



Proposed positions

**Framework and approach paper
Classification of services and control
mechanisms**

Energex and Ergon Energy 2010–15

July 2008

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Request for submissions

Interested parties are invited to make written submissions to the AER on the proposed positions set out in this paper by close of business 28 July 2008. Submissions can be sent electronically to [AERinquiry@aer.gov.au](mailto:AERinquiry@ aer.gov.au), or written submissions may be sent to:

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The AER prefers that all submissions be in an electronic format and publicly available to facilitate an informed, transparent and robust consultation process. Accordingly submissions will be treated as public documents and posted on the AER's website, www.aer.gov.au except and unless prior arrangements are made with the AER to treat the submission, or portions of it, as confidential.

Please direct enquiries about these proposed positions, or about lodging submissions, to the Network Regulation North Branch on (02) 6243 1233 or to the above email address.

Contents

Shortened forms	iv
1 Introduction	1
1.1 Nature of framework and approach paper	1
1.2 Transitional arrangements.....	2
1.3 Consultation on framework and approach paper	3
1.4 Proposed positions paper	3
2 Classification of services	4
2.1 Introduction.....	4
2.2 Requirements of the National Electricity Rules.....	4
2.2.1 Division of distribution services into direct control, negotiated and unregulated services	5
2.2.2 Division of direct control services into standard and alternative control services	6
2.3 Current arrangements.....	7
2.4 Proposals	9
2.4.1 Energex proposal	9
2.4.2 Ergon proposal	10
2.5 AER considerations	12
2.5.1 Grouping of distribution services.....	12
2.5.2 Considerations common to clauses 6.2.1 and 6.2.2	15
2.5.3 Division of distribution services	17
2.6 AER proposed position	33
2.6.1 Energex	33
2.6.2 Ergon.....	33
3 Form of control mechanism.....	35
3.1 Introduction.....	35
3.2 Requirements of the National Electricity Rules.....	35
3.2.1 Available control mechanisms	35
3.2.2 Deciding on a control mechanism.....	36
3.2.3 Pricing approvals	37
3.3 Current arrangements.....	37
3.3.1 Prescribed services.....	37
3.3.2 Excluded services.....	39
3.4 Proposals	40
3.4.1 Energex proposal	40
3.4.2 Ergon proposal	41
3.5 AER considerations	41
3.5.1 Control mechanism to apply to standard control services	41
3.5.2 Control mechanism to apply to alternative control services	48
3.6 AER proposed position	52
3.6.1 Energex	52
3.6.2 Ergon.....	52
Appendix A: The AER's proposed service groups and classification.....	54

Shortened forms

AARR	aggregate annual revenue requirement
ARR	annual revenue requirement
AER	Australian Energy Regulator
CPI	consumer price index
DNSP	Distribution Network Service Provider
DUOS	distribution use of system
EDSD	Electricity Distribution and Service Delivery Review
FRC	full retail competition
LNSP	Local Network Service Provider
MCE	Ministerial Council on Energy
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
NEL	National Electricity Law
NER	National Electricity Rules
PPS	pricing principles statement
QCA	Queensland Competition Authority
RAB	regulatory asset base
SCO	Standing Committee of Officials
WAPC	weighted average price cap

1 Introduction

The Australian Energy Regulator (AER) is responsible for the economic regulation of electricity distribution services in the National Electricity Market. The AER's functions and powers are set out in the National Electricity Law and the National Electricity Rules (NER).

Under chapter 6 of the NER, the AER may classify distribution services provided by a Distribution Network Service Provider (DNSP), and must make distribution determinations for each DNSP.

There are two DNSPs that operate in Queensland which are subject to economic regulation under chapter 6 of the NER:

- Energex—whose network covers mainly urban areas in south east Queensland
- Ergon Energy (Ergon)—whose network covers regional areas throughout Queensland.

Queensland distribution networks are currently subject to economic regulation by the Queensland jurisdictional regulator, the Queensland Competition Authority (QCA). The QCA released a distribution determination in April 2005 for the current regulatory period—1 July 2005 to 30 June 2010. The QCA is responsible for administering its 2005 distribution determination.

The AER will assume responsibility for the economic regulation of Energex and Ergon on 1 July 2010, with the commencement of its first distribution determination for those businesses. The AER is required to prepare for and make a distribution determination for the Queensland DNSPs for the next regulatory control period, 1 July 2010 to 30 June 2015. To this end, the AER commenced the process of making those distribution determinations on 1 April 2008. The process will continue to take place over the final two years of the current regulatory control period.

1.1 Nature of framework and approach paper

The AER must prepare and publish a framework and approach paper in anticipation of every distribution determination. The AER must commence preparation of and consultation on its framework and approach at least 2 years prior to the end of the current regulatory control period and complete its framework and approach paper 19 months prior to the end of a regulatory control period.

The aim of the framework and approach paper is to assist the DNSP prepare its regulatory proposal by:

- stating the form (or forms) of control to be applied by the distribution determination
- setting out the AER's likely approach (and its reasons for that likely approach) in the distribution determination to:
 - the classification of distribution services

- the application to the DNSP of a service target performance incentive scheme or schemes
- the application to the DNSP of an efficiency benefit sharing scheme or schemes
- the application to the DNSP of a demand management incentive scheme or schemes
- any other matters on which the AER thinks fit to give an indication of its likely approach.¹

1.2 Transitional arrangements

The NER sets out the revised arrangements for distribution regulation in chapter 6 but also includes transitional provisions in chapter 11. Clause 11.16 sets out transitional arrangements that are to apply to the Queensland DNSPs for the distribution determination that covers the regulatory control period 1 July 2010 to 30 June 2015.

Clause 11.16.6 provides that if either Energex or Ergon submit a proposal to the AER on or before 31 March 2008 on the classification of services and the form of control mechanisms to apply in the next regulatory control period, the AER is required to publish its framework and approach paper on these matters within five months of receiving the proposal. This transitional provision is unique to Queensland.

Due to the transitional arrangements, the framework and approach paper for Energex and Ergon is split into two stages:

- Framework and approach (stage 1)—classification of services and control mechanisms
- Framework and approach (stage 2)—application of schemes.

This framework and approach paper sets out the AER's proposed positions that are to apply to Energex and Ergon for the next regulatory control period, relating to:

- the classification of distribution services
- the form of control to apply to distribution services.

The AER has published a separate framework and approach paper setting its preliminary positions in relation to the application of schemes.² This preliminary positions paper was published on 30 June 2008 and is available on the AER's website.³

¹ NER, clause 6.8.1.

² AER, *Framework and approach paper—application of schemes Energex and Ergon Energy 2010–15*, Preliminary positions, 30 June 2008.

³ www.aer.gov.au.

1.3 Consultation on framework and approach paper

In order to consider common issues and for administrative simplicity the framework and approach papers for Energex and Ergon are being considered through a joint process. Where necessary, the AER will consider issues separately. The consultation process has been streamlined to allow for interested parties to respond to both or either proposal as necessary.

Due to transitional provision 11.16.6 the AER must complete and publish its framework and approach paper—classification of services and control mechanisms no later than 31 August 2008. The AER’s process for publishing the framework and approach paper—classification of services and form of control mechanisms is set out in table 1.1.

Table 1.1: Process for preparation of and consultation on framework and approach paper

Process	Date
Receipt of proposals	31 March 2008
Consultation on proposals	1 April – 28 April 2008
Publication of framework and approach proposed positions	7 July 2008
Submissions due on framework and approach positions paper	28 July 2008
Publication of framework and approach paper—classification of services and control mechanisms	31 August 2008

1.4 Proposed positions paper

Chapter 2 of this paper sets out the AER’s proposed position on the classification of distribution services and Chapter 3 sets out the form (or forms) of the control to be applied to the direct control services provided by Energex and Ergon.

In forming the proposed positions contained in this paper, the AER has considered Energex’s and Ergon’s respective proposals and Origin Energy’s submission on these proposals.

2 Classification of services

2.1 Introduction

This chapter sets out the AER's proposed position on the classification of Energex's and Ergon's distribution services for the 1 July 2010 to 30 June 2015 regulatory control period.

2.2 Requirements of the National Electricity Rules

A distribution determination made by the AER must include a decision on the classification of the services to be provided by the DNSP during the course of the relevant regulatory control period.⁴ In its framework and approach paper, the AER must set out its likely approach to the classification of distribution services in a DNSP's forthcoming distribution determination, and its reasons for that approach.⁵

The classification of services in the distribution determination must be as that set out in the framework and approach paper unless the AER considers that, in light of the DNSP's regulatory proposal and submissions received, there are good reasons for departing from the classifications.⁶

Where the NER require that a particular classification be assigned to a specified kind of distribution service, the service is to be classified in accordance with that requirement.⁷ In all other cases, the factors that will guide the AER's decision on service classification are discussed in the sections that follow. In classifying services that have previously been subject to regulation under the present or earlier legislation, the AER must act on the basis that:

- if the services have been previously classified, there should be no departure from a previous classification, and
- if there has been no classification, the classification should be consistent with the previously applicable regulatory approach, unless a different approach is clearly more appropriate.⁸

The distribution service classifications available under the NER are illustrated in the figure below.

⁴ NER, clause 6.12.1(1).

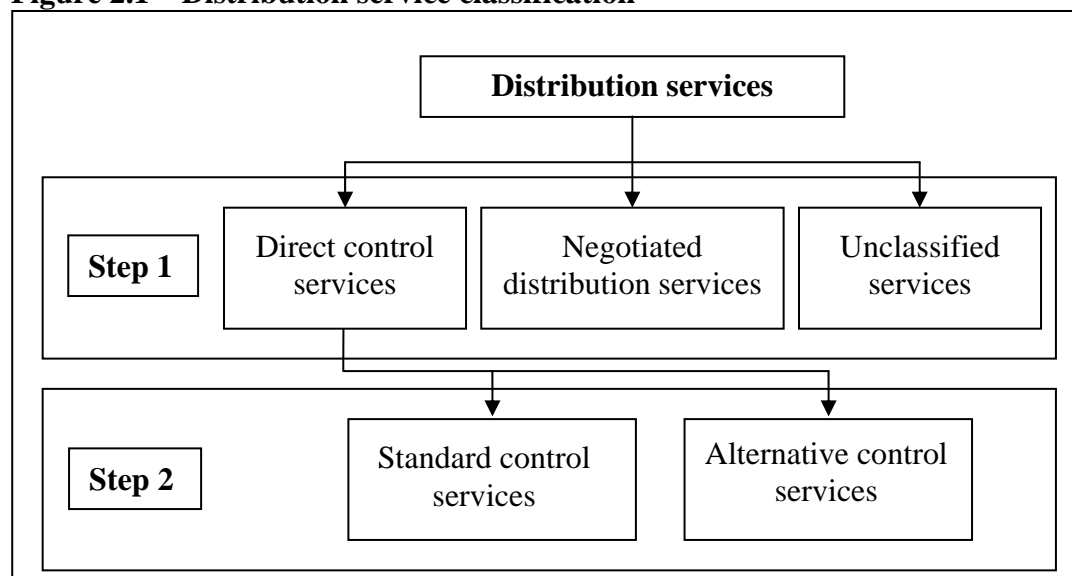
⁵ NER, clause 6.8.1(b)(1).

⁶ NER, clause 6.12.3(b).

⁷ NER, clause 6.2.1(e) and 6.2.2(e).

⁸ NER, clause 6.2.1(d).

Figure 2.1 – Distribution service classification



2.2.1 Division of distribution services into direct control, negotiated and unregulated services

Distribution services are defined in the NER, as services provided by means of, or in connection with, a distribution network, together with the connection assets associated with the distribution network, which are connected to another transmission or distribution system. Distribution services include services provided by means of, or in connection with, the apparatus, equipment, plant and buildings used to convey, and control the conveyance of, electricity to customers (whether wholesale or retail), excluding such services provided over a transmission network.⁹

The AER may classify a distribution service as either:

- a direct control service, or
- a negotiated distribution service.¹⁰

If the AER decides against classifying a distribution service the service is not regulated under the NER.¹¹

The AER may group distribution services together for the purpose of classification and a single classification made to the group applies to each service in the group.¹²

When classifying a distribution service as either a direct control service or negotiated service, the AER must have regard to:

- the form of regulation factors:

⁹ The definition of distribution services in this section paraphrases that contained in chapter ten of the NER. In the case of any inconsistency between the definition in this section and that in the NER, the definition in the NER prevails.

¹⁰ NER, clause 6.2.1(a).

¹¹ NER, clause 6.2.1.

¹² NER, clause 6.2.1(b).

- the presence and extent of any barriers to entry in a market for electricity network services
 - the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other electricity network service provided by the network service provider
 - the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other service provided by the network service provider in any other market
 - the extent to which any market power possessed by a network service provider is, or is likely to be, mitigated by any countervailing market power possessed by a network service user or prospective network service user
 - the presence and extent of any substitute, and the elasticity of demand, in a market for an electricity network service in which a network service provider provides that service
 - the presence and extent of any substitute for, and the elasticity of demand in a market for, electricity or gas (as the case may be), and
 - the extent to which there is information available to a prospective network service user or network service user, and whether that information is adequate, to enable the prospective network service user or network service user to negotiate on an informed basis with a network service provider for the provision of an electricity network service to them by the network service provider.¹³
- the form of regulation (if any) previously applicable to the relevant service or services and, in particular, any previous classification under the present system of classification or under the present regulatory system (as the case requires)
 - the desirability of consistency in the form of regulation for similar services (both within and beyond the relevant jurisdiction), and
 - any other relevant factor.¹⁴

2.2.2 Division of direct control services into standard and alternative control services

The AER must further classify each direct control service as either:

- a standard control service, or
- an alternative control service.¹⁵

In classifying a direct control service as either a standard control service or an alternative control service, the AER must have regard to:

- the potential for development of competition in the relevant market and how the classification might influence that potential

¹³ NEL, section 2F.

¹⁴ NER, clause 6.2.1(c).

¹⁵ NER, clause 6.2.2(a).

- the possible effects of the classification on administrative costs of the AER, the DNSP and users or potential users
- the regulatory approach (if any) applicable to the relevant service immediately before the commencement of the distribution determination for which the classification is made
- the desirability of a consistent regulatory approach to similar services (both within and beyond the relevant jurisdiction)
- the extent that costs of providing the relevant service are directly attributable to the customer to whom the service is provided, and
- any other relevant factor.¹⁶

2.3 Current arrangements

The QCA's approach to classifying services was set out in its determination of prescribed services.¹⁷ The QCA adopted the following approach:

- all services performed by a DNSP that are associated with or ancillary to, access to the network for the supply of electricity were prescribed services
- DNSPs or interested parties could apply to the QCA to have a specific service treated as an excluded service where it was demonstrated that the market for such services were subject to potential—if not—actual competition.¹⁸

A fixed revenue cap form of regulation was applied to prescribed services. In its 2001 and 2005 distribution determinations the QCA defined a service as a prescribed distribution service if it was:

- provided by a distribution system and
- associated with the conveyance of electricity through the distribution system.¹⁹

Based on this definition the list of prescribed distribution services used in the QCA's 2005 distribution determination were as follows:²⁰

- services associated with running the distribution network, including
 - network operations and maintenance
 - DNSP funded construction of distribution network assets
 - network switching and testing
 - network planning and demand management
 - emergency services

¹⁶ NER, clause 6.2.2(c).

¹⁷ QCA, *Electricity Distribution: Determination of Prescribed Services*, September 2000.

¹⁸ *ibid.*, p. 8.

¹⁹ QCA, *Regulation of Electricity Distribution*, Final Determination, April 2005, p .55.

²⁰ *ibid.*, pp. 54–55.

- connection services
- customer support services
 - call centres
 - network claim processing
 - network billing
 - non-contestable metering services
 - public lighting construction and maintenance
 - stand-by supply
 - recoverable works
 - subdivision fees
 - temporary builders' services.

In 2007, the QCA noted DNSP concerns that there could be a significant increase in the demand for non-DUOS services and consequential increases in non-DUOS revenue due to the sale of Energex's and much of Ergon's retail business and the introduction of full retail competition. It noted that—in the context of the fixed revenue cap form of control applied under the regulatory determination—this anticipated growth could potentially result in DNSPs artificially holding DUOS prices low resulting in non-DUOS services cross subsidising DUOS services. It noted that such an outcome would be an unintended and undesirable consequence.²¹

The AER is not aware of an explicit definition of non-DUOS services.²² However, the QCA's 2007 determination of prescribed services stated:

In its prescribed services determination, the Authority noted (at Appendix B) a range of services identified in the National Electricity Code (subsequent amended to the NER) as being activities the jurisdictional regulator might define as excluded services. This list includes many activities that form the non-DUOS services now identified by the distributors where demand is likely to substantially increase. ...In other jurisdictions, similar non-DUOS services are already treated as excluded services or otherwise subjected to a lighter form of regulation than DUOS services.²³

The services listed in appendix B, as possible excluded services included:

²¹ QCA, *Amendment Electricity Distribution: Determination of Prescribed Services*, Final Decision, August 2007.

²² QCA appears not to have explicitly identified how distribution services are classified as non-DUOS services, but its reference to non-DUOS services as including most of the services that were mentioned in the National Electricity Code as potential excluded services suggest that non-DUOS services in this instance includes services provided at a higher standard than required under any applicable statutory obligation.

²³ QCA, *Amendment to Electricity Distribution: Determination of Prescribed Services*, Final Decision, August 2007, p. 1.

- new connection and augmentation of existing connection to the distribution network
- services (including metering, electric lines or electrical plant) for the specific benefit of any network user requested by that network user and not made available by the DNSP as a normal part of prescribed distribution services to all customers
- charges for connection points requiring more than the least overall cost, technically acceptable assets
- charges for public lighting
- charges for reserve and duplicate supply.²⁴

In response to the potential inefficient pricing outcome, the QCA in August 2007 amended its determination of prescribed services. This amendment enabled the QCA to deem a service as excluded, having regard to the criteria set out in clause 6.2.4(a) of the NER (applicable at that time) and choose to apply a form of “light handed” regulation to such excluded services, although a contestable market could not be demonstrated.²⁵

Consistent with its August 2007 amendment to the prescribed services determination, the QCA in December 2007 determined that all non-DUOS services that were classified as prescribed services were to be reclassified as excluded services. The QCA recognised the need to make an adjustment to the existing fixed revenue caps and noted that in doing so it would ensure that any such revenues reflected the full costs associated with the provision of those services.²⁶ The regulation of prices for excluded services consists of:

- application of broad pricing principles and submission of pricing principles statements by the distributors
- annual price approval
- annual reporting of excluded services revenue and prices.²⁷

2.4 Proposals

Pursuant to clause 11.16.6 of the NER, Energex and Ergon submitted classification of services and control mechanism proposals to the AER on 31 March 2008.²⁸

2.4.1 Energex proposal

Energex proposed 11 distribution service groups and classified all of them as standard control services. It also proposed a group of negotiated distribution services in relation to the provision of subtransmission connection services. Energex’s proposed distribution service groupings are shown in table 2.1.

²⁴ QCA, *Electricity Distribution: Determination of Prescribed Services*, Final Determination, September 2000, appendix B.

²⁵ *ibid.*, pp. 3–5.

²⁶ QCA, *Electricity Distribution: Review of Excluded Distribution Services*, December 2007.

²⁷ *ibid.*, p. 6.

²⁸ Energex, *Service Classification and Control Mechanisms for Distribution Services Proposal to the Australian Energy Regulator under clause 11.16.6 of the National Electricity Rule*, March 2008
Ergon, *Proposal: Service Classification and Control Mechanism*, March 2008.

Table 2.1 Service classifications proposed by Energex

Group	Proposed service group title	Proposed classification
1	Network services	Standard control services
2	Connection services (excluding subtransmission connection services)	Standard control services
3	Customer services	Standard control services
4	De-energisation and re-energisation	Standard control services
5	Additions and alterations	Standard control services
6	Ancillary metering services	Standard control services
7	Supplementary services	Standard control services
8	Enhanced services	Standard control services
9	Quoted services	Standard control services
10	Temporary supply services	Standard control services
11	Subtransmission connection services	Negotiated distribution service

Source: Energex proposal.

Additionally, Energex provided a list of services that it considered should be unregulated.²⁹ These services were:

- provision of electricity industry training to external parties
- pole and duct rentals for non-electricity related purposes
- provision of watchman lights
- high load escorts and coverage of low voltage mains
- provision of contestable metering services—types 1–4
- provision of contracting services to other network service providers
- non-distribution services at customer requests
- street lighting.

2.4.2 Ergon proposal

Ergon proposed 10 distribution service groups and classified all of them as standard control services. It did not propose a separate group for subtransmission connection assets. Ergon’s proposed distribution service groupings are shown in table 2.2.

²⁹ Energex proposal, appendix B.

Table 2.2 Service classifications proposed by Ergon

Group	Proposed service group title	Proposed classification
1	Network services	Standard control services
2	Connection services	Standard control services
3	Customer services	Standard control services
4	De-energisation and re-energisation	Standard control services
5	Additions and alterations	Standard control services
6	Ancillary metering services	Standard control services
7	Supplementary services	Standard control services
8	Enhanced services	Standard control services
9	Quoted services	Standard control services
10	Temporary supply services	Standard control services

Source: Ergon proposal

Additionally, Ergon provided a list of services that it considered should be unregulated. These services were:

- provision of watchman lights
- high load escorts and coverage of low voltage mains
- meter data agent—collecting data for metering types 1–4
- non-distribution services at customer requests
- street lighting
- unregulated services provided by Ergon group companies including:
 - ownership and operation of 33 isolated system generators
 - ownership and operation of 34 isolated system networks
 - ownership and operation of a network in the North West minerals province
 - undersea cable
 - works for Powerlink
 - sale of remote area power stations and solar PV systems
 - non-competing retail entity selling on Queensland Government notified prices
 - wholesale fibre telecommunications services
 - IT services supporting Energex and Ergon businesses.

2.5 AER considerations

The AER's assessment of common issues has been undertaken jointly, for administrative simplicity and in order to streamline the process. The AER's proposed classification of services for Energex and Ergon are separately set out in section 2.6 and 2.7 respectively.

This section sets out the AER's considerations on the grouping of distribution services and the assessment of the NER factors set out in clauses 6.2.1 and 6.2.2.

2.5.1 Grouping of distribution services

Energex's and Ergon's proposed classification of services is based on service groups. As shown in tables 2.1 and 2.2, Energex has proposed 11 groups and Ergon have proposed 10. Except for subtransmission connection services proposed as a separate group by Energex, all other service groups are common to both businesses. Additionally, although not listed as a separate group, both businesses have also identified a list of services that they consider should be unregulated.

The AER considers that grouping services and applying a classification for each service is in accordance with the NER and is a reasonable approach to follow in making this classification decision for Energex and Ergon.³⁰

The AER's review confirms that the services described in each of Energex's and Ergon's service groups constitute distribution services. However, a review of the proposed grouping indicates that the service groups can be rationalised based on the nature of the activity and the impact of the service. This results in the service groups being categorised as a DNSP's core business and *other* services. The core businesses of a DNSP are in essence the DUOS service and as defined in the NER is a service provided to a distribution network user for use of the distribution network for the conveyance of electricity that can be reasonably allocated on a locational and/or voltage basis. The *other* services are those for which, generally, customer specific charges can be levied.

The AER considers that its re-grouping of the services allows for a better allocation of services based on nature and impact. This re-grouping has accounted for services that are closely related to each other, whether customer specific charges can be made and the available forms of control under the NER.

For the reasons discussed above and in section 2.5.1.1 below, the AER has rationalised Energex's and Ergon's service groupings into six groups, these are:

- network services
- connection services
- metering services
- quoted services
- compensable services
- unregulated services.

³⁰ NER, clause 6.2.1(b).

Network, connection and metering services are the core business of a DNSP. The AER considers that *other* services are better categorised as quoted and compensable services. Appendix A sets out the AER’s proposed service groupings and compares Energex’s and Ergon’s proposed groupings. The following section discusses the reasons for the re-allocations of services to the new service groups proposed by the AER and should be read in conjunction with appendix A.

2.5.1.1 Comparison of Energex’s and Ergon’s groupings with the AER’s proposed groupings

This section identifies the re-allocations of Energex’s and Ergon’s proposed services to the AER’s proposed service groupings and discusses the reasons for the changes.

Network services

Energex and Ergon included emergency responses and administrative support services within the customer services group. The AER considers that these two services are network services. The reasons are discussed under the customer services heading below.

Connection services

Energex and Ergon included installation inspection services within the customer services group and grouped de-energisation and re-energisation services as a separate *other* services group. The AER considers that these services are connection services. The reasons are discussed under the customer services heading and section 2.5.3.2.

Energex and Ergon proposed that the provision of type 5–7 metering services be included in the connection services group. Generally, the installation service is provided when a new connection is made and therefore would also fall within a connection service. However, given that the AER has rationalised the groups to include a separate metering services group this service has been allocated to that group.

Customer services

Energex’s and Ergon’s proposed customer services group included functions associated with call centres, network billing and claims, installation inspection services and metering services. The DNSPs noted that customer services include a range of service obligations under statutory instruments, for which no customer specific charges can be applied.

Origin Energy (Origin) submitted that it is not appropriate to decouple customer services from network services or create independent pricing for customer services as these are business costs that cannot exist without the network services.³¹

The call centre function could be allocated to at least three service groups as it is associated with at least three service groups. That is:

- network services—emergency response to faults and outages

³¹ Origin, *Queensland Distributors’ Proposals for Service Classification and Control Mechanisms*, 30 April 2008, p. 5.

- connection services—arranging connections meter installations, de-energisation, re-energisation
- customer services—arranging special meter read, hot water control alternations, inspections and meter tests.

It is arguable that the key driver for the costs associated with the establishment and operation of the call centre is the emergency response function. This function cannot be decoupled from the network service. Therefore, it is appropriate to consider the call centre function as an emergency response and allocate it to the network services group.

Similarly, the AER considers that the administrative support services is an integral part of the network service and all administrative support functions should be included in network services. Network billing and claim management have been specifically identified by Energex and Ergon within its customer services group. The AER considers that this function is one of the many components of administrative overheads. Therefore, network billing and claim management functions should be included in the administrative support services which are included in the network services group.

Installation inspections were included as customer services by Energex and Ergon. Generally, installation inspections are undertaken in relation to connecting new installations or checking whether existing installations may continue to be connected. Therefore the main purpose of these services is connection services. The AER considers that it is appropriate to allocate installation inspection services to connection services rather than to customer services.

Based on the re-allocations discussed, the remaining services in the customer services group relate entirely to metering. Therefore, the AER considers that these services should be a separate group named metering services.

Metering services

Energex and Ergon did not propose a separate metering service group. However, as discussed above the remaining customer services have been regrouped as metering services and type 5-7 metering services have been removed from the connection services group and allocated to the metering services group.

Other services

Energex's and Ergon's distribution service groups 4 to 10 as shown in tables 2.1 and 2.2 are common to both businesses. The AER considers that all these *other* services are more appropriately grouped on the basis of whether:

- the DNSP is required to quote a price before the user decides on whether to proceed with the service such as additions and alterations which are at a request of a customer that require modifications to existing connection assets
- costs have been imposed on the DNSP without its foreknowledge or approval and for which it may seek to recover payment after the event such as repair or replacement of shared network assets following interference such as vandalism or a vehicle accident.

On this basis the AER has re-grouped the DNSPs proposed service groups 4 to 10 into:

- quoted services—prices can be quoted prior to undertaking the work
- compensable services—costs are imposed without foreknowledge of the DNSP.

De-energisation and re-energisation services

As mentioned above, de-energisation and re-energisation services group (the DNSPs proposed service group 4) is moved to the connection services group.

Subtransmission services

Energex proposed a separate service group for subtransmission connection services, whereas Ergon did not. For the reasons discussed in 2.5.3.2 the AER has included subtransmission connection services in the quoted services group.

Unregulated services

The AER's assessment of unregulated services is set out in section 2.5.3.6.

Street lighting

Energex and Ergon proposed that street lighting should be unregulated. For the reasons discussed in section 2.5.3.5 the AER has included this service in the quoted service group.

High load escorts and coverage of low voltage mains

Energex and Ergon proposed that these services should be unregulated. For the reasons discussed in section 2.5.3.6 the AER has included these services in the quoted services group. These services are in essence services that are in nature associated with safety. Therefore, these two services fit into the description of safety services in the quoted services group.

2.5.2 Considerations common to clauses 6.2.1 and 6.2.2

As shown in figure 2.1, the classification of distribution services involves in the first instance a decision as to whether the distribution service is either a direct control, negotiated or unclassified service. Then, if classified as a direct control service, such a service has to be further classified as either a standard control or alternative control service. This section discusses the clauses in the NER that are common to both steps of the assessment.

2.5.2.1 Requirement to classify a service of a specified kind in a particular way

Under both steps of classification, if the NER requires a service to be classified in a certain way, then such a service has to be classified in accordance with that requirement.³² This requirement overrides all other considerations in chapter six of the NER.³³ The NER does not require a distribution service provided by Energex or Ergon to be classified in a particular way.

³² NER, clause 6.2.1(e) and 6.2.2(e).

³³ For example, NER, chapter 11, appendix 1, *Form in which chapter 6 applies to NSW and ACT for the regulatory control period 2009–14*, clause 6.2.3B and 6.2.3C specify the applicable classification of services for NSW and ACT distribution businesses.

2.5.2.2 Presumption in favour of prior classification or applicable regulatory approach

In classifying distribution services that have previously been regulated, unless a different classification is clearly more appropriate there is a presumption of not departing from a previous classification (if the services have been previously classified); and if there has been no previous classification—the classification should be consistent with the previously applicable regulatory approach.³⁴

The AER's assessment then involves the analysis of whether a different classification is clearly more appropriate, having had regard to the factors in the NER.

The NER classifications are new terms. Distribution services are currently classified as prescribed services or excluded services. The Ministerial Council on Energy Standing Committee of Officials envisaged transition from prescribed distribution services to standard control services, and from those services currently classified as excluded services to alternative control services where a direct price control was in place. They also envisaged a transition to negotiated services where the price may be set in an access dispute.³⁵

Energex's and Ergon's distribution services have not been previously classified according to the new classifications under the NER. Therefore, it is the presumption in favour of classification consistent with the previously applicable regulatory approach that is the relevant consideration.

2.5.2.3 Desirability of consistency both within and beyond the relevant jurisdiction

The AER recognises that consistent classifications for similar services between jurisdictions are a desirable outcome.³⁶ However, it notes that jurisdictional regulators have not adopted consistent service classifications for similar services across the NEM. Therefore, the presumption of consistency with current classifications has to be balanced with the desirability for consistency between jurisdictions. Although, these distinct objectives are not necessarily mutually exclusive, in the first round of regulatory determinations the AER will place more weight on the presumption of consistency with the current classification.

However, the AER considers that consistency within a jurisdiction is important and will give this factor the necessary weight in considerations. Where any inconsistency within a jurisdiction is justified the AER will set out reasons for the divergence. The AER's proposed positions for Energex and Ergon do not result in any inconsistent classification within the Queensland jurisdiction.

The AER recognises that different classifications for similar services between jurisdictions may be applicable due to different circumstances across the NEM.

³⁴ NER, clause 6.2.1(d) and 6.2.2(d).

³⁵ MCE, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution*, Explanatory material, April 2007, p. 8.

³⁶ NER, clause 6.2.1(c)(3) and 6.2.2(c)(4).

2.5.3 Division of distribution services

As stated above, the presumption is that Energex's and Ergon's distribution services will be classified consistent with the current classification unless a different classification is clearly more appropriate. This section analyses whether a different classification is clearly more appropriate.

2.5.3.1 Network services

A network service is defined in the NER as a distribution service associated with the conveyance, and controlling the conveyance, of electricity through the network³⁷.

Network services predominantly relate to services provided by the 'shared' network used to service all network users connected to it. Network services are delivered through the operation of assets such as substations, lines, communication and control systems, and involve activities such as repairs, maintenance, vegetation clearing and asset replacement, asset refurbishment and asset construction services that are not connection services.

Energex and Ergon proposed that network services be classified as standard control services. These services are currently classified as prescribed distribution services and are subject to direct regulatory control via a fixed revenue cap form of regulation.³⁸

Energex and Ergon noted high legislative barriers to entry including the *Electricity Act 1994* (Qld) which places obligations on the distribution entity in relation to operating, maintaining (including repair and replace as necessary) and protecting its supply network to ensure safe reliable and economic connection and supply to customers.³⁹ They also noted that legislation obliges distribution entities to provide as far as technically and economically practicable, network services on fair and reasonable terms.⁴⁰ The AER notes that section 88A of the *Electricity Act 1994* (Qld) prohibits the operation of a distribution network unless authorised. The prohibition on operating a distribution network without a licence indicates a high barrier to entry.

The significant capital costs of entry, and the economies of scale and scope available to the incumbents, are highly likely to make duplication of the shared networks by an alternative service provider both commercially unviable and economically inefficient. The economies of scale and scope available are also likely to prevent augmentation of the network being competitively provided by an alternative provider.

The AER considers that significant barriers to entry exist for the provision of network services limiting the potential for these services to be competitively supplied by providers other than Energex and Ergon.⁴¹

³⁷ NER, chapter 10.

³⁸ QCA's classification of network services does not explicitly identify how network services above the minimum standard becomes excluded services but its reference to non-DUOS services as including most of the services that were mentioned in the National Electricity Code as potential excluded services suggest that network services in this instance referred to services provided at a standard not higher than what is required under any applicable statutory obligation.

³⁹ *Electricity Act 1994* (Qld), section 42.

⁴⁰ *ibid.*, section 44.

⁴¹ NER, clause 6.2.1(c)(1).

Substitutes for using these shared network services are few, and are likely limited to embedded generation, switching the energy source to gas, or switching the connection point to the transmission network. These are unlikely to be viable commercial options in most instances for small customers and also unlikely even for existing large customers.⁴²

These factors contribute to the likely outcome of Energex and Ergon possessing significant market power in the provision of network services and consequently requiring a direct form of price control over the provision of network services. Even a high degree of information available to users would not neutralise the lack of countervailing power caused by these other factors.⁴³

Whilst there are few substitutes for ‘standard’ network services, ‘non-standard’ network services are likely to be substitutable in that customers could substitute these services for standard network services.⁴⁴ The AER notes that the regulatory approach currently applicable to ETSA Utilities in South Australia is based around the ‘non-standard’ services being classified as excluded services and regulated under an approach which includes a negotiate-arbitrate framework.⁴⁵

The AER recognises that, due to the presumption in favour of maintaining the prior approach, consistency in the classification of similar services across the jurisdictions in the first round of regulatory determinations by the AER may not be possible. Energex and Ergon proposed that network services be classified as direct control services. Therefore, in this instance there is no inconsistency in classification of network services within the Queensland jurisdiction.⁴⁶

The assessment of the form of regulation factors indicates that network services exhibit significant market power. Therefore, currently, network services have no potential for competition to develop.⁴⁷ In addition, the costs associated with providing network services are not directly attributable to the customer to whom the service is provided.⁴⁸

The effect of the classification on administration costs will be dependent on the control mechanism that applies to it. It is generally assumed that control mechanisms based on the building block approach will involve higher administrative costs than those that are not.. In this instance, given the lack of the potential for development of competition and costs not being directly attributable to the user, the AER considers that a classification that may attract a higher administrative cost is warranted.⁴⁹

The AER’s assessment of the NER factors indicates that Energex’s and Ergon’s network services should be classified in a manner which is consistent with the

⁴² *ibid.*

⁴³ *ibid.*

⁴⁴ *ibid.*

⁴⁵ AER, *Framework and approach paper ETSA Utilities 2010–15*, Preliminary positions, 30 June 2008, p. 13.

⁴⁶ NER, clause 6.2.1(c)(3).

⁴⁷ NER, clause 6.2.2(c)(1).

⁴⁸ NER, clause 6.2.2(c)(5).

⁴⁹ NER, clause 6.2.2(c)(2).

previously applicable regulatory approach, as no other classification is clearly more appropriate.

Having considered the factors listed in the relevant NER clauses, the AER determines that that network services should be classified as standard control services.

2.5.3.2 Connection services

The NER defines connection services as consisting of entry services and exit services. An entry service is a service provided to serve a generator or group of generators, or a network service provider or group of network service providers, at a single connection point. An exit service is a service provided to serve a distribution customer or a group of distribution customers, or a network service provider or group of network service providers, at a single connection point.⁵⁰

Energex's and Ergon's proposals stated that connection services relate to building individual customers' connection assets as well as connecting those connection assets to the distribution network.⁵¹ Both businesses noted that these connection services include building connection assets and type 5–7 metering installations. Energex made a distinction between subtransmission connection services and other connection services whereas Ergon did not.

Connection services are currently classified as prescribed distribution services and are subject to direct regulatory control via a fixed revenue cap control mechanism.⁵² The AER understands that the QCA's classification applied to all aspects of connection services including design and construction of connection assets and types 5–7 metering installations.⁵³

Energex and Ergon proposed de-energisation and re-energisation services as a separate distribution service group and noted that these services relate to the disconnection and re-connection at customers' existing premises either at customer requests or on its own volition. Further the DNSPs noted that de-energisation and re-energisation occur at the customer's connection point. The AER considers that these services whether on customer request or DNSP initiated are directly related to connection services and in particular to the physical connection or disconnection of connection assets. Therefore, a separate distribution service group is not warranted and the AER will consider de-energisation and re-energisation services as a connection service.

Section 88A of the *Electricity Act 1994* (Qld) states that a person must not supply electricity using a supply network unless the person is the holder of a distribution authority. The AER considers that this provides a legislative barrier that prohibits

⁵⁰ NER, chapter 10.

⁵¹ Energex proposal, p. 27.
Ergon proposal, p. 28.

⁵² QCA's classification of connection services does not explicitly identify how services above the minimum standard become excluded services, but its reference to non-DUOS services as including most of the services that were mentioned in the National Electricity Code as potential excluded services suggest that connection services in this instance refer to services provided at a standard not higher than what is required under any applicable statutory obligation.

⁵³ The AER's rationalisation of the proposed service groups resulted in type 5–7 metering installations being transferred to the metering services group.

others from physically connecting new assets to Energex's and Ergon's respective networks (as opposed to the design and construction of new assets) limiting the potential for these services to be competitively supplied by providers other than Energex and Ergon.⁵⁴

Although, the AER considers that significant barriers to entry do not exist for the construction of connection assets, there is an exception to this in relation to small service connections.⁵⁵ This is because, to enable third parties to provide small service connections a suitable scheme would need to be put in place in Queensland to train and authorise persons to provide this service. Energex and Ergon informed the AER that such an accreditation scheme does not exist at the current time. At this point in time, the AER considers that the lack of an accreditation scheme acts as a limited barrier to entry and therefore, construction of small service connections should continue as a connection service.⁵⁶

Substitutes for using connection services (except for design and construction of connection assets) are few, and are likely limited to instances where embedded generation, switching the energy source to gas, or switching the connection point to the transmission network are available. These are unlikely to be viable commercial options in most instances for small customers and also unlikely even for existing large customers.⁵⁷

These factors contribute to the likely outcome of Energex and Ergon possessing significant market power in the provision of connection services (except for design and construction of connection assets) and consequently requiring a direct form of price control over the provision of connection services. Even the possession of a high degree of information to users would not address the lack of countervailing power caused by these other factors.⁵⁸

The assessment of the form of regulation factors indicates that certain connection services (except for the design and construction of connection assets) exhibit significant market power. Therefore, certain connection services (except for the design and construction of connection assets) at this time have limited potential for competition to develop.⁵⁹ Further, costs associated with providing these services are not directly attributable to the customer to whom the service is provided.

The AER's assessment of the NER factors indicates that Energex's and Ergon's connection services (except for the design and construction of connection assets)

⁵⁴ NER, clause 6.2.1(c)(1).

⁵⁵ A small customer is defined in the NEL as a customer whose consumption of electricity is less than 160MWh per annum.

⁵⁶ The AER understands that such accreditation schemes are in place in other jurisdictions of the NEM, for example in NSW. Such schemes allow third parties to competitively provide the major cost item of the connection service (materials, equipment and labour) whilst the DNSP is only required to perform low cost tasks at the same time as commissioning the metering and load control devices. Such a scheme will assist in handling high volumes of work and also allow for the timeliness of the connection to be the responsibility of competitive providers.

⁵⁷ NER, clause 6.2.1(c)(1).

⁵⁸ *ibid.*

⁵⁹ NER, clause 6.2.2(c)(1).

should be classified in a manner which is consistent with the previously applicable regulatory approach as no other classification is clearly more appropriate.

Having considered the factors listed in the relevant NER clauses, the AER's proposed position is that connection services (except for design and construction of connection assets) should be classified as standard control services.

Design and construction of connection assets

The AER does not consider that, legislative barriers exist in Queensland that prevent third parties from designing and constructing connection assets to be connected to the network. This includes the design and constructing of connection assets of both subtransmission connection services down to small service connections.

Ergon advised the AER that it has introduced arrangements for electrical works on residential and industrial/commercial subdivisions to be designed and built by parties other than itself and that a process and charging scheme is in place for checking designs and auditing the infrastructure that is built. It also noted that the current scheme is restricted to electrical assets on private land and that based on experience, it believes that it is unlikely that customers wish to build electrical assets (un-energised) on public land.⁶⁰ Energex also advised that electrical works on residential and industrial/commercial subdivisions could be designed and built by parties other than itself and noted that others may be able to undertake construction of electrical assets that do not need energisation during construction.⁶¹

These responses support the AER position that there are no legislative barriers for third parties to construct de-energised connection assets and the legislative barriers only relate to the physical connecting of connection assets to the shared network (i.e. energisation).

In discussions, Energex and Ergon raised concerns about issues related to their obligations to maintain technical standards. The AER considers that a contestable market for the design and construction of connection assets would not prevent the DNSPs from exercising their responsibilities for maintaining the integrity of the network. For example, working in close proximity to energised assets, having access to energised assets or achieving all technical standards can be resolved by the provision of safety services and setting technical standards as well as checking completed works. The AER notes that the establishment and or enforcement of technical standards that rely solely on a DNSP's approval are not generally viewed as an appropriate function for the regulated entity to undertake.

Energex stated that connection services provided to large energy users at subtransmission levels (voltages 33kV and above) should be classified as a negotiated distribution service. It noted that these customers are generally sufficiently capable of negotiating with a DNSP about the technical and commercial aspects of connections. It also noted that the Electricity Distribution and Service Delivery review (EDSD) recommended that consideration should be given on how connection services can be better managed during the regulatory period. Energex considers that classification of

⁶⁰ Ergon, response to information request, confidential, submitted 6 June 2008.

⁶¹ Energex, response to information request, confidential, submitted 11 June 2008.

subtransmission services as negotiated distribution services will provide the ability to manage large connections.⁶²

In response to the AER, Energex also stated that it believed that there is an active market of experienced consultant/contractors in South East Queensland with the required technical expertise to provide design and construction of subtransmission network and noted that currently it has a panel of five contractors that can be engaged to assist Energex.⁶³ Energex is concerned that major works that come forward without warning could lead to limitations on funds and resources and considers that it should be allowed to negotiate terms that compensate it for time and resource constraints. The AER notes that such resource and time constraints result mainly if the DNSP is the monopoly service provider relating to the design and construction of connection assets including subtransmission assets. If the market for design and construction of connection assets including subtransmission assets were open to competition the concerns relating to better managing connection services will be alleviated to some extent. The AER understands that other jurisdictions in the NEM for example NSW and Victoria allow this aspect of connection services to be provided by third parties in a competitive market.

Origin stated that in order for the AER to classify subtransmission services outside of direct control there should be evidence of reduced market power. It noted that if Energex can demonstrate a contestable market the AER could consider a light handed regulatory approach via an alternative control classification. Origin was also concerned that a premature move to a negotiated distribution service classification may create less competition and result in an inefficient market. Further, it noted that an alternative control classification would better manage the transition to a negotiated distribution service classification and enable Energex to demonstrate a competitive market.⁶⁴

The AER's assessment indicates that there are no legislative barriers to entry for design and construction of connection assets. Enquiries made by the AER suggest that there are third parties in Queensland that, given the opportunity, can competitively provide this service. The availability of alternate providers indicates that users have viable substitutes. These factors indicate that although this service has not yet been made open to competition by the DNSPs there is potential for competition to develop in the market for design and constructing of connection assets. The other factors in clause 6.2.1(c)(1) of the NER do not indicate that this potential for competition to develop is inhibited. Further, the costs associated with providing this service is directly attributable to the customer to whom the service is provided.⁶⁵

Currently, design and constructing of connection assets including subtransmission connection assets are prescribed distribution services (as one aspect of connection services). The NER presumption of consistency with current classification requires

⁶² Energex proposal, pp. 27 and 44.

⁶³ Energex, response to information request, confidential, submitted 11 June 2008.

⁶⁴ Origin, *Queensland Distributors' Proposals for Service Classification and Control Mechanisms*, 30 April 2008, p. 4.

⁶⁵ NER, clause 6.2.2(c)(5).

the AER to apply a standard control service classification unless another is clearly more appropriate.⁶⁶

The AER notes Origin's submission on the potential for inefficient outcomes if competition does not eventuate. Based on the available information, the AER considers that a move to a negotiated distribution service is a significant change from the current regulatory approach, particularly given that the depth of competition in the relevant market is unclear. As discussed above, the AER is satisfied that there is potential for competition to develop and costs can be directly attributable to the relevant user. Therefore, an alternative control service classification is clearly more appropriate for design and construction of connections assets.

The AER's proposed position is to classify design and construction of connection assets including subtransmission connection services as an alternative control service.

2.5.3.3 Metering services

Each connection point in the NEM must have a metering installation.⁶⁷ Metering services are not explicitly defined in the NER, but are generally accepted as falling into two broad categories:

- meter provision services—the provision, installation, routine inspecting and maintenance of metering installations, and
- energy (i.e. metering) data services (which are defined in the NER), which involve:
 - collation of energy data from the meter or meter/associated data logger
 - the processing of the energy data in the metering installation database
 - storage of the energy data in the metering installation database, and
 - the provision of access to the data for those parties that have rights of access to the data.⁶⁸

Energex and Ergon did not propose a separate service grouping for metering services. Metering services were within the customer services group and installation of type 5–7 metering services were included as a connection service.

The QCA classified customer services and connection services as prescribed distribution services. Given that metering services were either within customer services or connection services groupings, the current classification relevant to metering services is a prescribed distribution service.

As the local network service providers (LNSP) Energex and Ergon are the responsible persons for type 5–7 metering installations in Queensland and must, at their own initiative or at the request of a market participant, provide the market participant with a standard set of terms and conditions that are 'fair and reasonable', on which the

⁶⁶ NER, clause 6.2.1(d).

⁶⁷ NER, clause 7.3.1A(a).

⁶⁸ NER, chapter 10.

DNSP will act as the responsible person for these metering installations.⁶⁹ A market participant must accept the DNSP's offer or may dispute the offer in accordance with clause 8.2 of the NER.⁷⁰

These provisions of the NER indicate that the provision, installation and maintenance of type 5–7 metering installations are not contestable, and are the exclusive responsibility of the LNSP. This barrier to entry, coupled with the non-substitutable nature of these services, is highly likely to provide Energex and Ergon with a significant degree of market power in the provision of these services.⁷¹ A high degree of information available to users would not significantly increase users' countervailing market power.⁷² Given these circumstances, a direct control classification is appropriate for all type 5–7 meter provision services.

The AER understands that type 5–7 metering works do not attract a separate fee under a standard connection agreement. Therefore, the cost associated with this service does not appear to be directly attributable to the relevant customer.

Having considered the factors in clause 6.2.2, the AER is satisfied that it is not appropriate to depart from the current classification. The presumption of consistency suggests that prescribed services should be transited to standard control services. Given that the assessment of NER factors do not indicate that a departure from the current classification is clearly more appropriate, a standard control service classification should be applied to metering services.

The AER's proposed position is to classify metering services as standard control services.

2.5.3.4 Other services

For the purpose of this assessment the AER will consider the DNSPs' service groupings 4 to 10 under the heading *other* services. That is all services other than network services, connection services and metering services. The common characteristic of all these *other* services is that customer-specific charges can or are able to be levied; therefore, costs need not be allocated across all users (or group of users).

Energex and Ergon proposed seven separate service groups that included all these *other* services. These groupings appear to have been made in order to align with the headings used by the QCA when it determined the list of excluded services. The DNSPs proposed that all seven groups should be classified as standard control services. Both proposed the same service groups and these were:

- de-energisation and re-energisation
- additions and alterations
- ancillary metering services

⁶⁹ A market participant is a person who is registered by NEMMCO as a Market Generator, Market Customer or Market Network Service Provider under chapter two of the NER.

⁷⁰ NER, clause 7.2.3.

⁷¹ NER, clause 6.2.1(c)(1).

⁷² *ibid.*

- supplementary services
- enhanced services
- quoted services
- temporary supply services (including temporary unmetered supply).⁷³

The services within these seven groups are currently classified as excluded distribution services by the QCA and are subject to regulatory control over their prices.⁷⁴

Energex and Ergon noted that their proposals were inconsistent with the current QCA classification of these other services. In explaining the reasons for this inconsistency the DNSPs noted that the potential for development of competition is a key distinguishing feature between standard control services and alternative control services under the new rules and the same test existed under the old rules when distinguishing between prescribed and excluded services. Further, the DNSPs noted that this test was not the deciding factor of the QCA's decision to classify these seven services as excluded services. The DNSPs noted that these services were deemed excluded services by the QCA in accordance with the previous rules which allowed it to do so although a contestable market could not be demonstrated.⁷⁵

The DNSPs also stated that they had reviewed all services in the seven groupings to determine whether alternative service providers exist or if legislation allows competition. Both concluded that no alternative providers are available and that they are the only party that can provide these services.⁷⁶

Most of the services that fall within these seven groups relate to services that are variations of standard network, connection or metering services. For example, data services (type 5–7 metering) is the provision of metering data beyond the standard service; temporary connections are a form of connection services; re-arrangement of shared network involves a wide range of activities that require work on the shared network assets.

The AER considers that significant barriers to entry exist for the provision of most of the services in these seven groups. Some of these are the legislative barriers that apply to the core services. The economies of scale and scope available to the incumbents and the interdependencies between these and the core distribution services also make it unlikely that alternative service providers will be in a position to competitively provide these services. This limits the potential for these services to be competitively supplied by providers other than Energex and Ergon.⁷⁷ Given these barriers to entry, it would be expected that the incumbent DNSP, would generally possess some market

⁷³ Energex proposal, p. 84.
Ergon proposal, p. 76.

⁷⁴ QCA, *Electricity Distribution: Review of Excluded Distribution Services*, December 2007, appendix A.

⁷⁵ Energex proposal p. 87.
Ergon proposal, p. 79.

⁷⁶ Energex proposal, chapters 7 and 8.
Ergon proposal, chapters 7 and 8.

⁷⁷ NER, clause 6.2.1(c)(1).

power in the provision of these services.⁷⁸ This assessment suggests that a direct control classification is justified.

However, a number of the *other* services may become contestable and provided by alternative providers. Further, the elasticity of demand and the substitutable nature of some services are greater than for the core distribution services enabling customers with some countervailing market power.⁷⁹ For example, if the cost of temporary connections or supply enhancements is too high the customer could lease or purchase stand-alone generation. Given that customers for some of these services are in a position to negotiate higher or lower levels of service suggests that such services could be considered as candidates for a negotiated distribution service classification.

The overall revenue that Energex and Ergon earn from all seven of these service groupings is very small.⁸⁰ The AER considers that it is unnecessary at this time to separate these services that may become competitive or negotiable for individual assessment given that the DNSPs revenue affected by these services is not significant and the services are subject to economic regulation.⁸¹

Energex and Ergon confirmed that for all *other* services, the costs of provision can be directly attributable to the user.⁸² However, the DNSPs' proposals indicated that they believed that this factor would not outweigh the assessment against the other factors in the NER, particularly the lack of potential competition.⁸³

The note to clause 6.2.2(c)(5) of the NER states that:

In circumstances where a service is provided to a small number of identifiable customers on a discretionary or infrequent basis, and costs can be directly attributed to those customers, it may be more appropriate to classify the service as an alternative control service than as a standard control service.

According to the example, one of the distinguishing features of alternative control services is that the costs of providing these services can be directly attributable to the user and therefore costs do not need to be recovered via the DUOS charges. On this basis, although services do not exhibit signs of competition, or potential for competition the AER considers that services can be classified as alternative control services on the cost attribution factor alone.

Having considered the factors in clause 6.2.2, the AER is satisfied that there is no reason to depart from the current classification. The presumption of maintaining

⁷⁸ *ibid.*

⁷⁹ *ibid.*

⁸⁰ Energex, supplementary information, confidential, submitted 8 April 2008.
Ergon, supplementary information, confidential, submitted 8 April 2008.

⁸¹ Design services could be provided by other parties in an environment where construction of connection assets is open to competition. The AER has proposed that this aspect of connection services be classified as an alternative control service. Further, safety services which include a wide range of activities that require work on or near shared network or connection assets could potentially be provided by third parties if an independently administered system of accreditation of non-DNSP service providers is in place. However, in the absence of such scheme, only the DNSP can provide this service.

⁸² Energex, response to information request, confidential, submitted 11 June 2008.
Ergon, response to information request, confidential, submitted 6 June 2008.

⁸³ Energex proposal, chapter 8.
Ergon proposal, chapter 8.

consistency suggests that excluded services which are subject to direct price control should be transitioned to alternative control services. Given that the assessment of NER factors do not indicate that a departure from the current classification is clearly more appropriate, an alternative control service classification should be applied to all *other* services.

The AER's proposed position is to classify *other* services as alternative control services.

As discussed in section 2.5.1 the AER has allocated *other* services to the quoted service and compensable service groups and the alternative service classification will apply to both these service groupings. Appendix A provides a description of activities that fall within these two service groupings.

2.5.3.5 Street lighting

Energex and Ergon have proposed that street lighting services relating to provision, construction and maintenance of street lighting is an unregulated service. The main contention is that this aspect of street lighting does not fall within the NER definition of a distribution service and that it is a matter of history that street lighting still remains as a distribution service. However, the proposals envisaged that the conveyance of electricity to street lights will continue to be a distribution (network) service and subject to a fixed revenue cap form of control.⁸⁴

Currently, street lighting services including their construction and maintenance are prescribed services.⁸⁵

As noted above, the AER is required to classify a distribution service as either a direct control service or negotiated distribution service.⁸⁶ Prior to classifying the service the AER must be satisfied that the service is a distribution service. The AER recognises that street lighting services across the NEM are currently either prescribed or excluded distribution services.⁸⁷

Ergon has advised the AER that street lighting is not a service that is provided in connection with a distribution system and noted that:

- Street lighting is a type of load, has a physical connection point per lamp which are aggregated to a market connection point and has a National Metering Identifier (NMI) allocated to the market connection point in accordance with National Electricity Market Management Company's (NEMMCO) NMI allocation guidelines
- Loads consume kilowatt hours of energy whereas distribution systems move energy from one point to another and the removal of the street light from the distribution system would not affect the functionality of the system

⁸⁴ Energex proposal, pp. 4 and 89.
Ergon proposal, pp. 6 and 80.

⁸⁵ Street lighting works related to glare screening of luminaries are excluded services.

⁸⁶ NER, clause 6.2.1(a).

⁸⁷ In Tasmania distribution services are either declared or undeclared. Services that are declared are broadly regulated under the same principles applicable to prescribed services under the NER. Street lighting is a declared service in Tasmania.

- The DNSP is not the party with the obligation to provide street lighting.⁸⁸

Energex stated that it believed that street lighting does not meet the definition of a distribution service or distribution system that the AER has regulatory responsibility for under clause 6.1.1 of the NER. Energex made similar arguments to Ergon. Additionally, it stated that the NER definition of a DNSP is “a person who engages in the activity of owning, controlling or operating a distribution system.” However, as street lighting services are currently provided by other entities such as the Department of Main Roads who are not a DNSP, such services are not part of a distribution system service.⁸⁹

Origin submitted that street lighting is provided in connection with a distribution system and by nature is part of the distribution system therefore, street lighting services should remain regulated under the NER. Origin noted that although aspects of street lighting do not necessarily fall within the definition of a distribution service, it is inappropriate to remove all aspects of street lighting from regulation.⁹⁰ Origin has not elaborated on what it believes to be the aspects that do not fall within a distribution service.

The AER does not agree that—as argued by Energex—the fact that services are provided by persons who are not a DNSP results in such services being automatically categorised as services that are not distribution services. Such an interpretation is untenable in that some distribution services could be provided by third parties, for example, design and construction of connection assets. Energex’s interpretation could lead to an outcome where distribution services that are contestable automatically become services that are not distribution services by the fact that third parties, other than DNSPs, can competitively provide distribution services.

The issue before the AER is whether the aspect of street lighting that Energex and Ergon wish to be unregulated clearly falls outside the definition of a distribution service.

Although a distribution service is defined in the NER, street lighting is not. It is noted that the transitional provisions for NSW/ACT distribution businesses contained in chapter 11 of the NER have prescribed street lighting services as a direct control service and further classified them as an alternative control services.⁹¹ The transitional provisions do not make a separation of street lighting services into the carriage of electricity or services relating to provision, construction and maintenance of street lighting. The AER considers that the inclusion of street lighting as an alternative control service in the transitional provisions of the rules provides an indication that policy makers wished to continue the position that street lighting should be a distribution service, at least during the next regulatory control period.

⁸⁸ Ergon, response to information request, confidential, submitted 6 June 2008.

⁸⁹ Energex, response to information request, confidential, submitted 11 June 2008.

⁹⁰ Origin, *Queensland Distributors’ Proposals for Service Classification and Control Mechanisms*, 30 April 2008, p. 5.

⁹¹ NER, Appendix 1, *Form in which Chapter 6 applies to New South Wales and the ACT for the regulatory control period 2009–14*, clause 6.2.3B(b).

From a technical perspective street lighting services relating to provision, construction and maintenance of street lighting could be considered closer to the definition of a customer rather than a distribution service. A customer is defined in the NER as:

A person who: (1) engages in the activity of purchasing electricity supplied through a transmission or distribution system to a connection point; and (2) is registered by NEMMCO as a customer under chapter 2.⁹²

However, in order to be reasonably satisfied that this aspect of street lighting is in fact a customer the AER would have to clearly identify the point of supply that demarcates the load from the distribution network. The AER understand that, generally, the connection points for street lighting are defined within the contracts between the parties. Therefore, the exact point of supply would play a critical role in unbundling the assets associated with street lighting services that are more akin to a customer.

At this stage, the point of supply which demarcates the regulated assets and the potential customer assets is unclear. The AER recognises that an exercise to clarify this point of supply will require a considerable amount of discussion with users and relevant stakeholders—including stakeholders across the NEM—and also potentially involve a review of connection contracts.

Given the policy intent demonstrated in the NSW/ACT transitional rules, the AER considers that the provision of street lighting is intended to be a distribution service.

Having determined that this service is a distribution service, the AER is required to classify the service. To demonstrate that a contestable market exists, Ergon noted that street lighting customers in Queensland currently have three options on how they arrange their street lighting requirements. These options allow the customer to either have:

- the DNSP provide, install and maintain the street lights—under this arrangement the assets are included in the regulatory asset base (RAB) and network tariffs include the costs of installation and maintenance as well as the use of the network to deliver energy to the lights (Rate 1)
- a party other than the DNSP provides and installs the street lights—under this arrangement the assets are handed over to be included in the RAB, however, network tariffs include only the costs of maintenance and the use of the network to deliver energy to the lights (Rate 2)
- a party other than the DNSP provides, installs and maintains the street lights—under this arrangement the assets are not included in the RAB and network tariffs include only the use of the network to deliver energy to the lights (Rate 3).⁹³

Ergon also noted that typically the Queensland Department of Main Roads have adopted the third option for public lighting on major roads and highways. Energex also noted that under the legacy tariff arrangements, tariffs are categorised into three groups which in effect recognises the three types of arrangements discussed above.⁹⁴

⁹² NER, chapter 10.

⁹³ Ergon, response to information request, confidential, submitted 6 June 2008.

⁹⁴ Energex, response to information request, confidential, submitted 11 June 2008.

The AER acknowledges that these three tariff type supports the view that currently in Queensland customers are entitled to install and maintain street lighting services and be charged accordingly. Further, the information provided by Energex and Ergon on the street light types shown in table 2.3 support a view that there is a market—albeit not of significant depth—for the provision and maintenance of street lights.

Table 2.3 Energex’s and Ergon’s total street lights according to tariff type

	Energex	Ergon
Rate 1	148,615	93,261
Rate 2	115,872	25,961
Rate 3	27,234	3,920

Source: Energex response to information requests, confidential, submitted 11 June 2008.
Ergon response to information requests, confidential, submitted 6 June 2008.

While the AER’s assessment indicates that barriers to entry are not high and there appears to be some competition in the market at least for the installation of street lights. The availability of alternate providers indicates that users have viable substitutes. These factors indicate that although not sufficiently competitive at the moment, there is potential for effective competition to develop in the market for street lighting services. The other factors in clause 6.2.1(c) of the NER do not indicate that this potential for competition to develop is inhibited. Further, as demonstrated by the different types of tariffs currently available, costs associated with providing street lighting service are directly attributable to the customer to whom the service is provided.⁹⁵

Currently, street lighting services are prescribed distribution services. The NER presumption of consistency with current classification requires the AER to continue with the same regulatory approach unless otherwise clearly more appropriate.⁹⁶

Based on the available information, the AER considers that on balance at this time a move to an unregulated distribution service is a significant step from the current regulatory approach, particularly given that the depth of competition in the relevant market is unclear.

The AER acknowledges that presumption of consistency suggests that current prescribed services should be transitioned to standard control services. However, having considered the factors in clause 6.2.2, the AER is satisfied that there is a potential for competition to develop and costs can be directly attributable to the relevant user. Therefore, an alternative control service classification is clearly more appropriate in this instance.

The AER’s proposed position is to classify street lighting services relating to provision, construction and maintenance of street lighting assets as an alternative control service.

⁹⁵ NER, clause 6.2.2(c)(5).

⁹⁶ NER, clause 6.2.1(d).

2.5.3.6 Unclassified (unregulated) services

An unclassified service is not defined in the NER. The AER may decide against classifying a distribution service and if so distribution services that are determined to be unclassified become unregulated under the NER.⁹⁷ If the service provided by a DNSP is not a distribution service then such a service will not be subject to economic regulation under the NER. Further, if the assessment of the NER factors demonstrates a fully competitive market for a particular distribution service then the AER considers that it is appropriate to decide against classifying such a service.

Energex and Ergon proposed that services currently unregulated by the QCA continue to be unregulated during the next regulatory control period. However, both DNSP's have proposed that street lighting, coverage of low voltage mains (also known as tiger tails) and high load escort services which are currently regulated by the QCA should not be classified and therefore be unregulated.⁹⁸

Given the presumption of consistency with the current regulatory approach unless a departure is clearly more appropriate, the AER's proposed position is to not classify currently unregulated services.

The AER has assessed the services listed by the DNSPs as those that are currently unregulated due to those services not being a distribution service and considers that the following types of activities that have been identified by the DNSPs fall into the unregulated category. These activities are:

- provision of electrical industry training
- pole and duct rentals for non-electricity related purposes
- services not related to the distribution system which are competitively offered by the DNSP to third parties—for example construction of non-distribution assets
- services related to isolated networks, isolated generation, remote area power stations and other installations which do not form of part of the network
- telecommunications services—wholesale fibre telecommunications.

Type 1–4 metering

Energex and Ergon propose that type 1–4 metering services be unregulated. The QCA currently do not regulate type 1–4 metering services.

The NER provide that the provision, installation and maintenance of type 1–4 metering installations are contestable, in that a market participant can choose whether it elects to be, or requires the LNSP to be, the responsible person for these metering installations.

Should a market participant elect to be the responsible person, it would be required to engage (or to be) a registered metering provider for the installation and maintenance of these metering installations. As at February 2008, 18 metering providers were

⁹⁷ NER, clause 6.2.1(a).

⁹⁸ See section 2.5.3.5 for the AER's proposed position on street lighting services.
Energex proposal, appendix B.
Ergon proposal, appendix B.

registered with NEMMCO who were accredited to provide, install and maintain certain type 1–4 metering installations.⁹⁹ Most of these registered metering providers appear to be, or be associated with, a DNSP. From this information alone the AER is unable to assess the competitiveness of metering provision services in Queensland for type 1–4 metering installations. That is, it is unclear the extent to which these potential alternative providers compete for the provision of type 1–4 meter provision services in Queensland. Acknowledging that these services are considered contestable, the AER will continue with the current regulatory approach and not classify these services.

The AER’s proposed position is that the provision of type 1–4 metering services should be an unclassified service.

Watchman lights

Energex and Ergon propose that provision of watchman lighting (also known as security lighting) be unregulated. The QCA currently does not regulate this service.

Provision of watchman lighting involves the installation of flood lights on DNSP structures and the supply of energy through an unmetered connection point usually located on the same pole. Substitutes are available to the customer in that it can install floodlights using the existing metered connection and such a service can be provided by any licensed electrical contractor. There are no interdependencies with the other network services that create a barrier to entry and entry costs for alternative providers are insignificant. Therefore, the AER considers that a competitive market exists for this service. Having considered the NER factors, the AER does not consider a departure from the current classification is clearly more appropriate.

The AER’s proposed position is that the provision of watchman lighting should be an unclassified service.

High load escorts and tiger tails

Energex and Ergon state that the provision of tiger tails and high load escorts are not a distribution service.¹⁰⁰ Currently the QCA has classified these services as excluded services and they are subject to price regulation.

High load escorts involves the lifting of power lines along transport routes which require authorisation from the DNSP for third parties to perform such work as it involves working in close proximity to the power lines including lifting. Tiger tails involves a mechanism by which power lines are identified by means of attaching synthetic tubes over power lines, in order to provide safety for parties operating plant or equipment close to energised power lines.

The AER considers that both these services are clearly provided by means of or in connection with a distribution system and therefore they are distribution services.¹⁰¹

⁹⁹ NEMMCO, *Registered category A and B metering providers—national electricity market*, February 2008.

¹⁰⁰ Energex proposal, pp. 94 and 98.
Ergon proposal, p. 87.

¹⁰¹ NER, chapter 10.

The DNSPs also state that other parties can provide these services and that there is a contestable market.¹⁰² This indicates that there is no legislative barrier to entry but the DNSP will need to authorise providers. Given that the interdependencies with other network services are not high, the cost of providing these services by third parties will be commercially viable. Therefore substitution is possible. The cost of providing these services are directly attributable to the user and that there is potential for competition to develop. However, the depth of competition in the relevant market has not been demonstrated.¹⁰³

Having considered the NER factors, in the absence of sufficient information supporting the position that a contestable market exists for the provision of these services the AER will continue with the current regulatory approach.

The AER’s proposed position is to classify the provision of high load escorts and tiger tails as alternative control services.

2.6 AER proposed position

2.6.1 Energex

Pursuant to clause 6.8.1 and in accordance with part B of the NER, the AER has determined its proposed likely approach for the classification of distribution services applicable to Energex for the forthcoming distribution determination.

The AER proposes to apply the following service classifications to the nominated distribution service groups, as set out in table 2.4.

Table 2.4 The AER’s proposed service classifications for Energex

Distribution service group	AER service classification
Network services	Standard control services
Connection services	Standard control services
Metering services	Standard control services
Quoted services	Alternative control services
Compensable services	Alternative control services
Unregulated	Unclassified

2.6.2 Ergon

Pursuant to clause 6.8.1 and in accordance with part B of the NER, the AER has determined its proposed likely approach for the classification of distribution services applicable to Ergon for the forthcoming distribution determination.

¹⁰² *ibid.*

¹⁰³ NER, clause 6.2.1 and 6.2.2.

The AER proposes to apply the following service classifications to the nominated distribution service groups, as set out in table 2.5.

Table 2.5 The AER’s proposed service classifications for Ergon

Distribution service group	AER service classification
Network services	Standard control services
Connection services	Standard control services
Metering services	Standard control services
Quoted services	Alternative control services
Compensable services	Alternative control services
Unregulated	Unclassified

3 Form of control mechanism

3.1 Introduction

This chapter sets out the AER's proposed position on the control mechanisms to be applied to Energex's and Ergon's direct control services for the 1 July 2010 to 30 June 2015 regulatory control period. This chapter does not deal with the form of control to be applied to negotiated distribution services, which are regulated under the negotiate-arbitrate framework set out in Part D of chapter 6 of the NER.

A control mechanism imposes a constraint on a DNSPs revenue function by imposing controls over the prices of direct control services or controls on the revenue to be derived from direct control services or both.

3.2 Requirements of the National Electricity Rules

Under the NER a distribution determination is to impose controls over the prices of direct control services or the revenue to be derived from direct control services or both.¹⁰⁴ The AER's framework and approach paper must state the form or forms of control to be applied in the distribution determination, as well as the reasons for deciding on each control mechanism.¹⁰⁵

Unlike other elements of the framework and approach paper, the AER's statement of the form or forms of control in the framework and approach paper is binding on the AER and the DNSP for the relevant distribution determination.¹⁰⁶

The NER allow the AER to group direct control services together for the purpose of classification. The AER can apply a control mechanism to either an individual or a group of direct control services.

3.2.1 Available control mechanisms

The NER provides that the control mechanism to be applied to direct control services may consist of:

- a schedule of fixed prices
- caps on the prices of individual services (i.e. a price cap)
- caps on the revenue to be derived from a particular combination of services (i.e. a fixed revenue cap)
- tariff basket price control (i.e. a weighted average price cap)
- revenue yield control (i.e. an average revenue cap) or
- a combination of any of the above (i.e. a hybrid control mechanism).¹⁰⁷

¹⁰⁴ NER, clause 6.2.5(a).

¹⁰⁵ NER, clause 6.8.1(c).

¹⁰⁶ NER, clause 6.12.3(c).

¹⁰⁷ NER, clause 6.2.5(b).

3.2.2 Deciding on a control mechanism

The AER decision on the control mechanism to apply to direct control services consists of two parts:

- the form of control mechanism¹⁰⁸
- the basis of the control mechanism.¹⁰⁹

Standard control services

In deciding on a control mechanism for standard control services, the AER must have regard to the following factors:

- the need for efficient tariff structures
- the possible effects of the control mechanism on administrative costs of the AER, the DNSP and users or potential users
- the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination
- the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction)
- any other relevant factor.¹¹⁰

The basis of the control mechanism to be applied to standard control services must be made according to Part C of the chapter 6 of the NER—using the building block approach and must be of the prospective consumer price index (CPI) minus X (CPI – X) form or an incentive based variant of that form.¹¹¹

A CPI – X mechanism is generally employed to provide a smooth price path that negates price shocks between regulatory years. The revenue increment or decrement associated with any applicable incentive schemes can be incorporated into the CPI – X mechanism. A mechanism for ensuring compliance with the control mechanism must be included in the distribution determination.¹¹²

Alternative control services

In deciding on a control mechanism for alternative control services, the AER must have regard to the same factors as those for standard control services in all but one respect. Where for standard control services the AER must have regard to the need for efficient tariff structures, for alternative control services the AER must instead have regard to the potential for development of competition in the relevant market and how the control mechanism might influence that potential.¹¹³

The basis of the control mechanism to be applied to alternative control services can be either:

¹⁰⁸ NER, clause 6.2.5(b).

¹⁰⁹ NER, clause 6.2.6(a).

¹¹⁰ NER, clause 6.2.5(c).

¹¹¹ NER, clause 6.2.6(a).

¹¹² NER, clause 6.12.1(13).

¹¹³ NER, clause 6.2.5(c).

- the building block approach
- certain elements of the building block approach, that is, a limited building block approach or ¹¹⁴
- may not be based on the building block approach. ¹¹⁵

The control mechanism must have a basis stated in the distribution determination and may, but is not required to, be of the CPI – X form or a variant of that form. ¹¹⁶

3.2.3 Pricing approvals

DNSPs must submit pricing proposals to the AER on an annual basis that include proposed tariff classes and tariffs for direct control services that are to apply for that regulatory year. ¹¹⁷ The AER is required to approve annual pricing proposals. If the AER determines a pricing proposal is deficient, it can require the DNSP to amend the deficiency or make the necessary amendments itself. ¹¹⁸

3.3 Current arrangements

3.3.1 Prescribed services

In 2000 the QCA made its determination of prescribed services, in which it declared all of Energex's and Ergon's distribution services were prescribed services. ¹¹⁹ In selecting the control mechanism to apply in the 2005–10 regulatory period, the QCA considered there was insufficient information to judge the performance of the DNSPs under the arrangements established in 2001, or to determine whether a change in the form of control was warranted. ¹²⁰ The QCA considered it appropriate to retain the fixed revenue cap form of control and apply it to Energex's and Ergon's prescribed services.

In its 2005 distribution determination, the QCA applied a fixed revenue cap to all of Energex's and Ergon's prescribed services. ¹²¹ Each fixed revenue cap was constructed using the building block approach and was of the CPI – X form. X factors were applied as a means of smoothing revenues over the regulatory period to reduce volatility in annual revenues and minimise year to year price shocks.

¹¹⁴ The building block approach determines an annual revenue requirement based on the elements under clause 6.4.3(a). A limited building block approach may not include one or more of these elements.

¹¹⁵ NER, clause 6.2.6(c).

¹¹⁶ NER, clause 6.2.6(b).

¹¹⁷ NER, clause 6.18.2.

¹¹⁸ NER, clause 6.18.8(b).

¹¹⁹ A DNSP or any interested party could apply to the QCA to have a particular service treated as an excluded service if it could demonstrate that there was potential for competition in the market for that service. QCA, *Electricity Distribution: Determination of Prescribed Services*, September 2000, p. 8.

¹²⁰ QCA, *Form of Regulation of Electricity Distribution to commence from 1 July 2005*, Final Decision, June 2003, p. 4.

¹²¹ At the time of making its 2005 distribution determination the QCA and the DNSPs considered the inclusion of non-DUOS services within the fixed revenue caps would not unduly affect DUOS tariffs as the demand for non-DUOS service had been relatively stable over time and nothing indicated this would change. QCA, *Electricity Distribution: Review of Excluded Services*, Final Decision, December 2007, p. 5.

The QCA's distribution determination included the following within period adjustments to each fixed revenue cap:

- a mechanism to allow for the under or over recovery of revenues in a regulatory year to be recovered from or returned to customers in subsequent years¹²²
- a general cost pass-through for Energex and Ergon, provided the pass-through event exceed one per cent of actual aggregate annual revenue requirement (AARR) for that year.

In light of the Electricity Distribution and Service Delivery review (EDSD) recommendations, the QCA provided improved investment certainty and increased regulatory flexibility to allow for changing circumstances via the addition of several within period adjustments to each fixed revenue cap.¹²³

- a demand trigger for Energex and Ergon that can be activated if the peak demand growth rate or the customer number growth rate is 3 per cent greater than (less than) than that forecast for that year. If either trigger is activated, the QCA may initiate a review to determine if an adjustment to the relevant fixed revenue cap is warranted.
- a capital expenditure pass-through mechanism for Energex to demonstrate there is a need and it has the capacity to undertake additional investment in its network up to its original capex forecast of \$3,427 million—a maximum pass-through amount of \$720 million. Provided that the expenditure is necessary to meet its EDSD related obligations or a reinstatement of capex specifically excluded by QCA's consultant (Burns and Roe Worley).¹²⁴
- a capital expenditure pass-through mechanism for Ergon to accommodate identified capital projects totalling \$400 million that are likely to proceed during the next regulatory period, but with a probability of proceeding of less than 80 per cent. Each project included had a potential cost of at least \$5 million. The pass-through is restricted to the forecast cost for each project.¹²⁵
- a pass-through for Energex and Ergon relating to large customer projects with a cost in excess of \$10 million that were unanticipated at the time of the distribution determination.

Any approved pass-through amount is added to the respective DNSPs fixed revenue cap in year following approval. The fixed revenue cap is then adjusted to establish the

¹²² Depending on the size of the variance from the approved fixed revenue caps, certain action was required by the DNSP. When the variance was less than 2 per cent of regulated revenue, the DNSP was required to ensure that the balance was cleared over the next year. When the variance was above 5 per cent, a clearly documented plan was required to be submitted to the QCA describing how the balance was to be corrected. A variation between 2 and 5 per cent required a plan to be submitted to clear the account over the subsequent two regulatory years.

QCA, *Regulation of Electricity Distribution*, Final Determination, April 2005, p. 39.

¹²³ The EDSD review was published in July 2004, after the QCA published its June 2003 decision on the form of control to apply in the 2005–10 regulatory period.

¹²⁴ QCA, *Regulation of Electricity Distribution*, Final Determination, April 2005, pp. 91–93.

In March 2007 the QCA approved Energex's application for pass-through of costs associated with an additional \$720 million of capex as it had satisfied the requirements set out in the 2005 final determination. QCA, *Energex Application for Capital Expenditure Pass-through*, Final Decision, March 2007.

¹²⁵ QCA, *Regulation of Electricity Distribution*, Final Determination, April 2005, p. 89.

AARR that Energex and Ergon use in setting their annual prices for distribution services.

3.3.2 Excluded services

On 28 September 2005 the Queensland Government announced its intention to introduce full retail competition (FRC) into retail electricity and gas markets on 1 July 2007. To facilitate competition in the retail electricity market the Queensland Government sold Energex's and Ergon's retail electricity businesses.¹²⁶

Energex and Ergon anticipated that the introduction of FRC in Queensland combined with the sale of their retail businesses would lead to a significant increase in the volume of non-DUOS services, resulting in a significant increase in the revenue earned from the provision of these services. Under the fixed revenue cap, the higher level of non-DUOS revenue would artificially lower DUOS prices, effectively non-DUOS services would be subsidising DUOS services. The QCA considered this was an unintended and undesirable outcome of the fixed revenue cap form of control and the introduction of FRC.¹²⁷ Therefore, the QCA amended its determination of prescribed services in August 2007 and in December 2007 reclassified all of Energex's and Ergon's non-DUOS services as excluded services and removed the forecast revenue associated with those services from each of the fixed revenue caps.

As mentioned in section 2.3, the AER is not aware of an explicit definition of non-DUOS services. Excluded services are categorised as either standard or non-standard excluded services. A standard excluded service is where the service has a maximum capped price—fee for service. A non-standard excluded service is where the price for the service is variable also known as a quoted service or price on application.

The QCA approves the maximum price to be charged for each excluded service.¹²⁸ The current form of control is therefore effectively a price cap, where the approved price is the maximum to be charged for a particular service but nothing prevents Energex or Ergon from charging below the capped price.

The QCA applies a three step process for regulating excluded services:¹²⁹

1. Prices for excluded services are required to be set consistent with the QCA's broad pricing principles, which are that:
 - prices should be cost reflective, with costs allocated to the excluded service in accordance with the approved cost allocation methods and procedures; and
 - prices should be subsidy free, economically efficient and reflect current industry practices and costs.¹³⁰

¹²⁶ Ergon continues to provide retail services to a number of non-contestable customers.

¹²⁷ QCA, *Electricity Distribution: Review of Excluded Services*, Final Decision, December 2007, p. 5.

¹²⁸ QCA, *Guidelines for the Regulation of Excluded Distribution Service Provided by Energex and Ergon Energy*, February 2008, p. 2.

¹²⁹ QCA, *Electricity Distribution: Review of Excluded Services*, Final Decision, December 2007, pp. 6–7.

¹³⁰ *ibid.*, p. 6.

2. Prices for all excluded services are approved on an annual basis as part of the pricing principles statement (PPS). In their PPS's Energex and Ergon must submit prices for each excluded service and provide an explanation of how the price is calculated including the formula used to derive the price. For non-standard (quoted services) services the PPS must include a formula identifying all the variables for the individual services and what variables are subject to change.¹³¹
3. Energex and Ergon must provide the number of each excluded service provided at the completion of a regulatory year. Using that data the QCA is able to determine the average price and average cost of each service, which can be compared against the approved prices or price formula for that year. The QCA has indicated that it intends to report summary pricing information in its annual financial and service quality performance reports.

3.4 Proposals

Clause 11.16.6 of the NER permitted Energex and Ergon to submit proposals to the AER in relation to the classification of services and the control mechanisms to apply for the 1 July 2010 to 30 June 2015 regulatory control period. The AER received proposals from Energex and Ergon on 31 March 2008.¹³²

3.4.1 Energex proposal

Energex proposed ten groups of standard control services, table 2.1 sets out each of these groups. Energex considered the NER permits more than one control mechanism to be applied to different groups of standard control services. It noted that clause 6.5.9(b)(3)(ii) indicates that there can be separate control mechanisms for different standard control services. Therefore, Energex proposed a hybrid control mechanism for standard control services, consisting of:¹³³

- a fixed revenue cap—covering network services (Group 1)
- a weighted average price cap (WAPC)—covering connection and customer services (Groups 2 and 3)
- a WAPC—covering all remaining standard control services (Groups 4 to 10).

Energex did not propose the basis of the control mechanisms, except that the fixed revenue cap and the WAPCs would incorporate the CPI – X mechanism as required under clause 6.2.6(a).

Energex did not propose any alternative control services and therefore did not propose a control mechanism to apply to these services.

¹³¹ QCA, *Guidelines for the Regulation of Excluded Distribution Service Provided by Energex and Ergon Energy*, February 2008, pp. 1–2.

¹³² Energex, *Service Classification and Control Mechanisms for Distribution Services Proposal to the Australian Energy Regulator under clause 11.16.6 of the National Electricity Rule*, March 2008
Ergon, *Proposal: Service Classification and Control Mechanism*, March 2008.

¹³³ Energex proposal, p. 74.

Energex proposed that subtransmission connection services as a negotiated distribution service and therefore did not propose a control mechanism to apply to these services as they are regulated under Part D of the NER.

3.4.2 Ergon proposal

Ergon also proposed the same ten groups of standard control services, which are set out in table 2.2. It proposed the same combination of control mechanisms for standard control services as Energex.

Ergon did not propose the basis of the control mechanisms to apply to the three groups of standard control services, except that the fixed revenue cap and the WAPCs would incorporate the CPI – X mechanism as required under clause 6.2.6(a).

Ergon did not propose any alternative control services and therefore did not nominate a control mechanism to apply to these services.

Ergon did not propose any negotiated distribution services and therefore did not propose a control mechanism to apply to these services.

3.5 AER considerations

In its framework and approach paper the AER must state the form of the control mechanism or mechanisms that will apply to direct control services during the 2010-15 regulatory control period.

The AER must have regard to the factors outlined in clause 6.2.5(c) and 6.2.5(d) when deciding on the control mechanism to apply to standard and alternative control services respectively, these factors are set out above in section 3.2.2.

The AER noted in section 2.2, that the NER provides when classifying direct control services that have previously been subject to regulation under present or earlier legislation, that the AER must act under the presumption that unless a different classification is clearly more appropriate, there should be no departure from the previous classification.¹³⁴

The NER does not extend this presumption to control mechanisms. However, under clause 6.2.5(c)(3) and 6.2.5(d)(3) the AER must have regard to the regulatory arrangements currently applicable. For the first round of distribution determinations the AER's assessment of the factors in clause 6.2.5(c) and 6.2.5(d) is aimed at determining whether it is more appropriate to adopt an alternative control mechanism—that is, move away from the current form of control.

3.5.1 Control mechanism to apply to standard control services

In section 2.5.3 the AER proposed to classify Energex's and Ergon's network, connection and metering service groups as standard control services. In section 2.5.1.1 the AER proposed to classify customer services as either network services or metering services.

¹³⁴ NER, clause 6.2.2(d).

Energex and Ergon proposed separate control mechanisms to apply to different groups of standard control services, a fixed revenue cap applied to network services and a WAPC applied to connection and metering services, and collectively referred to it as a hybrid form of control. The AER considers that the application of separate control mechanism to different groups of direct control services is permitted under the NER.¹³⁵

The following section sets out the AER’s assessment to determine whether it is more appropriate to adopt two separate control mechanisms as proposed by Energex and Ergon—that is, move away from the current fixed revenue cap approach.

The regulatory arrangements applicable in the current regulatory period

The fixed revenue cap control mechanism currently applicable to Energex’s and Ergon’s prescribed services is described above in section 3.3.1.

The need for efficient tariff structures

A tariff for a particular service would be regarded as efficient if it is set at the point where the DNSP can recover the efficient cost associated with providing that service. The AER will establish the efficient cost associated with the provision of standard control services as part of making its building block determination.¹³⁶

Energex and Ergon stated that a fixed revenue cap was an appropriate control mechanism for network services as it would not result in inefficient tariff structures as the control mechanism allows the DNSP to propose tariffs in order to recover allowable revenues—the efficient cost of providing its services.¹³⁷ A DNSP is likely to under or over recover revenues if actual energy use is below or above that forecast. Under a fixed revenue cap the operation of a mechanism that allows for the under or over recovery of revenues in a regulatory year to be recovered from or returned to users in subsequent years ensures the DNSP only recovers its efficient costs.

The AER considers a fixed revenue cap will not impede Energex’s and Ergon’s ability to set efficient tariffs as tariffs should be set at a level that allows the DNSPs to recover its efficient costs. On that basis the AER considers it appropriate to apply a fixed revenue cap to Energex’s and Ergon’s network services.

Energex and Ergon proposed that a separate WAPC for connection and metering services was appropriate and would not result in inefficient tariff structures as a WAPC allows individual tariffs to be rebalanced each year.¹³⁸ The issue before the AER is whether it is necessary for connection and metering services to have a separate WAPC form of control.

¹³⁵ NER, clause 6.5.9(b)(3)(ii).

¹³⁶ The AER is required to review Energex’s and Ergon’s proposed demand, capex and opex forecasts as part of making its distribution determination.
NER, clause 6.5.6 and 6.5.7.

¹³⁷ Energex proposal, p. 77–78.
Ergon proposal, p. 71.

¹³⁸ Energex proposal, p. 79.
Ergon proposal, p. 73.

Energex and Ergon both indicated that they use the same assets, labour and materials to provide connection and network services.¹³⁹ Origin stated that customer (metering) services could not logically be decoupled from DUOS charges and this prevents the services from having a separate control mechanism applied.¹⁴⁰

The AER agrees with Origin and considers that it is impractical to separate the costs associated with providing network services from the cost of providing certain connection and metering services. The AER considers it is inherently difficult to separate the cost of providing components of network services and hence difficult to ensure that particular tariffs can be set sufficiently to recover costs more efficiently than under a single control mechanism. Further, where the costs associated with the provision of connection and metering services are clearly identifiable and directly attributable to a user the AER has classified these services as alternative control services.

Origin considered where there is potential for significant deviations in forecast volumes and demand, a WAPC generally provides the most efficient tariff structure.¹⁴¹

A fixed revenue cap and a WAPC seek to align a DNSP's revenue to its efficient costs. Where energy use is greater (lower) than that forecast this may mean delivery costs are higher (lower) with a commensurate increase (decrease) in revenues. For DNSPs, the incremental cost associated with the delivery of an additional unit of energy is relatively low and hence this is not likely to affect the DNSPs efficient costs as energy use increases. However, if the growth in the number of customers increases above that forecast, this may have a greater affect on the DNSPs costs. If this were to occur, a DNSP's revenue would not necessarily be as constrained under a WAPC as under a fixed revenue cap.

If an increase in the demand for connection and metering services translated into a proportional increase in the efficient cost associated with providing these services, the application of a WAPC would appear justifiable. However, at this stage there appears to be insufficient information that the growth in the number of customers has been significantly above that forecast. Therefore, the AER considers that the cost increases that justify the application of a WAPC in this instance are not sufficiently verifiable.

The AER does not consider that a separate WAPC is warranted for connection and metering services on the basis that a WAPC may result in more efficient tariffs but rather that it is appropriate to apply a fixed revenue cap to Energex's and Ergon's standard control services.

Administrative costs

Clause 6.2.5(c)(2) requires the AER to consider the possible effects of the control mechanism on administrative costs of the AER, the DNSP and users or potential users. A control mechanism should minimise the complexity and administrative

¹³⁹ Energex proposal, p. 45.
Ergon proposal, p. 43.

¹⁴⁰ Origin, *Queensland Distributors' Proposals for Service Classification and Control Mechanisms*, 30 April 2008, p. 1.

¹⁴¹ *ibid.*, p. 2.

burden for the AER, the DNSP and users, without compromising the effectiveness of the constraint. Simplicity in regulatory approaches provides the potential benefits of more timely regulatory determinations, greater certainty and transparency, and reduced compliance costs for DNSPs.

Both Energex and Ergon proposed separate groups of standard control services, with each group having a different control mechanism applied. To implement separate control mechanisms would require the establishment of an asset base for each group of standard control services and then apply a separate building block determination to each category. Ensuring there is no unintentional double recovery of revenues and no cross-subsidisation of assets is particularly onerous. The implementation of two separate control mechanisms also poses additional complications for cost allocation methods. On that basis, the AER considers implementing Energex's and Ergon's proposed separate control mechanisms would be administratively complex and costly to the DNSP, users and the AER.

The AER considers the implementation of a single fixed revenue cap control mechanism for Energex's and Ergon's standard control services would involve significantly lower administrative costs for the DNSP, users and the AER than the imposition of a separate fixed revenue cap and WAPC control mechanisms.

The desirability of consistency

Clause 6.2.5(c)(4) of the NER requires the AER have regard to the desirability of consistency between regulatory arrangements for similar services, both within and beyond the relevant jurisdiction.

The AER notes that within each NEM jurisdiction the same control mechanism is applied to prescribed services (that is, those services likely to be classified as standard control services). The control mechanism applied to Energex's and Ergon's standard control service under this framework and approach paper is consistent.

Different control mechanisms are applied to standard control services (prescribed services) across the NEM.¹⁴² On the other hand, separate forms of control are not applied to different groups of standard control services in any NEM jurisdiction.

While consistency is desirable, the AER considers that the pursuit of consistency in forms of control between jurisdictions should not be a key consideration in the selection of a control mechanism to apply to standard control services for the first round of distribution determinations.

Any other relevant factor—incentives and risks

In deciding on a form of control for standard control services, the NER allows the AER to consider any factor it considers relevant.¹⁴³ The AER considers that both the incentive and risk properties created by specific control mechanisms are important considerations in this respect.

¹⁴² A WAPC is applied in Victoria and New South Wales, a fixed revenue cap is applied in Queensland and Tasmania, an average revenue cap is applied in the Australian Capital Territory and a variant of an average revenue cap is applied in South Australia.

¹⁴³ NER, clause 6.2.5(c)(5).

Incentive and risk properties arise due to the discrepancy between a DNSP's revenue and costs associated with different control mechanisms. Under a fixed revenue cap, the DNSP's revenue is fixed over the regulatory control period whereas the cost of providing distribution services depends upon factors such as the number of customers, the peak capacity of electricity that can be delivered to each user as well as changes in input costs.

Energex and Ergon proposed that a fixed revenue cap is an appropriate control mechanism to apply to network services.

Fixed revenue caps have a number of positive attributes:

- it establishes revenue and investment certainty for the DNSP
- it creates an incentive for the DNSP to minimise costs
- it creates an incentive for the DNSP to pursue demand management and energy efficiency projects, as revenues are not linked to the quantity of energy delivered.

In its submission, Origin Energy (Origin) noted the shortcomings of fixed revenue caps and also made reference to the Parer Report, which recommended the economic regulation of distribution networks be based on price caps (WAPCs) not revenue caps to reduce regulatory uncertainty.¹⁴⁴ Origin also considered the criticisms of the fixed revenue cap have not been resolved in Energex's proposal, it specifically highlighted the potential for volume and price risk, where volume risk is borne by the DNSP when demand is higher than forecast or consequently price risk is transferred to users when demand is lower than forecast.¹⁴⁵

Energex and Ergon stated that the risk inherent under a fixed revenue cap form of control had been addressed through improved operational procedures.¹⁴⁶ Energex stated that it has consolidated all of its energy and customer related forecasting functions into a single business unit, it also engaged ACIL Tasman to review and recommend improvements to its methodology used to develop long-term forecasts.¹⁴⁷ Ergon stated it has established capex and opex investment review committees and introduced a whole-of-business information communication and technology system.¹⁴⁸

The AER considers that both Energex and Ergon have taken steps to improve their operating procedures and methodologies, which should result in more accurate

¹⁴⁴ Origin, *Queensland Distributors' Proposals for Service Classification and Control Mechanisms*, 30 April 2008, p. 2.

Council of Australian Governments' Independent Review of Energy Market Directions, *towards a truly national and efficient energy market*, December 2002, p. 95.

¹⁴⁵ Origin, *Queensland Distributors' Proposals for Service Classification and Control Mechanisms*, 30 April 2008, p. 2.

¹⁴⁶ Energex proposal, p. 78.
Ergon proposal, p. 72.

¹⁴⁷ Energex, response to information request, confidential, submitted 11 June 2008.

¹⁴⁸ Ergon, response to information request, confidential, submitted 6 June 2008.

demand and network expenditure requirements and reduce the likelihood of volume risk.¹⁴⁹

Origin highlighted a potential deficiency of fixed revenue caps was price risk is transferred to users if actual demand is less than forecast. The critical factor is the accuracy of the demand forecasts as price volatility is possible under both a fixed revenue cap and a WAPC. If demand forecasts are largely inaccurate in a regulatory year both a fixed revenue cap and a WAPC will result in tariff adjustments in the following regulatory year. The operation of an under or overs mechanism under a fixed revenue cap ensures that an over or under recovery of revenues is either returned to or recovered from users. Under a WAPC, tariffs can be recalculated each year without reference to the revenues earned in the previous regulatory year. The AER considers that improved demand forecasts that have been identified by Energex and Ergon would to a large extent address the risk identified by Origin in relation to demand variations under a fixed revenue cap.

Energex and Ergon also proposed a separate WAPC to apply to connection and metering services.¹⁵⁰ In their respective proposal the DNSPs stated that:

The EDSO review found that, specifically in relation to connection services, in times of volatile growth (i.e. growth in both load and customer numbers), the revenue cap approach has serious shortcomings because the facts on which the original submissions and regulatory determination are based can change unexpectedly and significantly within the regulatory period.¹⁵¹

Energex and Ergon proposed to separate network services from the more volatile connection and metering service. The AER understands the primary reason why Energex and Ergon are seeking separate a separate WAPC form of control for connection and metering services is to obtain flexibility that can account for changes in the demand for these services.

Origin reiterated the criticisms raised in the EDSO review specifically that the fixed revenue cap may lead to underinvestment in times of volatile load growth.¹⁵² An ex ante fixed revenue cap does not necessarily lead to under investment. Network investment is funded from a number of sources, including borrowings which means a DNSP is not constrained by approved revenues when funding new capital assets. The AER acknowledges that the rate of return achieved on assets constructed above the level of forecast capex may be less than a DNSP's implied rate of return. However, this reduction in the rate of return is marginal for long-lived assets.

Energex and Ergon are also subject to enhanced service standard requirements in their licence conditions. These arrangements are designed to address failings observed by the EDSO review in relation to inadequate investment. That is, a service standards

¹⁴⁹ The AER is required to review Energex's and Ergon's demand, capex and opex forecasts as part of making its distribution determination. NER, clause 6.5.6 and 6.5.7.

¹⁵⁰ Energex proposal, pp. 79–88.
Ergon proposal, pp. 71–72.

¹⁵¹ Energex proposal, p. 88.
Ergon proposal, pp. 79–80.

¹⁵² Origin, *Queensland Distributors' Proposals for Service Classification and Control Mechanisms*, 30 April 2008, p. 2.

scheme is designed to provide a financial incentive for DNSPs to maintain and improve service performance. The AER has canvassed the potential application of a service target performance incentive scheme (STPIS) to Energex and Ergon in a separate framework and approach paper.¹⁵³

The AER expects that Energex's and Ergon's improved forecasting procedures and methodologies will result in more accurate demand and network expenditure forecasts, which should in turn to some degree mitigate the likelihood of volatility in the demand for connection and metering services.

The AER does not consider that Energex and Ergon have presented sufficient evidence to suggest the application of a separate WAPC for connection and metering services is warranted at this time.

Further, as discussed in section 2.5.3.2, the AER has proposed to classify Energex's and Ergon's services relating to the design and construction of connection assets as alternative control services. The AER considers that services associated with the design and construction of connection assets accounts for a large proportion of the overall costs involved with the provision of connection services. Classifying the services associated with the design and construction of connection assets as alternative control services is intended to address the concerns that a fixed revenue cap will not address demand variability which increase the cost of service delivery.

Overall, the AER does not consider that a separate WAPC form of control is warranted for connection and metering services. Therefore, in addition to network services, it is appropriate to include connection and metering services under a fixed revenue cap. That is, apply a fixed revenue cap form of control to all of Energex's and Ergon's standard control services.

Basis of a control mechanism for standard control services

For standard control services the AER must implement a control mechanism that is of the prospective CPI – X form made in accordance with Part C of the NER—using the building block approach.¹⁵⁴ The building block approach entails, the AER determining a DNSPs annual revenue requirement (ARR) for standard control services based on the following building block elements:

- indexation of the regulatory asset base
- the return on capital for that year
- the depreciation for that year
- the estimated cost of corporate income tax for that year
- the revenue increments or decrements (if any) for that year arising from the application of the efficiency benefit sharing scheme, the service target performance incentive scheme and the demand management incentive scheme
- the other revenue increments or decrements (if any) for that year arising from the application of the a control mechanism in the previous regulatory control period

¹⁵³ AER, *Framework and approach paper—application of schemes Energex and Ergon Energy 2010–15 Preliminary positions*, 30 June 2008.

¹⁵⁴ NER, clause 6.2.6(a).

- the forecasting opex for that year.¹⁵⁵

The AER's proposes that the basis of the control mechanism to apply to standard control services will be of the CPI – X form incorporating any revenue increment or decrement associated with any applicable STPIS and demand management incentive scheme (DMIS).¹⁵⁶

3.5.2 Control mechanism to apply to alternative control services

In section 2.5.3.4 the AER proposed to classify Energex's and Ergon's quoted services and compensable service groups as alternative control services. All services within these groups are currently classified as excluded services with the exception of street lighting services and services associated with the design and construction of connection assets that are currently classified as prescribed services.

Energex and Ergon proposed to classify service groups 4 to 10 as standard control services regulated via a WAPC control mechanism. Although proposed by Energex and Ergon, the AER has not classified the current excluded services as standard control services. However, it is recognised that a WAPC is control mechanism available to the AER to apply to alternative control services.

The following section sets out the AER's assessment to determine whether the continuation of the current price cap form of control is appropriate having considered the factors under clause 6.2.5(d).

The current regulatory arrangements applicable to Energex and Ergon, clause 6.2.5(d)(3), is the factor that the AER considers is most important in the first round of distribution determinations unless the remaining factors demonstrate a clear need to depart from the current form of control.

The regulatory arrangements applicable in the current regulatory period

The price cap control mechanism currently applicable to Energex's and Ergon's excluded services is described above in section 3.3.2.

The influence on the potential for development of competition

The AER considered the potential for competition as part of classifying Energex's and Ergon's direct control services as either standard or alternative control services. Where the potential for competition exists the AER elected to classify the service as an alternative control service so as not to impede the development of competition. Equally, the AER considers that the control mechanism to apply to that service should not impede the development of competition.

A price cap form of control establishes the maximum price that a DNSP is permitted to charge for a given service. This does not prevent the DNSP from charging below the capped price. Where there are no significant or legislative barriers to entry, the application of a price cap may facilitate competition as a competitor or potential

¹⁵⁵ NER, clause 6.4.3(a).

¹⁵⁶ The AER's preliminary positions on the application of the STPIS, an EBSS and a DMIS to Energex and Ergon are set out in a separate framework and approach paper. AER, *Framework and approach paper—application of schemes Energex and Ergon Energy 2010–15* Preliminary positions, 30 June 2008.

competitor can readily assess the approved price for a given alternative control service and then decide whether to enter the market.

Energex and Ergon considered that a WAPC allows individual tariffs and components of tariffs to be rebalanced each year by more than or less than the overall CPI – X constraint.¹⁵⁷ The AER accepts that a WAPC could give Energex and Ergon greater price flexibility than that provided by a price cap. To warrant this level of flexibility one would have to assume either that the initial price is not cost reflective or the service is susceptible to significant input price shocks. This could occur if there are deficiencies in the DNSPs forecasting. As noted above, Energex and Ergon have both indicated they have improved forecasting procedures and methodologies which should address this concern.

The AER notes that a WAPC would also give the DNSPs greater scope to either cross-subsidise the cost of more competitive services from less competitive services or price discriminate. Therefore, these potential outcomes under a WAPC could adversely affect the potential for the development of competition.

The AER considers the application of a price cap will not have an adverse impact on the potential for the development of competition where there are no significant or legislative barriers to entry.

Administrative costs

Clause 6.2.5(d)(2) requires the AER to consider the possible effects of the control mechanism on the administrative costs of the AER, the DNSP and users or potential users. A control mechanism should aim to minimise complexity and administrative burden for the AER, the DNSP and users without compromising the effectiveness of the constraint. Simplicity in regulatory approaches brings the potential benefits of more timely regulatory determinations, greater certainty and transparency, and reduced compliance costs for DNSPs.

Alternative control services have two defining characteristics: the service can either be directly attributable to a user and/or competition exists or there is potential for the development of competition in the relevant market for that service.

The AER considers that the implementation of the price cap in the first year of a regulatory control period and the application of a price path for the subsequent years will impose some administrative costs to users, the DNSPs and the AER. However, the majority of these costs will be concentrated at the time of the distribution determination. By establishing a price path for the remaining years of the regulatory control period the AER considers that administrative costs can be minimised. The WAPC requires a more detailed assessment of the services cost base and demand forecasts. Forecasting the demand for these services, however, can be problematic, as was noted in section 3.3.2.

The AER's considers the application of a price cap form of control to Energex's and Ergon's alternative control services with a price path imposed for the remaining years

¹⁵⁷ Energex proposal, p. 81.
Ergon proposal, p. 74.

of the regulatory control period will not impose higher administrative costs on the DNSP, users and the AER than the WAPC proposed by Energex and Ergon.

The desirability of consistency

Clause 6.2.5(d)(4) of the NER requires the AER to have regard to the desirability of consistency between regulatory arrangements for similar services, both within and beyond the relevant jurisdiction.

The AER notes that within each NEM jurisdiction the same control mechanism is applied to excluded services (that is, those services likely to be classified as alternative control services). The control mechanism applied to Energex's and Ergon's alternative control services under this framework and approach paper is consistent.

Different forms of control are applied to alternative control services (excluded services) across the NEM. A negotiate arbitrate framework is applied in Victoria and South Australia, a revenue cap is applied in the Australian Capital Territory, and a variant of a schedule of fixed prices is applied in New South Wales. There are no excluded services in Tasmania. A WAPC form of control is not applied to alternative control services in any NEM jurisdiction.

While consistency is desirable, the AER considers that the pursuit of consistency in forms of control between jurisdictions should not be a driving consideration in the selection of a control mechanism to apply to Energex's and Ergon's alternative control services for the first round of distribution determinations. The price cap approach proposed is broadly consistent however with other jurisdictions.

Any other relevant factor

The NER allows the AER to consider any factor it considers relevant in deciding on a form of control for alternative control services.¹⁵⁸ The AER does not consider there are any other relevant factors that are important in deciding on the control mechanism to apply to alternative control services.

Basis of a control mechanism for alternative control services

The AER is able to apply a control mechanism to a DNSP's alternative control services using Part C of the NER—the building block approach, but may elect to only apply certain elements of the building block approach—a limited building block approach. Alternatively, the AER may elect to implement a control mechanism that does not use the building block approach.

The AER has separated Energex's and Ergon's alternative control services into two groups:

- street lighting services
- all remaining alternative control services.

¹⁵⁸ NER, clause 6.2.5(c)(5).

The AER proposes to retain the existing price cap form of control to regulate both groups of Energex's and Ergon's alternative control services for the 2010–15 regulatory control period, where:

- a price cap is established in the first year of the regulatory control period
- a price path is established for the remaining years of the regulatory control period.

Energex and Ergon will be required to submit annual pricing proposal for all alternative control services as part of the distribution pricing rules set out in Part I of the NER.

Street lighting services

The AER proposes to assess the efficient costs of providing street lighting services under the price cap control mechanism via a limited building block approach. The AER will permit Energex and Ergon to simplify the building block approach in the following ways:

- Energex and Ergon will not be required to provide a separate proposal on the weighted average cost of capital for alternative control services.
- Energex and Ergon may propose reasonable simplifying assumptions within the building block model.
- Energex and Ergon may base their opening asset valuation for existing alternative control services on the existing asset valuation, with any efficiency adjustments for capex and depreciation in the current regulatory control period.

Remaining alternative control services

The AER proposes to assess the efficient costs of providing Energex's and Ergon's remaining alternative control services through a price cap form of control. The AER does not propose to apply the building block approach contained in Part C of the NER. The AER considers that it is reasonable to retain the QCA's current approach to derive prices for each individual service in the first year of the 2010–15 regulatory control period. The QCA's current approach is set out in section 3.3.2. For the remaining years of the regulatory control period the AER proposes to establish a price path such as $CPI - X$.

Energex and Ergon have both indicated that they use the same assets, labour and materials to provide connection and network services.¹⁵⁹ A DNSP's regulatory proposal must contain a building block proposal that relates to direct control services classified as standard control services.¹⁶⁰ A DNSP's regulatory asset base (RAB) is the value of assets used by the DNSP to provide standard control services, but only to the extent that those assets are used to provide such services.¹⁶¹ The NER provides that value of the RAB may be added to or reduced to incorporate assets that have now been or are no longer classified as standard control services.¹⁶²

¹⁵⁹ Energex proposal, p. 45.
Ergon proposal, p. 43.

¹⁶⁰ NER, clause 6.8.2(c)(2).

¹⁶¹ NER, clause 6.5.1(a).

¹⁶² NER, schedule 6.2, clause 6.2.1(e)(7) and 6.2.1(e)(8).

In accordance with the NER requirements Energex's and Ergon's respective building block proposals will need to propose a RAB value that includes those assets or a proportion of those assets that are used to provide standard control services.

As part of making its distribution determination the AER will review and consult on the appropriateness of Energex's and Ergon's proposed RAB.

3.6 AER proposed position

3.6.1 Energex

Control mechanism to apply to standard control services

The AER's proposed position is to apply a fixed revenue cap form of control to Energex's standard control services for the 2010–15 regulatory control period.

The control mechanism will be of the CPI – X form and will include adjustments to incorporate any revenue increment or decrement associated with a STPIS and DMIS.

Control mechanism to apply to alternative control services

The AER's proposed position is to apply a price cap form of control to Energex's alternative control services in the 2010–15 regulatory control period.

The AER proposes to apply a limited building block approach to determine the efficient costs of providing street lighting services under the price cap control mechanism in the first year of the regulatory control period and establish a price path for remaining years of the period.

For all of Energex's remaining alternative control services, the AER proposes to approve prices in the first year of the regulatory control period and establish a price path for remaining years of the period. The approved price is the maximum price Energex is permitted to charge for a particular service.

3.6.2 Ergon

Control mechanism to apply to standard control services

The AER's proposed position is to apply a fixed revenue cap form of control to Ergon's standard control services for the 2010–15 regulatory control period.

The control mechanism will be of the CPI – X form and will include adjustments to incorporate any revenue increment or decrement associated with a STPIS and DMIS.

Control mechanism to apply to alternative control services

The AER's proposed position is to apply a price cap form of control to Ergon's alternative control services in the 2010–15 regulatory control period.

The AER proposes to apply a limited building block approach to determine the efficient costs of providing street lighting services under the price cap control mechanism in the first year of the regulatory control period and establish a price path for remaining years of the period.

For all of Ergon's remaining alternative control services, the AER proposes to approve prices in the first year of the regulatory control period and establish a price path for remaining years of the period. The approved price is the maximum price Ergon is permitted to charge for a particular service.

Appendix A: The AER’s proposed service groups and classification

Table A1 sets out the AER’s proposed service groups, a description of the activity types and Energex’s and Ergon’s proposed service groupings. It also sets out the current QCA service classification and the AER’s proposed classification.

Table A1 The AER’s proposed service groups and classification

AER proposed group	Activity description	Energex proposed group	Ergon proposed group	QCA current classification	AER proposed classification
Network services	Construction of shared network	Network services	Network services	Prescribed service	Standard control service
	Maintenance of shared network	Network services	Network services	Prescribed service	Standard control service
	Operating the shared network for DNSP purposes	Network services	Network services	Prescribed service	Standard control service
	Planning the shared network	Network services	Network services	Prescribed service	Standard control service
	Designing the shared network	Network services	Network services	Prescribed service	Standard control service
	Emergency Response	Customer services	Customer services	Prescribed service	Standard control service
	Administrative Support	Customer services	Customer services	Prescribed service	Standard control service
Connection services	Connection of connection assets	Connection services	Connection services	Prescribed service	Standard control service
	Small service connections	Not specifically mentioned	Not specifically mentioned	Prescribed service	Standard control service
	Installation inspection	Not mentioned	Customer services	Prescribed service	Standard control service
	Commissioning of metering and load control equipment.	Connection services	Connection services	Prescribed service	Standard control service

	De-energisation and Re-energisation	De-energisation and Re-energisation	De-energisation and Re-energisation	Prescribed service	Standard control service
Metering services	Type 5–7 metering	Connection services	Connection services	Prescribed service	Standard control service
	Scheduled meter reading	Customer services	Customer services	Prescribed service	Standard control service
	Unscheduled meter reading—non chargeable	Customer services	Customer services	Prescribed service	Standard control service
	Metering investigation	Customer services	Customer services	Prescribed service	Standard control service
	Maintenance and repair of meters and/or control equipment	Not mentioned	Not mentioned	Prescribed service	Standard control service
Quoted services	Rearrangement of shared network assets	Quoted services	Quoted services	Excluded service	Alternative control service
	Safety services (including high load escorts and covering of low voltage mains)	Supplementary services and Unregulated	Quoted services and Unregulated	Excluded service	Alternative control service
	Data services (type 5–7 metering)	Quoted services	Quoted services	Excluded service	Alternative control service
	Design services	Quoted services	Quoted services	Excluded service	Alternative control service
	Supply enhancement	Enhanced services	Enhanced services	Excluded service	Alternative control service
	Ancillary Metering services (type 5–7)	Ancillary Metering services	Ancillary Metering services	Excluded service	Alternative control service
	Metering enhancement	Enhanced services	Enhanced services	Excluded service	Alternative control service

	Re-test	Not mentioned	Supplementary services	Excluded service	Alternative control service
	Supply abolishment	Quoted services & Additions and Alterations	Additions and Alterations	Excluded service	Alternative control service
	Temporary connections	Temporary Supply Services	Temporary Supply services	Excluded service	Alternative control service
	Design construction of connection assets including at subtransmission level	Connection services Subtransmission connection services	Connection services (Subtransmission connection services were not separated)	Prescribed service	Alternative control service
	Street lighting	Unregulated	Unregulated	Prescribed service	Alternative control service
	After hours service	Quoted services, Enhanced services and Supplementary services	Quoted services, Enhanced services and Supplementary services	Excluded service	Alternative control service
Compensable services	Recoverable works	Supplementary services	Supplementary services	Excluded service	Alternative control service
	Fault response—not DNSP fault	Supplementary services	Supplementary services	Excluded service	Alternative control service
	Wasted attendance	Supplementary services	Supplementary services	Excluded service	Alternative control service
Unregulated services	Non distribution services				
	Distribution services provided in a competitive market	Unregulated	Unregulated	Unregulated	Unclassified