22 February 2013

Mr. Warwick Anderson
General Manager – Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr. Anderson

NSW DNSP Submission on the Formulae for Control Mechanisms Discussion Paper

The NSW Distribution Network Service Providers, Ausgrid, Endeavour Energy and Essential Energy ('the NSW DNSPs') welcome the opportunity to provide this joint submission in response to the AER's *Control Mechanism formulae discussion paper – NSW and ACT February 2013 Revised* (the "discussion paper") as issued on 19 February 2013.

We welcome the invitation to provide comment on the proposed control mechanism formulae which may apply to the NSW DNSPs for the 2014-19 regulatory control period.

We offer comment on the mathematical operation of each formula and on some of the practical implications for standard and alternative control services. We are limited, however, in commenting on the practical implications of the formulae as they are highly dependent on details of the AER's final decisions on the forms of control that are yet to be issued. The following comments are provided for the AER's consideration of the operation of the formulae and should not be taken as providing endorsement of the AER's proposed classification of services or control mechanisms.

NSW Standard Control Services

The formulae presented in the AER's discussion paper for standard control services are:

$$MAR_t = \sum_{i=1}^{n} \sum_{j=1}^{m} p_{ij}^{t} q_{ij}^{t^*} \qquad (1)$$

for i=1,...,n and j=1,...,m and t=1,..,5

$$MAR_t = AR_t + I_t + T_t + B_t \qquad (2)$$

$$AR_t = AR_{t-1}(1+CPI)(1-X_t) \qquad (3)$$

In order to provide the key elements that the AER has listed in section 1.1 of the discussion paper, the NSW DNSPs request the AER to consider the following adjustments:

a) In equation (1), p_{ij}^{t} be updated to $p_{ij}^{t^*}$ to provide consistency with the AER's variable definitions; and
b) In equation (3), CPI be updated CPI_t to provide consistency with the AER's variable definitions.

We also request clarification on the following:

- We assume that the AR variable in the above revenue cap formula relates to the annual smoothed revenue requirement in the Post Tax Revenue Model. It would benefit external stakeholders if the AER clearly defines this term to avoid any confusion. We would also welcome clarification on the role of equation (1) as it does not appear in other revenue cap control mechanisms, such as NSW's transmission revenue cap;

- We assume that the variables B_t and T_t in equation 2 will operate in a similar manner to the current NSW transmission unders and overs account – clarification by the AER on this matter would be appreciated; and

- Equation 2 would be simplified considerably if the transitional adjustment (T_t) and the sum of the annual adjustments (B_t) were combined into a single annual adjustment variable. If the AER believes that this is not appropriate, it would benefit external stakeholders if the AER explains the rationale of separately accounting for these adjustments in the revenue cap formula;

- In order to avoid price shocks in the event of significant DUOS under-recovery, it would be prudent to adjust equation (1) to allow the flexibility of setting sum of p_{ij}^t * p_{ij}^t below the MAR. I.e. revising equation (1) to be:

$$MAR_t \geq \sum_{i=1}^{n} \sum_{j=1}^{m} p_{ij}^t q_{ij}^{t*} \qquad (1a)$$

- Without the proposed adjustments to equation (1) its role seems to be related to proving compliance with a revenue cap. It doesn't appear to add any further information to the operation of the control mechanism. We would welcome some more information on the role of equation (1) and why it does not appear in other revenue cap control mechanisms such as NSW's transmission revenue cap.

NSW alternative control services currently classified as alternative control (public lighting)

The control mechanism formulae presented in the AER's discussion paper relating to public lighting are:

$$\overline{p}_i^t \geq p_i^t \qquad (4) \qquad \text{for i=1,...,n and t=1,..,4,}$$

and

$$\overline{p}_i^t = \overline{p}_i^{t-1}(1 + CPI_t)(1 - X_t) \qquad (5)$$

Mathematically the formula results in a schedule of fixed prices, with a price path dependent on X_t.

However, the NSW distribution businesses note that the public lighting control mechanism currently in place has multiple components – a revenue cap for pre 2009 assets, a price control for post 2009 assets and a price control for maintenance services. There is also a residual charge which is applied to customers who choose to replace public lighting assets

before the end of their economic life. All these components form part of the current control mechanism and it is not apparent how a simple formula with one X factor can be effectively applied to all components.

In order to ensure flexibility in the public lighting control mechanism, or at the very least ensure the ability to maintain the existing control mechanism's structure, we suggest that variable X_t in equation (5) be modified to be X_t^i for i=1,...n, where i represents the tariffs in each component.

This will allow the formula to produce a revenue control and a price control which maintains appropriate price paths for each customer. This will not, however, address the control mechanism for the recovery of residual values and given the time available we would suggest the continued operation of the formula established in the current determination.

Finally, the prices for services in the transitional year are this period's final year prices escalated by CPI as per section 11.56.3(j) of the Rules as reproduced below:

> **Pricing of alternative control services**
>
> (j) The prices for *alternative control services* that are provided by an affected DNSP during the transitional regulatory control period must be the prices that applied as at the end of the current regulatory control period of the affected DNSP escalated by the *CPI* as at that time.

We believe that the formula should provide some method to adjust for any over or under recovery in the transitional year, should the AER's final determination result in a price path different from CPI in the transitional year. It is our interpretation that X_t^i can provide these adjustments for each service.

We would like to receive advice as to:

a) Whether the AER considers that an adjustment is necessary; and if so
b) The AER's intended approach to making this adjustment.

NSW alternative control services currently classified as standard control (metering services and 'non-network' services)

The control mechanism formulae presented in the AER's discussion paper for metering and 'non-network' services are:

$$\overline{p}_i^t \geq p_i^t \qquad (6)$$ for i=1,...,n and t=1,..,5

and

$$\overline{p}_i^t = \overline{p}_i^{t-1}(1+CPI_t)(1-X_t) \qquad (7)$$

Mathematically, applying the formula will result in a schedule of prices for each service.

However, similar to public lighting, adding the flexibility of allowing different X-factors for each service by adjusting X_t to X_t^i would allow prices to better reflect underlying cost and provide an appropriate revenue trajectory for each service over the period. The current

determination applies a different X-factor to each public lighting customer's fixed charge, or a revenue cap for pre 2009 assets.

Regarding metering services, the NSW DNSPs offer the following comments:

- It is difficult to comment on the appropriateness of the proposed formula as how the initial price is set and how this price relates to cost to serve is critical to the practical outcomes;

- The suitability of this formula is highly dependent on the definition of the 'services'. For example, a simple, averaged charge for metering services across all customers may cause undesirable outcomes. We are unable to comment further until there is more guidance provided by the AER on service groupings and until additional analysis has been performed; and

- Assuming only indicative prices are determined for these services in the transitional year, the formula should provide a mechanism to move from the transitional year prices to the subsequent year's prices. It should also allow some true-up amount to be smoothly recovered over the remaining years to account for any over or under recovery resulting from transitional year prices. We welcome clarification on this issue.

The NSW DNSPs would like to reiterate that it is difficult to offer comment beyond the mathematical operation of the formulae as the practical implications are dependent on factors which are unclear at this time. We welcome any further information the AER can provide.

If you would like to discuss this matter further, please contact Mr Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9249-3120 or via email at michael.martinson@endeavourenergy.com.au.

Yours sincerely,

Vince Graham
Chief Executive Officer
Ausgrid, Endeavour Energy and Essential Energy