistent with the NER. The F&A paper sets out the formulae to give effect to this revenue cap control mechanism.

¹ Australian Energy Regulator (July 2022), *Framework and approach: Ausgrid, Endeavour Energy and Essential Energy (New South Wales) Regulatory control period commencing 1 July 2024*.

Australian Energy Regulator formulae for standard control services

The AER's proposed revenue cap formulae for standard control services is set out below.

1. $TAR_t \geq \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij}$ where $i = 1, \dots, n$ and $j = 1, \dots, m$ and $t = 1, 2, 3, 4, 5$
2. $TAR_t = AAR_t + I_t + B_t + C_t$ where $t = 1, 2, 3, 4, 5$
3. $AAR_t = AR_t$ where $t = 1$
4. $AAR_t = AAR_{t-1} \times (1 + \Delta CPI_t) \times (1 - X_t)$ where $t = 2, 3, 4, 5$

Where:

Variable	Represents
t	the regulatory year, with $t = 1$ being the 2024–25 financial year
TAR_t	the total annual revenue for year t
p_t^{ij}	the price of component 'j' of tariff 'i' for year t
q_t^{ij}	the forecast quantity of component 'j' of tariff 'i' for year t
AR_t	the annual smoothed revenue requirement in the Post Tax Revenue Model (PTRM) for year t
AAR_t	the adjusted annual smoothed revenue requirement for year t
I_t	the sum of incentive scheme adjustments for year t . To be decided in the distribution determination
B_t	the sum of annual adjustment factors to balance the 'unders' and 'overs' account for year t . To be decided in the distribution determination
C_t	the approved pass-through amounts (positive or negative) for year t , as determined by the AER. C_t will also include any annual or end of period adjustments for year t . To be decided in the distribution determination
ΔCPI_t	the annual percentage change in the Australian Bureau of Statistics (ABS) Consumer Price Index All Groups, Weighted Average of Eight Capital Cities ² from December in year $t-2$ to December in year $t-1$. For example, for the 2024–25 year, $t-2$ is December 2022 and $t-1$ is December 2023
X_t	the X factor in year t , incorporating annual adjustments to the PTRM for the trailing cost of debt where necessary

There has been a change in the approach to the pass-through of the Service Target Performance Incentive Scheme (STPIS) rewards and penalties, from a percentage to a dollar amount. This required minor revisions to the formulae that give effect to the revenue cap control mechanism.

The AER has updated the control mechanism formulae to remove the transitional formulae. For the 2024–29 regulatory control period, the AER applies STPIS 2.0 as an adjustment to the I-factor in the formula above, continuing its operation from the final years of the 2019–24 regulatory period.

² If the ABS ceases to publish the Consumer Price Index, the AER will determine the best available alternative index and use it in its stead.

Demonstrating compliance with the revenue cap control mechanism

In demonstrating Essential Energy's compliance with the F&A paper and Clause 6.2.6 and Part C of Chapter 6 of the NER, we make the follow observations.

- > Essential Energy accepts the AER's proposed formulae to apply to standard control services to give effect to the AER's proposed revenue cap control mechanism.
- > Essential Energy's proposed revenues in this Regulatory Proposal assume a revenue cap control is based on applying the AER's approved PTRM, which generates the revenue outputs in the AER's proposed revenue cap formulae, including the annual smoothed revenue requirement (ARt).
- > Our calculation of annual revenue adjustments in the revenue cap control formulae is in accordance with:
 - the formulaic expressions provided by the AER under each of the relevant incentive schemes
 - formulaic expressions applied in our Annual Pricing Proposals in the current regulatory control period (as approved by the AER), including the application of the approved distribution use of system (DUOS) revenue unders and overs mechanism.
- > Indicative prices for standard control services for each regulatory year, which are included in our Tariff Structure Statement, are based on adjusted annual smoothed revenues (AARt) generated by the PTRM.
- > Each year of the regulatory control period, our Annual Pricing Proposal will demonstrate that forecast annual revenue (in year t) based on our proposed network tariffs (in year t) is equal to the approved AARt, calculated in accordance with the AER's revenue cap formulae, including to account annually for the trailing average cost of debt adjustment.

Other compliance considerations

Essential Energy's network use of system (NUoS) charges include:

- > the transmission use of system (TUoS) charges of New South Wales and Queensland transmission network service providers, TransGrid and Powerlink
- > payments to other Distributor Network Service Providers (DNSPs)
- > avoided TUoS charges paid to eligible embedded generators.

The charges we make to TransGrid and others are termed 'designated pricing proposal charges' and are defined in Chapter 10 of the NER.

Through its NUoS charges, Essential Energy is also required to recover revenue associated with certain programs implemented by the NSW Government that place legislative obligations on distribution networks.

Finally, Essential Energy's NUoS charges at the tariff class level are subject to what are known as side-constraints – in terms of the size of allowable annual price increases – to prevent price shocks for customers.

Our proposed approach to each of these issues is outlined below.

Transmission charging matters and designated pricing proposal charges

Clause 6.12.1(19) of the NER requires the AER to decide how Essential Energy is to report on the recovery of designated pricing proposal charges for each regulatory year of the 2024–29 regulatory control period, and on adjustments to account for under or over recovery of these charges.

Further, Clause 6.18.7 of the NER requires us to specify in our Annual Pricing Proposal how designated pricing proposal charges are to be recovered from customers.

To meet these requirements, we propose to use the same AER's approved mechanism for recovering these charges during the 2019–24 regulatory control period.

This will entail reporting to the AER on the recovery of designated pricing proposal charges as part of our Annual Pricing Proposal, including the revenue adjustments made through the associated unders and overs account for designated pricing proposal charges.

Specifically, we will set out in our Annual Pricing Proposal:

- > the forecast level of designated pricing proposal charges that will apply for the relevant regulatory year

- > how those designated pricing proposal charges will be passed on to customers
- > detailed information regarding the unders and overs account for designated pricing proposal charges.

These charges include amounts paid to:

- > transmission companies such as TransGrid and Powerlink for TUoS
- > other DNSPs for inter distributor transfers
- > large embedded generators for Avoided TUoS.

Jurisdictional scheme payments

Essential Energy is required to make what are known as ‘jurisdictional scheme payments’ to the NSW Government under relevant NSW legislation. These payments are beyond our control and are treated separately to the AER’s approved maximum allowable revenue and charges for our direct control services.

‘Jurisdictional schemes’ are not limited to the NSW Government – they include any schemes set out under Clause 6.18.7A(e) of the NER, as well as those determined by the AER to be jurisdictional schemes under clause 6.18.7A(i).

Under the NER, there are currently two jurisdictional schemes operating that are relevant to Essential Energy – the NSW Climate Change Fund and the Queensland Government Solar Bonus Scheme (both of which satisfy Rule 6.18.7A(e)(3)). For the 2019–24 regulatory control period, we will have a continuing obligation to make payments to the NSW Government to support the Climate Change Fund and to pay those customers entitled to use the Queensland Government Solar Bonus Scheme.

Clause 6.12.1(20) of the NER requires the AER to make a constituent decision on how a DNSP is to report the recovery of revenue amounts associated with a jurisdictional scheme for each regulatory year of the regulatory control period, and on the adjustments to be made to subsequent pricing proposals to account for over or under recovery of those amounts. The AER’s constituent decision only relates to jurisdictional scheme obligations in place at the time the final revenue determination is made.

Further, Clause 6.18.7A of the NER sets out the requirements for recovery of jurisdictional scheme amounts.

We propose the same mechanism for reporting on recovery of jurisdictional scheme amounts to that in place during the 2024–29 regulatory control period, including the approved mechanism for revenue under or over recovery adjustments. This information will be reported in our Annual Pricing Proposals. The unders and overs account mechanism will ensure amounts for each jurisdictional scheme are passed through to customers in a manner that ensures they pay no more or less than required as per the requirements under Clause 6.18.7A of the NER.

Side constraints

Clause 6.18.6(b) of the NER requires the expected weighted average revenue to be raised from a standard control services tariff class to not exceed the corresponding expected weighted average revenue from the preceding year by more than a permissible percentage (the tariff side constraint).

The F&A paper did not endorse a network tariff side-constraint formula. However, Essential Energy will comply with the formulas and constraints set out in the AER’s standardised annual pricing model, when finalised.

Compliance with control mechanism for alternative control services

An alternative control service is a service we provide to customers on a discretionary or infrequent basis and for which the costs of the specific service can be directly attributed to the requesting customer. Alternative control service revenues do not form part of the DUOS revenue allowance approved by the AER.

The F&A paper proposed the following alternative control service classification groups for the 2024–29 regulatory period:

- > public lighting services
- > Type 5 and Type 6 metering services
- > ancillary network services.

Chapter 13 – Alternative Control Services, provides detail on the nature of each of these services.

In its F&A paper, the AER noted that the NSW distributors' alternative control services are currently subject to price cap regulation. The AER considered concluded that the continuation of these individual service price caps over the 2019–24 regulatory control period best address the factors set out under clause 6.2.5(d) of the NER.

The AER indicated the NER is not prescriptive about the basis of the control mechanism for alternative control services. Accordingly, the AER set out proposed formulae that will give effect to the individual price cap control mechanisms but noted that it is at the distributor's discretion as to the approach it undertakes to develop initial prices for the first year of the 2019–24 regulatory control period.

Further, the AER indicated that prices for certain ancillary services will be determined on a quoted rather than prescribed fee basis. Quoted services are non-standard and specific to an individual customer's needs, including the scope of required work. Consequently, the cost of these services will depend on the actual time required to perform the service. Because of this uncertainty, the AER's proposed price cap formula for quoted services differs to that proposed for legacy metering, public lighting, and fee-based ancillary services. For quoted ancillary network services, the AER has added margin and tax components to the formula.

Australian Energy Regulator formula for alternative control services

The AER's F&A paper sets out the proposed price cap formulae to apply to:

- > Type 5 and Type 6 (legacy) metering, public lighting, and fee-based ancillary services
- > quoted services.

Essential Energy accepts the AER's proposed formula and will apply it to calculate the prices of these services during the 2024–29 regulatory control period. The formula is set out below.

Price cap formula to apply to legacy metering, public lighting, and ancillary services (fee based)

1. $\bar{p}_t^i \geq p_t^i$ where $i = 1, \dots, n$ and $t = 1, 2, 3, 4, 5$
2. $\bar{p}_t^i = \bar{p}_{t-1}^i \times (1 + \Delta CPI_t) \times (1 - X_t^i) + A_t^i$ where $i = 1, \dots, n$ and $t = 1, 2, 3, 4, 5$

Where:

Variable	Represents
t	the regulatory year, with $t = 1$ being the 2024–25 financial year
\bar{p}_t^i	the cap on the price of service 'i' for year t
p_t^i	the price of service 'i' in year t . The initial value is to be decided in the distribution determination.
\bar{p}_{t-1}^i	the cap on the price of service 'i' for year $t-1$
ΔCPI_t	the annual percentage change in the Australian Bureau of Statistics (ABS) Consumer Price Index All Groups, Weighted Average of Eight Capital Cities ³ from December in year $t-2$ to December in year $t-1$. For example, for the 2024–25 year, $t-2$ is December 2022 and $t-1$ is December 2023
X_t^i	the X factor for service 'i' in year t
A_t^i	the sum of any adjustments for service 'i' in year t

Applying the above basis of control to public lighting services, annual labour cost escalation will mainly affect public lighting maintenance costs, whereas other cost components will be driven by CPI only. Nevertheless, the X factor for public lighting will be determined by the AER as part of its final determination. Further details of our public lighting tariffs are provided in Essential Energy's public lighting attachments and supporting documents.

³ If the ABS ceases to publish the Consumer Price Index, the AER will determine the best available alternative index and use it in its stead.

Applying the above basis of control to ancillary services, annual escalation of charges will be due primarily to labour escalation. However, for some services other cost drivers will need to be reflected in the specific X factor.

Price cap formula to apply to quoted services

$$Price = Labour + Contractor Services + Materials + Margin + Tax$$

Where:

Variable	Represents
t	the regulatory year, with $t = 1$ being the 2024–25 year
$Price$	the charge paid by the customer
$Labour$	the labour costs directly incurred in the provision of the service, which may include labour on-costs, fleet on-costs and overheads. Labour is escalated annually by $(1 + \Delta CPI_t) \times (1 - X_t^i)$
ΔCPI_t	the annual percentage change in the Australian Bureau of Statistics (ABS) Consumer Price Index All Groups, Weighted Average of Eight Capital Cities ⁴ from December in year $t-2$ to December in year $t-1$. For example, for the 2022–23 year, $t-2$ is December 2020 and $t-1$ is December 2021
X_t^i	the X factor for service 'i' in year t . The X factors are to be decided in the distribution determination and will be based on the approach the distributor undertakes to develop its initial prices
$Contractor Services$	the costs associated with the use of external labour, including overheads and any direct costs incurred. The contracted services charge applies the rates under existing contractual arrangements. Direct costs incurred are passed on to the customer
$Materials$	the cost of materials directly incurred in the provision of the service, material storage, and logistic on-costs and overheads
$Margin$	definition to be decided in the final determination
Tax	definition to be decided in the final determination

Demonstrating compliance with price cap control mechanism

Attachments 12.05, 12.06, and 12.07, explain the basis of Essential Energy's proposed initial efficient prices for public lighting, legacy metering, and fee-based ancillary services for the first year of the 2024–29 regulatory control period.

The AER's proposed price cap formulae provide for these efficient starting prices to be escalated from one regulatory year to the next based on changes in the CPI and application of X and A factors. Our Annual Pricing Proposals from the second regulatory year of the 2024–29 regulatory control period onwards will include updated alternative control service prices escalated in accordance with the approved price cap formulae. Our published price lists will demonstrate compliance with the individual service price cap requirements.

In contrast, prices for quoted services are typically based on quantities of labour and materials, with the quantities dependent on the nature of the specific service. Prices for Essential Energy's quoted services during the 2024–29 regulatory control period will reflect the AER's approved labour and material costs, with escalation applied annually in line with the approved formula.

⁴ If the ABS ceases to publish the Consumer Price Index, the AER will determine the best available alternative index and use it in its stead.