



NSW and ACT revenue smoothing rule change

AER submission to Australian Energy Market Commission consultation paper

December 2016

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GPO Box 4141,
Canberra ACT 2601
or publishing.unit@accg.gov.au.

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: (03) 9290 1444
Fax: (03) 9290 1457

Email: AERInquiry@aer.gov.au
AER Reference: D16/165175

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1 Introduction

The AER welcomes the opportunity to respond to the AEMC's consultation paper regarding the respective revenue smoothing rule change requests from ActewAGL and the NSW distributors (the NSW/ACT distributors).¹

We recognise there is potential for price shocks if the ongoing appeals for the NSW/ACT distributors' 2015 final determinations result in adjustments to their total revenue requirements (revenue adjustment).²

We therefore support the aim of the proposed participant derogations (proposed derogations) to minimise price volatility that may arise from the appeals process. We also support the general solution of smoothing the effect of revenue adjustments over two regulatory control periods.

However, we consider there are issues with several aspects of the proposed derogations. Accordingly, we do not support the proposed derogations as they are currently drafted and consider they require changes.

Broadly, we consider the detailed and legalistic provisions in the proposed derogations may have unintended implications beyond the intention to minimise price shocks. We consider it is preferable to have high level provisions that focus on the core problems (potential price shocks) and the core solution (smoothing of revenue across regulatory control periods). We consider the AER, the NSW/ACT distributors and other stakeholders can then resolve the details of application.

We also consider the process for determining the allocation of revenue across regulatory control periods is prescriptive and inflexible. It does not allow for adjustments to this allocation until the annual pricing proposals. However, approval of annual pricing proposals is a time-constrained process with no stakeholder consultation.

Section 3 of this submission discusses some concerns with the proposed derogations and suggests potential solutions.

Section 4 of this submission includes our consideration of more specific aspects of the proposed derogations. We include these issues for the AEMC's consideration, particularly if the AEMC opts to maintain particular aspects of the proposed derogations.

Section 5 contains our responses to the AEMC's questions in the consultation paper.

We have not provided suggestions on rule drafting at this time. However, we would be pleased to provide assistance to the AEMC in this regard later in the process.

¹ The NSW distributors are Ausgrid, Endeavour Energy and Essential Energy.

² We use the term 'revenue adjustment' to mean any increment or decrement to a NSW/ACT distributor's revenue allowance for the 2014–19 regulatory control period due to the ongoing appeals. This term is broadly similar to 'adjustment amount' from the NSW distributors' proposal and 'distribution adjustment amount' from ActewAGL's proposal. Note, however, the latter terms have very specific definitions in the rule change proposals, which we discuss in section 4.1.

2 Summary of the proposed derogations

2.1 Background

On 26 February 2016, the Australian Competition Tribunal (the Tribunal) handed down its decision on the NSW/ACT limited merits review of our April 2015 determinations (2015 determinations).³ These decisions covered the appeals of Ausgrid, Endeavour Energy, Essential Energy, ActewAGL, and the NSW Public Interest Advocacy Centre (PIAC). The Tribunal set aside our 2015 decisions and remitted them back to the AER to be remade in accordance with the Tribunal's directions.

On 24 March 2016, the AER applied to the Full Federal Court for judicial review of the Tribunal's decisions. The Full Federal Court has heard the matter and reserved its judgement. It is likely to be some time before the appeal process is resolved, which might involve a remittal back to the Tribunal to consider the matter again.

Regardless of whether the Full Federal Court affirms the AER's 2015 determinations or remits the matter back to the Tribunal, there is a risk of price shocks to consumers. Price shocks could occur if the NSW/ACT distributors are required to recover revenue adjustments in the current regulatory control period only. We consider the NER as currently drafted is likely to be able to accommodate smoothing of any revenue adjustments across different regulatory control periods. For policy clarity, however, we support a rule change that explicitly enables such smoothing.

2.2 Proposed revenue smoothing process

The primary objective of the rule change proposals is to minimise network pricing volatility for consumers. In order to not pre-judge the outcome of the Full Federal Court process, the proposed derogations maintain the remaking of the 2015 determinations under the usual criteria in Chapter 6 of the NER. In other words, we would remake the 2015 determinations without regard to smoothing the revenue adjustment across regulatory control periods.

The proposed derogations would be given effect through Chapter 8A and would only apply to the NSW distributors and ActewAGL. The proposed derogations provide that:

- any smoothing of revenues between the current regulatory period and the subsequent regulatory control period occurs through the annual pricing proposal process
- any revenue carried forward to the subsequent regulatory control period will be spread across more than one year through adjustment to the building blocks in the determination for the subsequent regulatory control period.

The proposed derogations would achieve the above aims through the following general steps:

³ The Tribunal also handed down its decision on the limited merits review of our June 2015 determination for Jemena Gas Networks (NSW). We do not consider this appeals process in this submission.

1. Determine any revenue adjustment and the allocation of this amount between the current and subsequent regulatory control periods (this process is termed the 'adjustment amount allocation determination' in the proposed derogations).
2. Make any required adjustments in the current regulatory control period via the pricing proposal process (these adjustments are termed 'annual adjustment amount' in the NSW distributors' proposed derogation).⁴
3. Make any required adjustments in the subsequent regulatory control period via the building blocks determination.

If the AER does not remake the 2015 determinations by 1 March 2018 (one month before the deadline for submitting pricing proposals for 2018–19) any revenue adjustment is recovered in the subsequent regulatory control period.⁵

⁴ ActewAGL uses the term 'annual distribution adjustment amount'.

⁵ See clause 8A.14.1(c) on the NSW distributors' proposal and clause 8A.15.1(c) of ActewAGL's proposal.

3 Issues

The issues we discuss in this section relate to the process of allocating revenue between regulatory control periods in the adjustment amount allocation determination.⁶

3.1 Process of allocating revenue across regulatory control periods in the proposed derogations

The adjustment amount allocation determination, as currently drafted in the proposed derogations, is a prescriptive and mechanical process with little room for flexibility.⁷ Broadly, it involves determining:

- the revenue adjustment as a result of remaking the 2015 determinations—The NSW distributors and ActewAGL use the terms *adjustment amount* and *distribution adjustment amount*, respectively. These are specifically defined and calculated terms in the proposed derogations. We discuss these terms in more detail in section 4.1.
- the allocation of the revenue adjustment across the current and subsequent regulatory control period—The allocation is mathematical in nature and prescribed in several clauses in the proposals.⁸

The proposed derogations then allow the NSW/ACT distributors and the AER to amend the allocation of the revenue adjustment through the pricing proposal process.⁹

We have several concerns with this two-stage process.

Firstly, the pricing proposal process is subject to very limited timeframes. The NER requires the AER to approve and publish a pricing proposal within 30 business days of receipt.¹⁰ This timeframe does not allow for stakeholder consultation on departures from the default allocation in the adjustment amount allocation determination. 30 business days is also a limited timeframe for the AER to assess and make a decision on a complex matter with potentially material consequences for consumers.

Second, allowing the NSW/ACT distributors or the AER to vary the revenue smoothing through the pricing proposals would increase uncertainty. Stakeholders would base expectations on the default allocation in the adjustment amount allocation determination. However, this allocation may change without consultation through the annual pricing proposal process.

⁶ See clause 8A.14.3 of the NSW distributors' proposal, and clauses 8A.15.3 of ActewAGL's proposal.

⁷ See clauses 8A.14.3(a)–(d) of the NSW distributors' proposal, and clauses 8A.15.3(a)–(d) of ActewAGL's proposal.

⁸ For the NSW distributors' proposal see the definitions of *expected subsequent adjustment amount* and *annual adjustment amount* in clause 8A.14.5 and their application in clauses 8A.14.3(e) and 8A.14.3(k). For ActewAGL's proposal see the definitions of *expected subsequent distribution adjustment amount*, *annual distribution adjustment amount* and *average annual distribution adjustment amount* in clause 8A.15.5 and their application in clauses 8A.15.3(e) and 8A.15.3(k).

⁹ See clauses 8A.14.3(f) and 8A.14.3(g)(3) of the NSW distributors' proposal, and clauses 8A.15.3(f) and 8A.15.3(g)(3) of ActewAGL's proposal.

¹⁰ NER, cl 6.18.8(c3).

Lastly, we consider the proposed derogations create unnecessary duplication of the regulatory process. The participant derogation splits the decision making process on the smoothing of revenue across two separate processes. This would increase the administrative burden for the AER and the NSW distributors.

In section 3.2, we provide our high level suggestions to address these concerns.

3.2 Suggested amendments to proposed derogations

As we noted earlier, we have not provided detailed suggestions on rule drafting at this stage. Here, we provide our high level suggestions to address our key concerns with the proposed derogations.

We consider it is preferable to finalise the allocation of revenue adjustments across regulatory control periods during the adjustment amount allocation determination. In turn, we do not consider it is necessary or desirable to vary the allocation of revenue adjustments during the pricing proposal process. To facilitate this, we consider the AER should determine the allocation of the revenue adjustment having regard to high level principles, rather than a prescribed calculation.

We consider our suggested process would address the concerns we have regarding the proposed derogations' 'two-stage' process (see section 3.1). It would increase certainty for stakeholders regarding the final allocation of the revenue adjustment between regulatory control periods. It would also enable greater stakeholder consultation regarding the allocation.

We note the proposed derogations provide for the adjustment amount allocation determination to occur in parallel with the remaking of the 2015 determinations.¹¹ We consider there would likely be sufficient time during this process to determine the appropriate allocation of the revenue adjustment between regulatory control periods, and to consult on this allocation, without requiring amendments during the pricing proposal process.

Table 1 summarises the proposed derogations and our suggested high-level amendments.

We understand the AEMC may opt to retain certain aspects of the proposed derogations. In section 4, we discuss particular aspects of the proposed derogations, which may further assist the AEMC in drafting provisions for the proposed derogations. For example, we consider it would be preferable to not include an adjustment amount definition in the rules and instead leave this to be a matter determined using judgement, which is guided by a set of appropriate principles or criteria in the rules. However, if the AEMC is minded to retain an adjustment amount definition in the rules, we make a preliminary recommendation in section 4.1 on how the distributors' proposed definition can be improved.

¹¹ See clause 8A.14.3(b) of the NSW distributors' proposal, and clauses 8A.15.3(b) of ActewAGL's proposal.

Table 1 Summary of proposed derogations and AER suggested amendments

	Proposed derogations	AER suggested amendments
Process	<p>Two-stage:</p> <ol style="list-style-type: none"> 1. Adjustment amount allocation determination—the AER determines the allocation of the revenue adjustment between the current and subsequent regulatory control periods. 2. Pricing proposal—the distributor (or the AER) can propose a different allocation of the revenue adjustment. 	<p>One stage:</p> <p>Adjustment amount allocation determination—the AER consults on and determines the amount and allocation of the revenue adjustment between regulatory control periods, and between regulatory years, based on a set of principles or criteria in the rules.</p>
Allocation of revenue	<ol style="list-style-type: none"> 1. Adjustment amount allocation determination—the proposed derogations prescribe the allocation of the revenue adjustment between regulatory control periods (default allocation). Applies a mathematical formula codified in the rules and requires little or no judgement. 2. Pricing proposal—the distributor or the AER can propose an alternative allocation of the revenue adjustment if it better minimises pricing variation than the default allocation. The AER approves or rejects the proposed variation during the pricing proposal process based on this principle. Applies judgement. 	<p>The AER consults on and determines the amount and allocation of the revenue adjustment between regulatory control periods, and between regulatory years, based on a set of principles or criteria in the rules. Applies judgement.</p>
Takes into account other sources of price stability or instability?	<ol style="list-style-type: none"> 1. Adjustment amount allocation determination—No. Applies mathematical formula codified in 	<p>Yes. The set of principles or criteria should be broad enough to take into account these considerations.</p>

(e.g. under/over recovery of distribution revenue against s.59A undertakings; unders/overs account adjustment of transmission and jurisdiction scheme amount charges)

the rules that does not take into account these factors.

2. Pricing proposal—Unclear whether these would be relevant considerations under the proposed drafting.

Consultation

1. Adjustment amount allocation determination—there are few matters for consultation given the prescribed nature of the default allocation.
2. Pricing proposal—no scope for stakeholder consultation. 30 business day timeframe from start to end of process is too limited to facilitate meaningful consultation.

The adjustment amount allocation determination, including stakeholder consultation, occurs in parallel with the remaking of the 2015 determinations.

Careful consideration would need to be given in designing the principles or criteria in the rules to guide the revenue smoothing decision making process. As an example and starting point to guide consideration, the AER’s preliminary view is to suggest the following principles and criteria:

- In the adjustment amount allocation determination, the AER must determine the amount and allocation of expected revenue to be smoothed:
 - between the 2014–19 period and the 2019–24 period,¹² and
 - between the remaining regulatory years of the 2014–19 period
- In determining these amounts and allocations, the AER must take into account the following criteria:
 - The amount and allocation of expected revenue should be such as to minimise, as far as reasonably possible, variance between network charges for consumers between regulatory years
 - The amount and allocation of expected revenue should be designed to equalise (in terms of net present value) the expected revenue that would have been earned by the distribution network service provider if no revenue smoothing had occurred

¹² The drafting of this provision assumes that the ultimate outcome of the appeals process is that the distribution determination is remitted back to the AER, and that the remittal determination is completed within the 2014–19 period. Accordingly, an additional provision may be needed to be added to deal with alternative scenarios.

- The amount and allocation of expected revenue should be designed having regard to other factors that may influence the level of total network charges (inclusive of distribution charges, transmission charges and jurisdictional scheme amounts), so that the decision on the amount and allocation is not made in isolation of these other factors.

The first two criteria are broadly modelled from the provisions in clause 6.5.9 of the rules that guide the smoothing of revenue *within* a regulatory control period. The AER considers these provisions contain relevant principles, specified at an appropriate level of detail, and can be tailored to also guide the smoothing of revenue *between* regulatory control periods.

3.3 Reasons for a more flexible process

Remaking the 2015 determinations may result in significant revenue adjustments for the NSW/ACT distributors. Without provisions allowing recovery of the revenue adjustment across regulatory control periods, this may result in price shocks. This is because the NSW/ACT distributors may need to recover the revenue adjustment in the final year(s) of the current regulatory control period.

The proposed derogations focus on the difference between the 2015 determinations and the appeal outcome. However, there are other factors that could affect revenue and price levels. Whether or not we need to remake the 2015 determinations, the NSW/ACT distributors may be significantly under or over recovering revenues in the current regulatory control period. This applies particularly to Ausgrid and Endeavour Energy, who escalated 2015–16 NUOS prices by CPI to derive 2016–17 NUOS prices in their enforceable undertakings.¹³ Enforceable undertakings may also be required for the 2017–18 regulatory year, which may add further uncertainty regarding the level of over or under recovered revenues. This underlines the importance of determining the revenue smoothing having regard to high level principles, rather than a prescribed calculation.

In previous appeals, under/over recovered revenues were settled through the unders and overs accounts of the pricing proposal process. Even if we do not need to remake the 2015 determinations, the enforceable undertakings may result in price shocks if Ausgrid and Endeavour Energy have significant amounts in their unders and overs accounts. Under or over recovered revenues may therefore be an important consideration in minimising price shocks (in addition to differences between the 2015 determination and the appeal outcome).

We consider the proposed derogations should be flexible enough to enable consideration of under/over recovered revenues during the adjustment amount allocation determination. It is unclear whether the proposed derogations allow this.

In addition, distribution customers ultimately pay what are commonly known as NUOS charges. NUOS charges include charges relating to standard control services (commonly known as DUOS charges).¹⁴ However, they also include designated pricing proposal

¹³ We note ActewAGL applied an enforceable undertaking similar to Ausgrid and Endeavour. As ActewAGL is under an average revenue cap, it does not require an unders and overs account. However, a true-up will likely be required if we remake our 2015 determination for ActewAGL.

¹⁴ The NSW/ACT distributors' appeals relate to the revenue they would earn from providing standard control services.

(commonly known as TUOS) charges and jurisdictional scheme amounts. The enforceable undertakings could result in NSW/ACT distributors incurring large under or over recovery of TUOS charges, which could translate to price shocks at the NUOS level. We consider the proposed derogations should be flexible enough to enable consideration of these factors during the adjustment amount allocation determination. Again, it is unclear whether the proposed derogations allow this.

We consider allocating the revenue adjustment across regulatory control periods must balance:

- any price shocks from recovering any revenue adjustments in the final year(s) of the current regulatory control period
- any distortion caused by deviation from the efficient price/revenue path as determined in the distribution determination for the subsequent (2019–24) regulatory control period.

It is possible that allocating a greater portion of the revenue adjustment to the final year(s) of the current regulatory control period is desirable on balance, considering all the factors that could influence the prices customers face. For example, it may be desirable for a NSW/ACT distributor to recover the entire revenue adjustment in the final year of the current regulatory control period if this is balanced by a negative adjustment in DUOS and/or TUOS revenues that it over-recovered in the first years of the current regulatory control period. This would mitigate fluctuations in NUOS charges, while avoiding the distortionary effect of re-allocating revenue to the subsequent regulatory control period.

4 Comments on specific provisions and issues

This section addresses certain details of the proposed derogations. We include them here as issues for the AEMC's consideration, particularly if the AEMC opts to maintain particular aspects of the proposed derogations.

4.1 Definition of adjustment amount

The NSW distributors' rule change request stated that, in some circumstances, the prescribed mechanism (the 'default position') for calculating the annual adjustment amount will not lead to the intended outcome of minimising pricing volatility for NSW customers.¹⁵ In these circumstances, the NSW submission noted that it would be necessary to vary the annual adjustment amount at the pricing proposal stage to achieve the stated aim of minimising pricing volatility. The ActewAGL rule change request addresses this same point indirectly, though the same principles apply.¹⁶

We consider that the NSW/ACT distributors' rule change requests understate the problem with their proposed default calculation. In most circumstances, the annual adjustment amount will either be in the wrong direction or of the wrong magnitude to minimise pricing volatility. It would be possible to correct this at the pricing proposal stage, as stated in the NSW/ACT distributors' submissions. However, in most circumstances there would be a significant difference between the default annual adjustment amount and any varied annual adjustment amount that would minimise pricing volatility. This exacerbates our concerns over the lack of consultation and short timeframe available at the pricing proposal stage, as discussed in section 3 above. It also calls into question the usefulness of having this detailed and prescriptive mechanism included in the proposed derogations.

In our view, the problem with the proposed calculation in the rule change request stems from the NSW/ACT distributors' initial definition of an adjustment amount. The core of this definition is the change in annual revenue requirements (ARRs) from the original 2015 determination to the remade 2015 determination.¹⁷ The ARR is the base, unsmoothed building block total for each year. This definition focuses on the uncertainty around what the unsmoothed building blocks should be, which is resolved when the remade 2015 determination is made.

Minimising pricing volatility for customers means minimising changes in final, smoothed (expected) revenue from year to year. The change in unsmoothed building blocks is one cause of changes in smoothed revenue, but for the NSW/ACT distributors it is not the primary driver. Other factors include the 2014–15 transitional determination, changes in the (annually updated) cost of debt during the 2015–2019 regulatory control period, the X factors chosen in the original 2015 determination, and the yearly changes in smoothed revenues

¹⁵ See page 22 of attachment 1 of the NSW distributors' rule change request.

¹⁶ See pages 15–16 of the ActewAGL rule change request.

¹⁷ The comparison occurs in net present value terms across the regulatory control period. The calculation is remade by taking the annual ARR less the original ARR, so an increase in ARR in the remade determination means a positive adjustment amount. In turn, a positive adjustment amount means revenue that would have been recovered in 2017–18 or 2018–19 is instead deferred until the 2019–2024 regulatory control period.

(via enforceable undertakings) since this time. The smoothed revenue to be recovered in the final year or years (depending on the timing of the remade 2015 determination) of the 2015–2019 regulatory control period will reflect the combined effect of all these factors.

In other words, the remade 2015 determination determines:

- to what extent the unsmoothed building blocks in the original 2015 determination were too low or too high
- to what extent the smoothed revenues already recovered by the DNSP were too low or too high, relative to the unsmoothed revenue for those years.

The second effect generally outweighs the first in terms of its effect on customer pricing volatility; but only the first is recognised in the NSW/ACT distributors' proposed definition of an adjustment amount. Hence, where the effects are in opposite directions, the proposed adjustment amount can be in the wrong direction.¹⁸ Where the effects are in the same direction, the proposed adjustment amount may be in the right direction, but of the wrong magnitude.¹⁹

This apparent misspecification of the adjustment amount is a key reason behind our stated preference for allowing greater discretion when setting the initial adjustment amount at the time of the remade determination, prior to the pricing proposal stage.

Removing the detailed and prescriptive mechanism entirely would resolve this issue. If, however, a prescriptive adjustment allocation were to remain in the participant derogations, it is possible to define the adjustment amount in such a way that it is more likely to minimise volatility. For example:

The **adjustment amount** represents the expected revenue (smoothed revenue) for the remaining year(s) of the 2015–19 regulatory control period in the remade 2015 determination less the annual revenue requirement (unsmoothed revenue) for the equivalent year(s) in the original 2015 determination for the 2015–19 regulatory control period.

Conceptually, this definition reflects the numerous factors identified above that influence smoothed revenue in addition to changes in unsmoothed building blocks. It would require changes to the definition section of the derogation, but would retain the existing structure for the subsequent calculation steps based on the adjustment amount. We note there would still be scenarios where it would be necessary to vary the calculated adjustment amount in order to better minimise pricing volatility. However, these variations would be relatively infrequent, and of smaller magnitude, than those arising under the NSW/ACT distributors' proposed adjustment amount definition. In general, our alternative approach produces a revenue path that is more likely to minimise pricing volatility than the distributors' proposed approach.

¹⁸ For example, consider the case where the original 2015 determination ARR's were too low, but the smoothed revenue already recovered was too high. In these circumstances the default mechanism may calculate that revenue should be deferred from 2018–19 into the 2019–2024 regulatory control period, but minimising volatility requires that revenue be brought forward from 2019–2024 into 2018–19.

¹⁹ For example, consider the case where the original 2015 determination ARR's were too low, and the smoothed revenue already recovered was also too low. In these circumstances the default mechanism may calculate that so much revenue should be deferred until the 2019–2024 regulatory control period that it reduces final revenue in 2018–19, when minimising volatility requires a small increase in that year.

4.2 Mechanism for recovering revenue adjustments in the current regulatory control period

The proposed derogations provide for the NSW/ACT distributors to recover part of the revenue adjustment in the current regulatory control period through their pricing proposals.²⁰ To be compliant with the relevant distribution determination, we consider such revenue adjustments should be accounted for in the control mechanism and side constraint formulas during the pricing proposal process. However, the control mechanism and side constraint formulas in the 2015 determinations do not appear to provide for recovery of such revenue adjustments.²¹ This may introduce uncertainty in the pricing proposal process.

As we noted earlier, the proposed derogations maintain the remaking of the 2015 determinations under the usual processes required by chapter 6 of the NER. We note the NSW/ACT distributors did not appeal any aspect of the control mechanism and side constraints in the 2015 determinations.

If we remake our 2015 determinations, we consider it is appropriate to amend the control mechanism and side constraint formulas in that process to facilitate the revenue smoothing. However, we are open to consultation with the AEMC, the NSW/ACT distributors and other stakeholders regarding this matter.

For completeness, we also considered whether any revenue adjustment can be recovered as a pass through or as a jurisdictional scheme amount in the pricing proposals. For the reasons below, we do not consider either of these options is appropriate.

- Pass through—the NSW/ACT distributors can recover approved pass through amounts via the ‘B factor’ in the revenue cap and side constraint formulas. However, a pass through event, as defined under clause 6.6.1(a1), appears to require a change in the costs of providing distribution services. Our remade 2015 determination would not result in a change in costs.
- Jurisdictional scheme amount—the NSW/ACT distributors can recover jurisdictional scheme amounts as part of their overall NUOS charges under clause 6.18.7A(a)–(c) of the NER. However, a jurisdictional scheme, as defined under clause 6.18.7A(x), appears to require a payment to a person. Our remade 2015 determination would not require such a payment.

4.3 Amendments to the distribution pricing rules

The proposed derogations provide for the distributors to recover a portion of the revenue adjustment amount through their pricing proposals.²² To facilitate recovery through pricing

²⁰ See clauses 8A.14.3(e) and (f) of the NSW distributors' proposal, and clauses 8A.15.3(e) and (f) of ActewAGL's proposal.

²¹ AER, *Final decision: Endeavour Energy distribution determination 2015–16 to 2018–19: Attachment 14 – Control mechanism*, April 2015; AER, *Final decision: Ausgrid distribution determination 2015–16 to 2018–19: Attachment 14 – Control mechanism*, April 2015; AER, *Final decision: Essential Energy distribution determination 2015–16 to 2018–19: Attachment 14 – Control mechanism*, April 2015; AER, *Final decision: ActewAGL distribution determination 2015–16 to 2018–19: Attachment 14 – Control mechanism*, April 2015.

²² See clauses 8A.14.3(e), (f) and (g) of the NSW distributors' proposal, and clauses 8A.15.3(e), (f) and (g) of ActewAGL's proposal.

proposals, the proposed derogations include provisions that amend various clauses in section 6.18 (the distribution pricing rules).²³

We are concerned these highly detailed and legalistic provisions may have unintended implications beyond the intention of the participant derogation (to minimise price shock due to the appeals process). This could result in uncertainty during the annual pricing proposal process. We consider the drafting of these provisions requires more careful consideration.

We have particular concerns with clause 8A.14.3(h)(1). It states each NSW distributor does not have to comply with the tariff structure statement when setting prices ‘to the extent necessary to allow’ deferral of revenue in accordance with the participant derogation.²⁴

Tariff structure statements must contain a description of the approach to setting each tariff, which must reflect the efficient costs of providing distribution services.²⁵ Tariff structure statements must also contain the distributor’s tariff structures for a regulatory control period including tariff classes, charging parameters, tariff assignment policies. It is unclear if clause 8A.14.3(h)(1) would enable the NSW/ACT distributors’ to submit pricing proposals that are not consistent with these aspects of the tariff structure statements.²⁶ If so, the reasons for such exemptions are unclear.

4.4 References to regulatory control period

The proposed derogations make many references to the defined terms ‘current regulatory control period’ and ‘subsequent regulatory control period’.²⁷ For example, the provisions that set out the calculation of the adjustment amount and its allocation across regulatory control periods make many references to these defined terms. These terms therefore have important implications for the practical application of the proposed derogations. As we discuss below, these particular terms may lead to legal technicality issues. We consider this is another example where highly detailed and legalistic provisions may have unintended implications beyond the intention of the participant derogation. That is, this is an example of where the intended application of the rule change may not eventuate because it is discovered after the mechanism is codified in the rules that there are technical legal problems with the rule drafting. These drafting problems could make the rule unimplementable, or require the rule to be implemented in a way that was not intended. These risks increase with the level of complexity and prescriptiveness in the rule drafting.

Clause 8A.14.5 of the NSW distributors’ derogation defines these terms as:

current regulatory control period means, for each NSW DNSP, the regulatory control period of five years that commenced on 1 July 2014 and ends on 30 June 2019, which includes the transitional regulatory control period and subsequent regulatory control period as those terms are defined in clause 11.55.1.²⁸

²³ See clauses 8A.14.3(h)(1)–(6) of the NSW distributors’ proposal, and clauses 8A.15.3(h)(1)–(6) of ActewAGL’s proposal.

²⁴ The equivalent provision in ActewAGL’s proposed derogation is clause 8A.15.3(h)(1).

²⁵ NER, clause 6.18.1A(a)(5).

²⁶ NER, cll 6.18.2(b)(2) and (7).

²⁷ See clause 8A.14.5 of the NSW distributors’ proposal, and clause 8A.15.5 of ActewAGL’s proposal.

²⁸ We note this definition appears to use the term ‘subsequent regulatory control period’ to mean the 2015–16 to 2018–19 regulatory years (the years after the transitional regulatory control period). However, the proposed derogations also define

subsequent regulatory control period, of a NSW DNSP, means the regulatory control period for the NSW DNSP that immediately follows the current regulatory control period.

However, it is unclear whether there is currently a regulatory control period for the NSW/ACT distributors because the Tribunal set aside our 2015 determinations. It is therefore unclear whether the proposed derogation's references to the 'current regulatory control period' could lead to legal technicality issues.

4.5 Interaction of the proposed derogations with the NSW Electricity Price Guarantee

The Electricity Price Guarantee (the Guarantee) is a jurisdictional obligation on the NSW distributors (as well as the NSW transmission business, TransGrid). It requires the winning bidder(s) in the sale of the NSW distribution and transmission networks to guarantee that revenues for 2018–19 will be lower than for 2013–14.²⁹ The Guarantee is silent on revenue for other years.

If we remake the 2015 determinations, it is conceivable that allowed revenues for 2018–19 may exceed actual revenues for 2013–14 even with revenue smoothing under the proposed derogations. In this case, the NSW distributors would under-recover revenues in 2018–19 under the Guarantee.

The Guarantee is silent on whether the NSW distributors are able to recoup any under-recoveries in future periods. We note the Electricity Price Commissioner, who monitors compliance with the Guarantee, has a general role of ensuring the sale of the networks 'will not put upward pressure on prices in the short, medium and long term'.³⁰

We suggested the proposed derogation should be amended such that we determine the allocation of the revenue adjustment having regard to high level principles, rather than a prescribed calculation (see section 3). If this suggested amendment is introduced in the proposed derogation, an issue to consider is how we should account for the effect of the Guarantee on 2018–19 revenues when making the adjustment amount allocation determination. For example, does the Guarantee place a ceiling on how much revenue we can allocate to the 2018–19 financial year, such that the rest of the revenue adjustment is automatically smoothed in the subsequent regulatory control period? Or, does the adjustment amount allocation determination effectively ignore the Guarantee? That is, if the revenue we determine for 2018–19 is above 2013–14, the NSW distributors are required to forego revenue above the 2013–14 levels.

The uncertainty surrounding the Guarantee's implications on revenue recovery further emphasises the importance of a flexible approach to revenue smoothing. A flexible approach would enable us to consult on the Guarantee's implications on revenue recovery in the

'subsequent regulatory control period' as the regulatory control period that will encompass the 2019-20 to 2023-24 regulatory years.

²⁹ http://www.austlii.edu.au/au/legis/nsw/consol_act/enata2015566/s8.html

³⁰ NSW Government, *Submission to legislative council inquiry into the leasing of electricity infrastructure*, 12 May 2015, pp. 4, 7 and 11.

adjustment amount allocation determination. A prescriptive approach, on the other hand, precludes such considerations.

5 Questions from the AEMC consultation paper

Question 1 Long term interest of consumers

(a) To what extent would significant pricing volatility lead to inefficient usage and uneconomic investment decisions by consumers?

(b) Would recovering any potential adjustments in revenue over two regulatory periods lead to more efficient usage and investment decisions by consumers?

We agree with the AEMC that price shocks, even if they are one-off, can lead customers to incorrectly assume they will continue into the future. Customers may then make inefficient investment decisions based on these assumptions.³¹ We therefore support mechanisms that minimise revenue and price fluctuations. We note the regulatory framework generally attempts to minimise price fluctuations. This is evident in:

- the requirement for tariffs to move towards efficient structures 'albeit after a reasonable period of transition'.³² In the first round of tariff structure statements, the general view is that a transition to efficient prices that is too rapid would result in bill impacts, both positive and negative.
- the application of side constraints.³³ While side constraints apply to tariff classes, they inhibit price fluctuations when compared to the counterfactual.
- revenue smoothing through the X factor. The AER uses the X factor to ensure a smoother revenue path over a regulatory control period. This in turn minimises price fluctuations. The AEMC noted the X factor "allows the AER to minimise fluctuation in average network prices by setting a 'smoothed' revenue path for the regulatory control period."³⁴

Regarding question 1(b), the adjustment amount allocation determination must balance:

- any price shocks from recovering any revenue increments in the final year(s) of the current regulatory control period
- deviating from the efficient price/revenue path as determined in the distribution determination for the subsequent (2019–24) regulatory control period.

We consider having greater flexibility in the adjustment amount allocation determination (see section 3) would enable us to better balance these two factors.

³¹ AEMC, *Consultation paper: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2016; National Electricity Amendment (Participant derogation – ACT DNSP revenue smoothing) Rule 2016*, 17 November 2016, p. 17.

³² NER, cl 6.18.5(h)(1).

³³ NER, cl 6.18.6.

³⁴ AEMC, *Consultation paper: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2016; National Electricity Amendment (Participant derogation – ACT DNSP revenue smoothing) Rule 2016*, 17 November 2016, p. 8.

Question 2 Adjustment mechanism

What is the appropriate degree of detail and prescription for a mechanism to manage revenue smoothing under uncertain circumstances?

The degree of detail and prescription should seek the appropriate balance between:

- certainty of process for the AER, the NSW/ACT distributors and other stakeholders
- flexibility to deal with factors not accounted for in the proposed derogations.

As we discussed in sections 1 and 3, we consider the proposed derogations are overly detailed and prescriptive. We consider it is preferable to have more high level provisions that focus on the core problems (potential price shocks) and the core solution (smoothing of revenue across regulatory control periods). We consider the AER, the NSW/ACT distributors and other stakeholders can then resolve the details of application.

Question 3 Net present value

Should the AER have discretion over how it calculates the NPV of the adjustment amounts, or should it be specified in the NER, if any rules are made?

We consider that the basis for calculating the NPV of the adjustment amounts is relatively clear. The discount rate for the NPV calculation will be the relevant weighted average cost of capital in the remade 2015 determination, noting that this will vary year-by-year because of annual updates to the cost of debt.³⁵ When the resulting revenue adjustment (positive or negative) is included in the 2019–2024 PTRM, the NPV calculation will use the relevant WACC from that decision, on an equivalent basis to the other building block components.³⁶

In section 1, we stated our preference that the derogation should avoid being overly prescriptive. We consider that this principle should apply in this area. Rather than attempting to legislatively prescribe the exact basis for the NPV calculation, the derogation should adopt similar terms to those in the NSW/ACT distributors' proposals. These provide the requirement for NPV calculation but leave the exact implementation to the AER's discretion.

³⁵ There are some minor aspects where a choice between two options will be required. For instance, it will be necessary to decide if the nominal WACC from the remade PTRM should be paired with the expected inflation rate used in the PTRM, or the lagged actual inflation series used in pricing outcomes.

³⁶ The revenue adjustment will be inputted into the 2019–24 PTRM as a single payment on 30 June 2020 expressed in real 2018–19 dollars.