

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

15 July 2016

Dear Mr Pierce

Confidential

Request for rule change (participant derogation) to minimise pricing volatility following Tribunal decision

On behalf of each of Ausgrid, Endeavour Energy and Essential Energy (**NSW DNSPs**), we **enclose** a request in accordance with section 91(5) of the National Electricity Law (**NEL**) for the making of a participant derogation to change the National Electricity Rules (**NER**).

The proposed rule change provides a workable approach to minimise price volatility for NSW consumers while providing the NSW DNSPs with a reasonable opportunity to recover at least their efficient costs (as determined by the Australian Energy Regulator (**AER**) in the remade 2015 determinations).

The proposed participant derogation relates to the operation of Chapters 6 and 6B and would be included in Chapter 8A of the NER. A draft participant derogation is **included** at Appendix 1 to the **attached** rule change request. The attached rule change request also contains the information required under section 92 of the NEL.

1 Background

As Distribution Network Service Providers, the revenue and pricing of the NSW DNSPs are regulated by Chapters 6 and 6B of the NER.

On 26 February 2016, the Australian Competition Tribunal (**Tribunal**) made a decision on the merits review applications of the NSW DNSPs (and other third parties) (**Decision**), which set aside the distribution determinations made by the AER in 2015 for each of the NSW DNSPs (each a **2015 determination**) and remitted them to the AER.

The AER has sought reviews in the Full Federal Court of the Tribunal's Decisions under the *Administrative Decisions (Judicial Review) Act 1977* (Cth) (**ADJR Act**) (**ADJR Applications**).

2 Proposed rule change (participant derogation)

This application is made to the AEMC on the basis that there is a real chance that consumers will experience a price shock as a result of any significant adjustment in the sum of the aggregate revenue requirements (**adjustment amount**) for the current regulatory control period of 1 July 2014 to 30 June 2019

(**current regulatory control period**) made as a consequence of the 2015 determinations and/or ADJR Applications.

In the absence of a rule change, any adjustment amount (positive or negative) must be recovered in the current regulatory control period, which may lead to significant pricing volatility for NSW consumers given the limited time left to recover the adjustment amount in the current regulatory control period following the AER's remade 2015 determinations. The rule change would therefore enable a specified portion of the adjustment amount to be recovered over two regulatory control periods, with a specified "default" allocation of the adjustment amount being recovered in the subsequent regulatory control period commencing 1 July 2019 (**subsequent regulatory control period**).

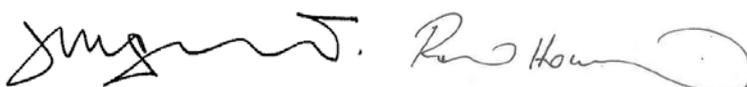
For reasons outlined in the enclosed submission, the NSW DNSPs consider that the proposed participant derogation is the most preferable rule to contribute to the national electricity objective (**NEO**). The proposed participant derogation is also consistent with the revenue and pricing principles and, in particular, minimises price volatility for NSW consumers while providing the NSW DNSPs with a reasonable opportunity to recover at least their efficient costs (as determined by the AER in the remade 2015 determinations).

3 Stakeholder engagement

As part of the preparation of this rule change request, the NSW DNSPs have held discussions with a range of external stakeholders including consumer groups, industry associations, electricity retailers and the AER. This allowed the DNSPs to understand and consider stakeholder views in our rule change request. It also allowed our stakeholders to be better informed so they can meaningfully participate in the AEMC consultation process. A summary of the key issues raised and the organisations that we consulted with is also **attached** to this letter.

If you have any queries regarding this request, please contact one of the following from the NSW DNSPs: Mr Son Truong Vu at Ausgrid on (02) 9269 4360, Mr Jon Hocking at Endeavour on (02) 9853 4386 or Ms Natalie Lindsay at Essential Energy on (02) 6589 8419.

Yours sincerely



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Attachments (2)

REQUEST FOR A RULE CHANGE

Relating to

Derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision

1 Introduction

This document is a proposal to change the National Electricity Rules (**NER** or **Rules**). The proponents of this proposal are Ausgrid, Endeavour Energy and Essential Energy (each a **NSW DNSP**), each of which is:

- A 'Registered Participant' within the National Electricity Market (**NEM**); and
- A 'Distribution Network Service Provider' (**DNSP**) that engages in the activity of operating a distribution system in New South Wales.

As Distribution Network Service Providers, the revenue and pricing of the NSW DNSPs are regulated by Chapters 6 and 6B of the NER.

On 26 February 2016, the Australian Competition Tribunal (**Tribunal**) made a decision on the merits review applications of the NSW DNSPs (and other third parties) (**Decision**), which set aside the distribution determinations made by the Australian Energy Regulator (**AER**) in 2015 for each of the NSW DNSPs (each a **2015 determination**) and remitted them to the AER.

The AER has sought reviews in the Full Federal Court of the Tribunal's Decisions under the *Administrative Decisions (Judicial Review) Act 1977 (Cth)* (**ADJR Act**) (**ADJR Applications**). The AER has not sought an interim order in the Full Federal Court that the Tribunal's Decisions be stayed pending the hearing of the ADJR Applications. The possible outcomes of the ADJR Applications include that the Full Federal Court: dismisses the ADJR Applications on the AER; or upholds in whole or in part the ADJR applications of the AER and the matters be referred back to the Tribunal for further consideration, subject to such directions as the court thinks fit.

In May 2016, the NSW DNSPs gave undertakings to the AER under section 59A of the National Electricity Law to regulate prices in the year 1 July 2016 to 30 June 2017 (**Section 59A Undertakings**). As a consequence of the section 59A undertakings, the NSW DNSPs are recovering revenues greater than those provided for in the 2015 determinations.

This application is made to the AEMC on the basis that there is a real chance that:

- (a) The AER will be required to remake the 2015 determinations either as a consequence of the Tribunal's Decisions or as a consequence of some future Tribunal decisions that are made in accordance with orders of the Full Federal Court in the ADJR Applications and consumers will experience a price shock in the last year of the current regulatory period; or
- (b) The AER will not be required to remake the 2015 determinations as a consequence of some future Tribunal decisions that are made in accordance with orders of the Full Federal Court in the ADJR Applications and consumers will experience a price shock in the fifth year of the current regulatory control period as a consequence of the application of the bringing of the "unders and

over account” provided for to a zero balance in the last year of the current regulatory period in accordance with Attachment 14 to the AER’s 2015 determinations (constituent decision dealing with the control mechanism).

The consequence of the AER remaking the 2015 determinations (each a **remade 2015 determination**) in accordance with the directions in the Tribunal’s Decision is the potential for there to be a significant adjustment in total revenue requirements (**adjustment amount**) for the current regulatory control period that commenced on 1 July 2014 and will end on 30 June 2019 (**current regulatory control period**).

In the absence of a rule change, any adjustment amount (positive or negative) must be recovered in the current regulatory control period, which may lead to significant pricing volatility for NSW consumers given the limited time left to recover the adjustment amount in the current regulatory control period following the AER’s remade 2015 determinations. The rule change would therefore enable a specified portion of the adjustment amount to be recovered over two regulatory control periods, with a specified “default” allocation of the adjustment amount being recovered in the subsequent regulatory control period commencing 1 July 2019 (**subsequent regulatory control period**).

In addition, the actual or forecast revenues recovered by the NSW DNSPs in the regulatory years of the current regulatory control period in the lead-up to the remade 2015 determinations (assumed to be Years 1 to 4) will necessarily impact on the annual revenue requirement for Year 5 as determined by the AER in the remade 2015 determination (**annual revenue requirement** or **ARR**) given the AER’s requirement as set out in each 2015 determination to ensure the sum of the five annual revenue requirements equate to the building block allowances for the current regulatory control period (in net present value terms).

In the absence of a rule change, it is unclear whether any change in the annual revenue requirement in the last year of the current regulatory control period that leads to significant network price volatility can be managed by spreading the revenue impacts over a longer period. The proposed rule change includes such adjustments as may be necessary to best minimise variations of network charges between regulatory years and regulatory control periods.

To ensure an appropriate level of flexibility is available to address a range of circumstances in the absence of the remade 2015 determinations, in the pricing proposal process for a regulatory year in the current regulatory control period each NSW DNSP may propose and the AER may revise an annual adjustment amount so that it is different from the “default” amount determined by the AER in its adjustment amount allocation determination (the **varied annual adjustment amount**).

The proposed variation must better minimise the variation in network charges between regulatory years and regulatory control periods taking into account all relevant factors, including the revenues forecast to be recovered in the first four years of the current regulatory control period.

A feature of the proposed rule change is that it seeks to minimise network pricing volatility, while at the same time leaving the rules for the AER’s remaking of the determinations untouched. Any adjustments required to the annual revenue requirements contained in the AER’s remade 2015 determinations to manage pricing volatility are given effect through:

- The pricing proposals in the current regulatory control period (2014-2019); and
- The building blocks in the subsequent regulatory control period (2019-2020).

The proposed rule change would also operate if the AER ceases to be under an obligation to remake the 2015 determinations, but as a consequence of the actual or forecast revenues recovered or if the AER remakes its determinations on or after the commencement of the final regulatory year of the current regulatory control period by providing for the recovery or payment of the adjustment amount in the subsequent regulatory control period.

The NSW DNSPs consider that the proposed participant derogation makes an important contribution to the achievement of the national electricity objective (NEO) by allowing the NSW DNSPs to recover any increase in their annual revenue requirements for the current regulatory control period over two regulatory periods, thereby avoiding price shocks for NSW consumers while allowing the NSW DNSPs to recover the revenue that they are entitled to. The NSW DNSPs consider that the proposed participant derogation is the most preferable rule to achieve this contribution to the NEO.

In addition, the NSW DNSPs consider that the proposed participant derogation is consistent with the revenue and pricing principles and, in particular, provides the NSW DNSPs with a reasonable opportunity to recover at least their efficient costs (as determined by the AER in the remade 2015 determinations) while minimising price shock for NSW consumers.

2 Proponents

The proponents for the participant derogation are the NSW DNSPs:

- Ausgrid, a New South Wales State Owned Corporation incorporated under the Energy Services Corporations Act 1995 (NSW) (**Ausgrid**).
 - Address: 570 George Street, Sydney, NSW, 2000.
- Endeavour Energy, a New South Wales State Owned Corporation incorporated under the Energy Services Corporations Act 1995 (NSW) (**Endeavour Energy**).
 - Address: 51 Huntingwood Drive, Huntingwood NSW 2148.
- Essential Energy, a New South Wales State Owned Corporation incorporated under the Energy Services Corporations Act 1995 (NSW) (**Essential Energy**).
 - Address: Suite 3, Level 12, 227 Elizabeth Street, Sydney NSW 2000.

3 Statement of issue

3.1 2015 determinations and merits review

The AER is responsible for the economic regulation of the NSW DNSPs under section 15(1)(f) of the National Electricity Law (NEL) and is given obligations in relation to the making of distribution determinations and the approval of pricing proposals under Chapter 6 of the NER. Each NSW DNSP must comply with the distribution determination that applies to the electricity network services it supplies under section 14B of the NEL.

The 2015 determinations were made by the AER in April 2015 to apply until 30 June 2019. Each of the 2015 determinations was a 'reviewable regulatory decision' under section 71A of the NEL.

The NSW DNSPs and other third parties applied to the Tribunal for a review of their 2015 determinations under section 71B of the NEL. On 26 February 2016, the Tribunal delivered its Decision on these reviews. The Tribunal's Decision set aside the 2015 determinations and remitted them to be remade by the AER in accordance with the Tribunal's directions under section 71P of the NEL. The AER's application of the reasons for the Tribunal's Decision in the remade 2015 determinations may result in a significant increase or decrease in the annual revenue requirements (as applicable) in the current regulatory control period for each of the NSW DNSPs.

The AER has sought reviews in the Full Federal Court of the Tribunal's Decisions under the *Administrative Decisions (Judicial Review) Act 1977 (Cth) (ADJR Act) (ADJR Applications)*. The AER has not sought an interim order in the Full Federal Court that the Tribunal's Decisions be stayed pending the hearing of the ADJR Applications. The possible outcomes of the ADJR Applications include that the Full Federal Court: dismisses the ADJR Applications on the AER; or upholds in whole or in part the ADJR applications of the AER and the matters be referred back to the Tribunal for further consideration, subject to such directions as the court thinks fit.

The proposed rule change has been prepared to mitigate the pricing impact of any higher revenues arising from the remade 2015 determinations taking effect in the final year of the current regulatory control period by permitting the recovery of a portion of any higher revenues over the subsequent regulatory control period. For completeness, the proposed rule change is symmetrical with any decrease in the annual revenue requirements of the NSW DNSPs being treated in the same way.

3.2 Remaking of the 2015 determinations

There is a real chance that the AER will be required to remake the 2015 determinations either as a consequence of the Tribunal's Decisions or as a consequence of some future Tribunal decision that is made in accordance with orders of the Full Federal Court in the ADJR Applications.

If required to remake the 2015 determinations, the AER must undertake the same fundamental steps as it took when it made the 2015 determinations. The process that the AER was required to follow when making the 2015 determinations is set out in part E of Chapter 6 of the NEL. While the timing for the AER's remaking of the 2015 determinations is currently unknown, it is unlikely that the remade 2015 determinations will be in place until the fifth year of the current regulatory control period and the illustrative examples in this submission adopts this assumption.

If required to remake the 2015 determinations, the AER must do so in accordance with the Tribunal's directions. These directions have the potential to result in an increase or decrease in the annual revenue requirement (as applicable) for each regulatory year of the current regulatory control period when compared with the annual revenue requirements of the 2015 determinations. Network charges for 2015-2016 were set by the NSW DNSPs on the basis of the 2015 determinations, while network charges for 2016-2017 were set on the basis of undertakings given to the AER in accordance with section 59A of the NEL.

Prices for 2016-2017 standard control services as included in the s59A undertakings have been set to promote stability, predictability and transparency for all stakeholders and are based on the following parameters:

- Ausgrid 2015-2016 network charges to be increased by the annual rate of change in inflation as measured by the December to December change in the Consumer Price Index;
- Endeavour Energy 2015-2016 network charges to be increased by the annual rate of change in inflation as measured by the December to December change in the Consumer Price Index; and
- Essential Energy 2015-2016 network charges to be increased by the price path specified in the AER's 2015 determination for the regulatory year 2016-2017.

The NSW DNSPs will be entitled to recover any differences in the annual revenue requirements in the 2015 determinations and the annual revenue requirements of any remade 2015 determinations.

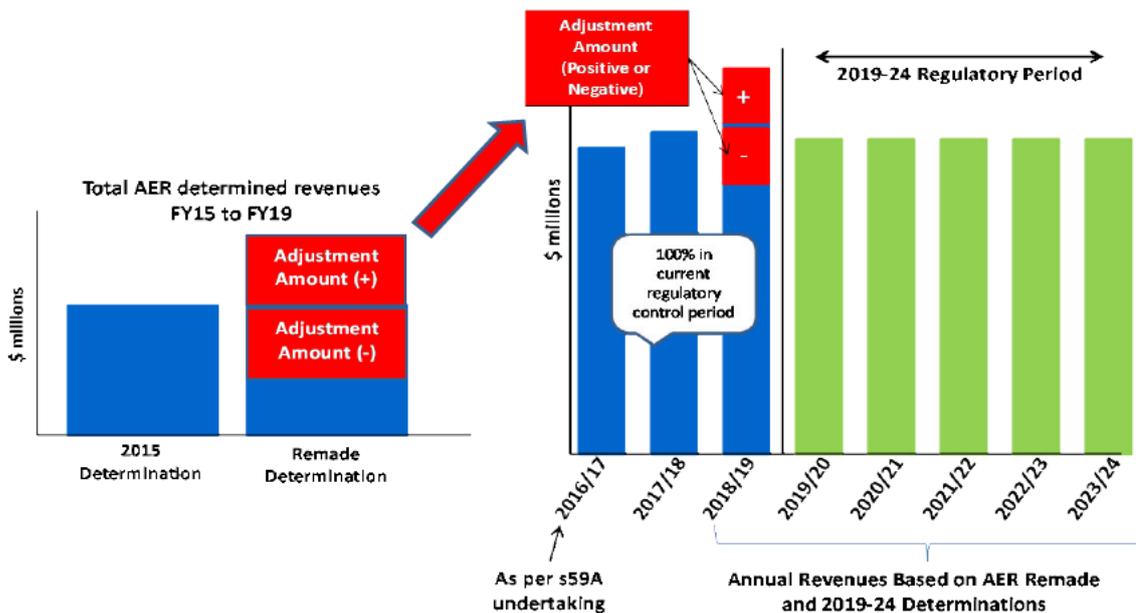
3.3 Potential for price shock

The NER does not clearly authorise a portion of any higher or lower revenues (as applicable) arising from the remade 2015 determinations to be recovered in the following regulatory control period.

This has the potential to lead to significant price shocks for NSW customers if the AER’s remade 2015 determinations result in an adjustment amount and if that adjustment amount is fully incorporated in network prices in the last year of the current regulatory control period. This is discussed further in section 4.4.

The following stylised example highlights how the potential for price shock may arise:

Figure 1 – Potential for price shock in the absence of a rule change



The adjustment amount as shown by the red bars in Figure 1 is based on the **sum of the annual revenue requirements** for the remade 2015 determination, less the sum of the annual revenue requirements for the 2015 determination for each NSW DNSP.

The level of actual or forecast revenues collected in Years 1 to 4 of the current regulatory control period as shown by the blue bars in the chart on the right above will also impact on the Year 5 annual revenue requirement and the revenue volatility introduced in the last year of the current regulatory control period arising from the AER’s remade 2015 determinations.

This proposed rule change has been developed to provide a mechanism to allow a proportion of the adjustment amount to be recovered through adjustments to the pricing proposals in the current regulatory control period with the balance to be recovered through an adjustment to the building blocks in the subsequent regulatory period to provide revenue and pricing stability over two regulatory control periods.

3.3.1 Illustrative revenue changes in the absence of a rule change

There is a wide range of revenue outcomes that could arise from the AER’s remade 2015 determinations based on the findings of the Tribunal. While not attempting to predict any particular outcome, it is nevertheless instructive to test the revenue and pricing outcomes against an unbiased revenue scenario to assess the potential pricing impacts for NSW customers.

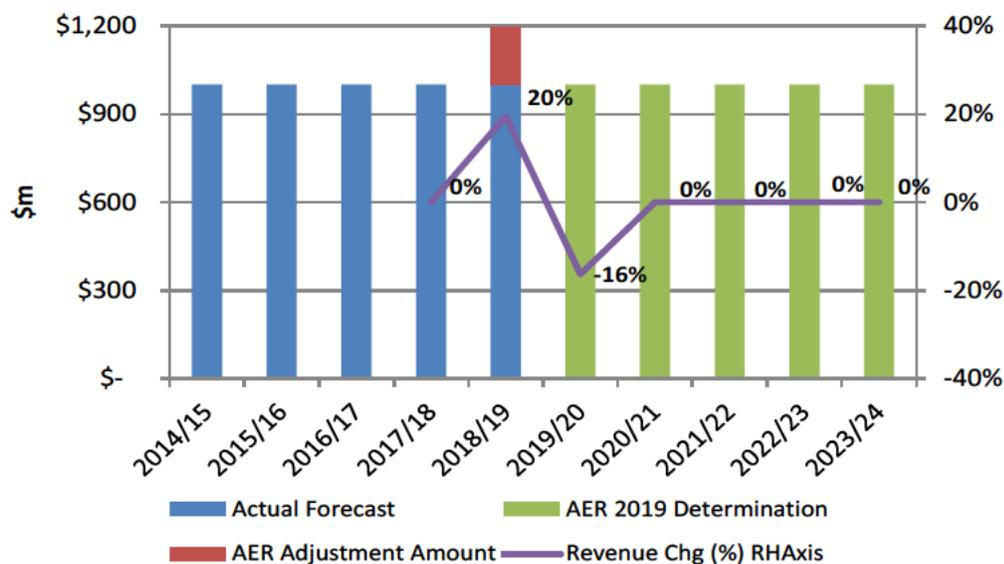
The following analysis is based on a “hypothetical” NSW DNSP, rather than a particular network business, and outlines the indicative, stylised annual revenue changes (in percentage) and the annual revenues (in \$ millions) associated with the AER’s remade 2015 determinations applying in the fifth year of the current regulatory control period.

For illustrative purposes, it is assumed in Figure 2 and Figure 3 that:

- Annual revenues in Years 1 to 4 of the current regulatory control period are pegged at \$1,000 per annum, as shown by the blue bars;
- The remade 2015 determinations incorporate approximately one quarter (25 percent) of the contested amounts arising from the Tribunal’s Decisions, or approximately three to four per cent of total revenues over the period, as shown by the red bar;
- As the 2015 determinations were set aside, there is no under- or over-recovery of revenues in Years 1 to 4; rather it is assumed that the revenues form an input to the calculation of the revenue required in Year 5 to achieve the AER’s building block revenues over the five years (in net present value terms); and
- The subsequent determination (commencing 1 July 2019) assumes annual revenues pegged at \$1,000 per annum prior to any other adjustments, as shown by the green bars.¹

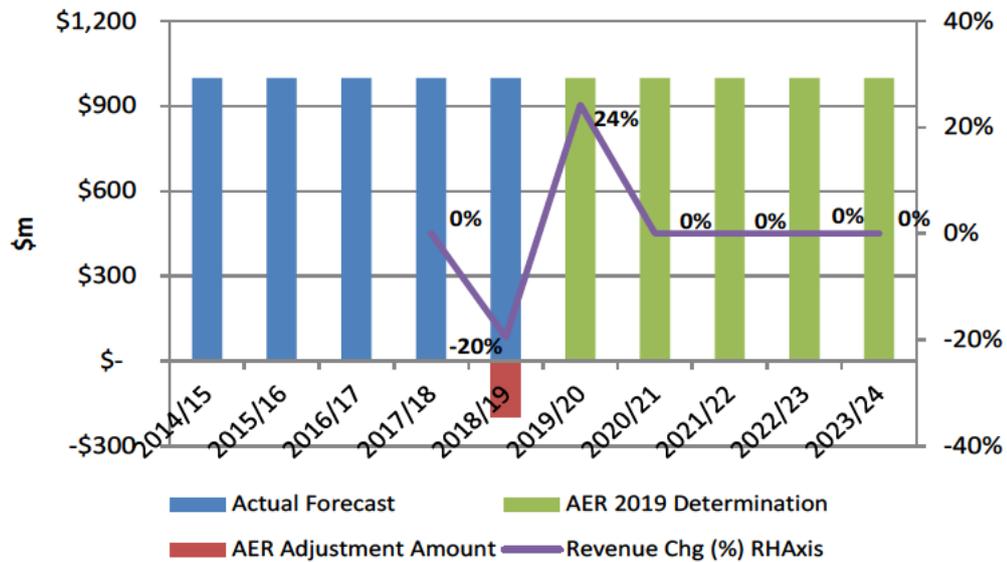
As illustrated below, in the absence of a rule change, the extent of the price shock with a positive or negative adjustment amount may be significant.

Figure 2 – Indicative annual revenue change WITHOUT a rule change (positive adjustment amount)



¹ As was discussed during pre-lodgement consultation with stakeholders, it is possible that the revenues in the subsequent regulatory control period may be higher or lower than those illustrated in Figures 2 and 3 depending on the outcomes of the AER’s ADJR application and any remade 2015 determinations. While the NSW DNSPs have not modelled all possible outcomes arising from the appeals process, it is possible that the pricing variation from 2018-2019 to 2019-2020 may be reduced somewhat from the annual changes illustrated in Figures 2 and 3 as a result of a positive adjustment amount leading to higher revenues in the subsequent regulatory control period (which would reduce the revenue variation in the first year of the subsequent regulatory control period). The same effect (lower revenue variation in the first year of the subsequent regulatory control period) is also possible for a negative adjustment amount if this leads to lower annual revenues in the subsequent regulatory control period.

Figure 3 – Indicative annual revenue change WITHOUT a rule change (negative adjustment amount)



As illustrated in Figure 2 and Figure 3, in the absence of a rule change and based on the assumptions noted above, the hypothetical NSW DNSP's indicative annual revenues would increase or decrease (as applicable) by 20 percent in the last year of the current regulatory control period (2018-2019) before decreasing by 16 percent or increasing by 24 percent (as applicable) in the first year of the subsequent regulatory control period (i.e. 2019-2020), before prices stabilise from 2020-2021.

The potential annual increases or decreases (as applicable) over the remainder of the current regulatory control period followed by similarly large offsetting decreases or increases (as applicable) at the start of the subsequent regulatory control period would result in pricing volatility in the absence of a rule change that is inconsistent with the achievement of the NEO. As noted above, the magnitude of any revenue changes between the current and subsequent regulatory control periods would be affected by the annual revenue requirements in the AER's remade determinations and the AER's subsequent determinations for the regulatory control period starting on 1 July 2019.

For most scenarios where the Tribunal's Decision stands and the contested revenues are included in the AER's remade 2015 determinations in whole or in part, there is the potential for significant price shocks for NSW customers in the current regulatory control period.

Even if approximately one quarter of the contested revenues associated with the Tribunal's decision are ultimately included in the AER's remade 2015 determinations, network revenues in the current regulatory control period would need to increase to recover the adjustment amount in the current regulatory control period. Network revenues would then need to decrease in the first year of the subsequent regulatory control period (2019-2020) once the new determination takes effect and the impact of the adjustment amount is removed.

The "saw tooth" pricing trajectory illustrated in Figure 2 arises from the NER not clearly permitting a portion of any higher or lower revenues (as applicable) from the remade 2015 determinations to be recovered in the subsequent regulatory control period.

A similar impact on pricing volatility could occur if the AER is successful in its judicial review and the revenues recovered by the businesses in Years 1 to 4 are higher than permitted by the 2015 determinations leading to the need for lower revenues in Year 5. This possible eventuality is discussed further in section 4.1.2.

4 Description of the proposed participant derogation

4.1 Description of the proposed participant derogation

The proposed participant derogation ensures that the rules applying to the AER's calculation of revenues in the remade 2015 determinations are untouched and that any adjustments as may be necessary to best minimise variations in network charges between regulatory years and regulatory control periods occurs through the annual pricing proposal process for the current regulatory control period.

Any adjustment amount that is carried forward to the subsequent regulatory control period would be addressed through an adjustment to the building blocks in the determination for the subsequent regulatory control period.

The proposed participant derogation would be included in Chapter 8A of the NER. A draft participant derogation to apply to the NSW DNSPs is included at Appendix 1 to this rule change request.

Conceptually, the proposed participant derogation requires the following steps, which are discussed in the sections below:

- Step 1 – Determine the adjustment amount and the allocation of this amount between regulatory control periods;
- Step 2 – Make any required adjustments in the current regulatory control period via the pricing proposal process to recover a proportion of any required adjustments in the current regulatory control period; and
- Step 3 – Make any required adjustments in the subsequent regulatory control period via the building block process to recover the remaining proportion of any required adjustments in the subsequent regulatory control period.

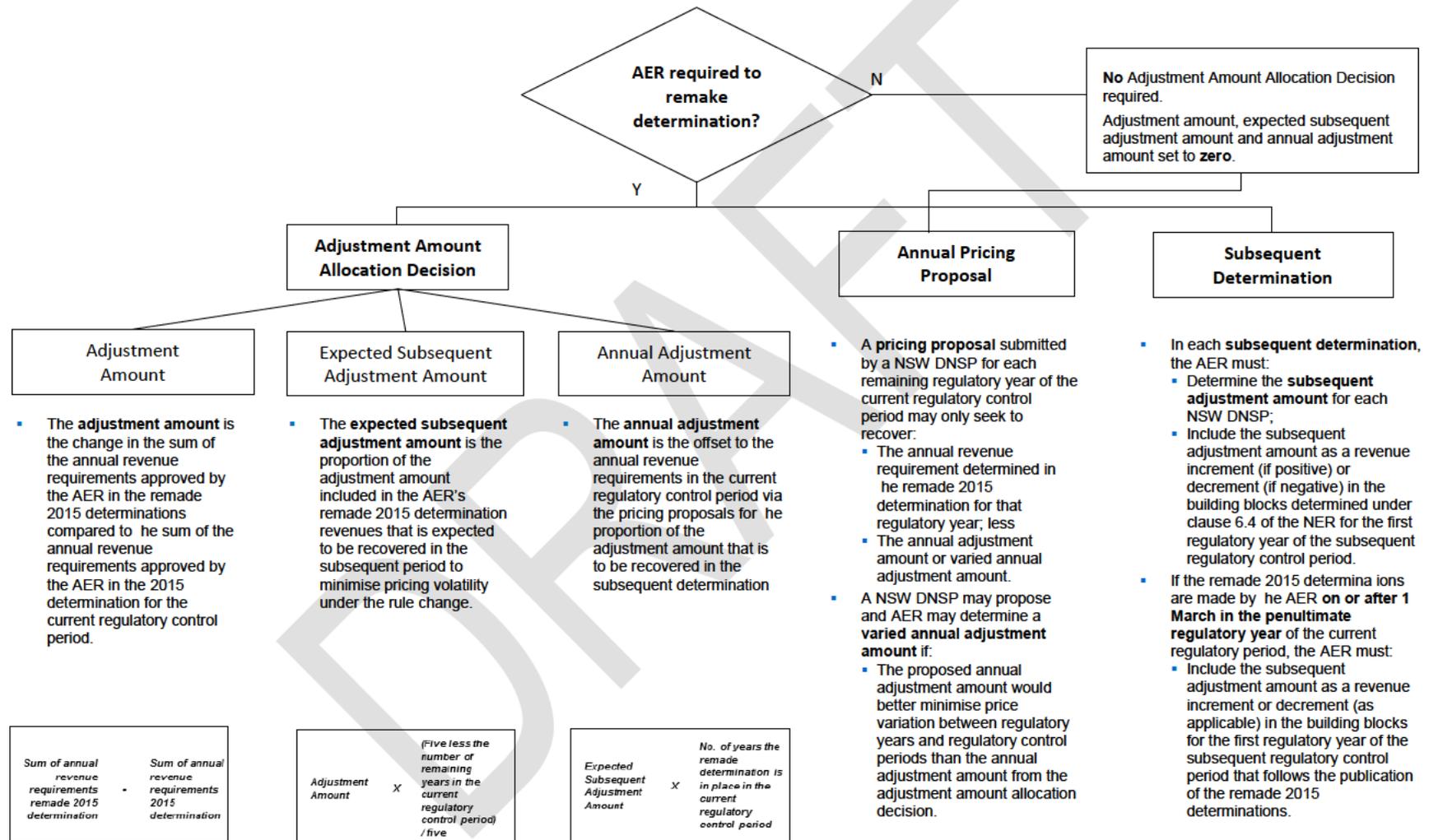
The proposed participant derogation is implemented by the AER making a separate determination (**adjustment amount allocation determination**) at the time of making the remade 2015 determination that sets out:

- The adjustment amount for each NSW DNSP (discussed in Step 1);
- The expected subsequent adjustment amount for the subsequent regulatory control period for each NSW DNSP (discussed in Step 1); and
- The annual adjustment amount for each remaining regulatory year of the current regulatory control period for each NSW DNSP (discussed in Step 2).

Note: if the AER ceases to be under an obligation to remake the 2015 determinations, as may be the case if the AER is successful in its judicial review application, then the proposed participant derogation still has application. This potential eventuality and the application of the proposed participant derogation are discussed further in section 4.1.2.

A flowchart setting out the operation of the proposed participant derogation is provided on Figure 4 overleaf.

Figure 4 – Participant Derogation Flowchart



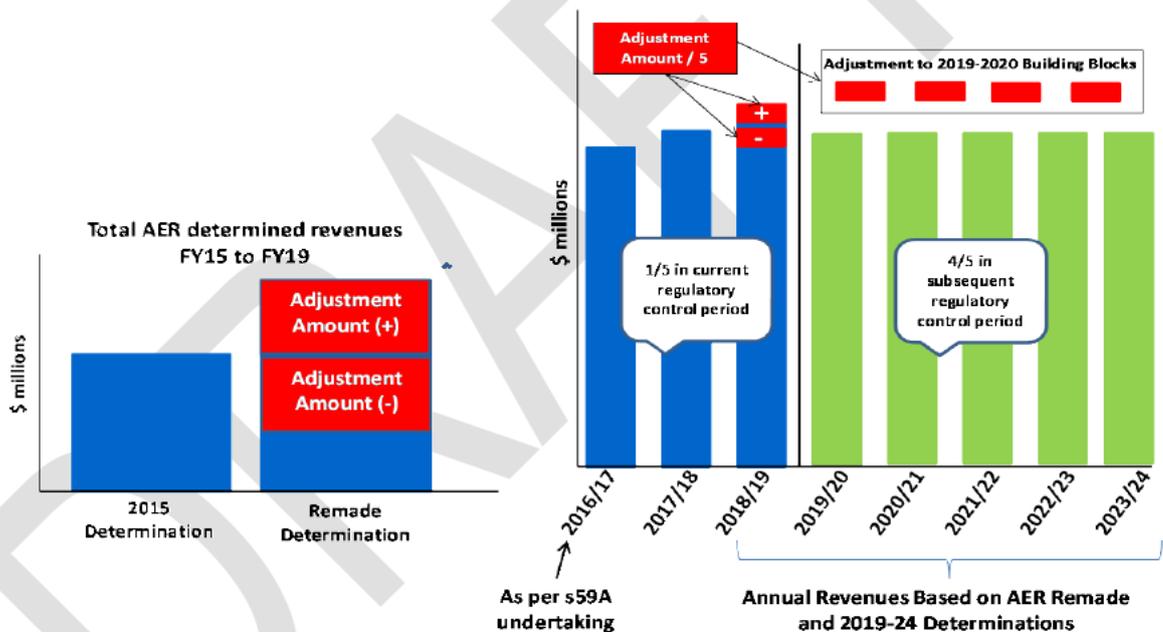
STEP 1 – Determine the adjustment amount and the allocation between regulatory control periods

At the time of remaking the determinations, the AER is required to determine an adjustment amount and to estimate the proportion of the adjustment amount that will be recovered in the current and subsequent regulatory control periods (by determining the expected subsequent adjustment amount).

The proposed participant derogation includes as a default position that any adjustment amount is to be allocated between the current and subsequent regulatory control periods based on an equal allocation over five regulatory years. As discussed in Step 2 below, the default position can be varied through the annual pricing proposal process in the current regulatory control period in order to minimise pricing volatility should circumstances warrant.

The calculation of the adjustment amount and its expected allocation between the current and subsequent regulatory control periods is illustrated in the stylised figure below, which builds on Figure 1 and contains both a positive and negative adjustment amount:

Figure 5 – Calculation of the adjustment amount and allocation between regulatory periods



As illustrated above, allocating the adjustment amount over two regulatory control periods under the proposed rule change is likely to better minimise pricing volatility than without a rule change where the adjustment amount is recovered fully in the current regulatory control period.

Allocating the adjustment amount over five years as the default position is consistent with the usual five year regulatory control period and is consistent with incentive elements contained in the regulatory framework (e.g. the five year penalty / reward period for the Efficiency Benefit Sharing Scheme and the Capital Expenditure Sharing Scheme).

While the adjustment amount is allocated between regulatory control periods on a five year default basis, the adjustment amount allocated to the subsequent regulatory control period may be recovered over all regulatory years of the subsequent regulatory control period. This is because the subsequent adjustment amount is included in the building blocks in the subsequent regulatory control period and its recovery may therefore be smoothed by the AER through the determination of the X factors.

Allocating the adjustment amount between the current and subsequent regulatory control periods based on a five year default position is seen by the NSW DNSPs as an appropriate balance between setting a longer allocation period to address the potentially significant short term price shocks that could arise from the AER's remade 2015 determinations and a shorter allocation period to avoid inefficient consumption and usage decisions (as discussed in section 5.5).

In preparing its adjustment amount allocation determination, the AER would be required to undertake the following steps:

A. Determine the **adjustment amount** for each NSW DNSP.

The **adjustment amount** represents the aggregate change in net present value terms in the sum of the annual revenue requirements approved by the AER in the remade 2015 determinations compared to the sum of the annual revenue requirements approved by the AER in the 2015 determination for the current regulatory control period.

The adjustment amount for each NSW DNSP is determined as:

- The sum of the annual revenue requirements approved by the AER in the remade 2015 determination for each regulatory year of the current regulatory control period; less
- The sum of the annual revenue requirements approved by the AER in the 2015 determination for each regulatory year of the current regulatory control period,

subject to such modifications as are necessary to ensure that:

- The sum of the total revenue requirements for the current regulatory control period approved by the AER in the 2015 determination and the adjustment amount,

is equivalent in net present value terms² to:

- The total revenue requirements for the current regulatory control period approved by the AER in the remade 2015 determination.

B. Determine the **expected subsequent adjustment amount**.

The **expected subsequent adjustment amount** represents the proportion of the adjustment amount included in the AER's remade 2015 determinations that would be recovered in the current regulatory control period in the absence of a rule change, but that is targeted to be recovered in the subsequent period to minimise pricing volatility under the rule change.

The annual revenue requirements permitted in the remade 2015 determinations implicitly include the full adjustment amount, because the AER's remaking of its 2015 determinations must be completed under the NER as currently drafted and therefore is likely to result in the sum of the annual revenue requirements in the remade 2015 determinations being higher or lower than the sum of the annual revenue requirements from the 2015 determinations (i.e. an adjustment amount is likely to exist).

If the adjustment amount is positive, and in order to reduce network charges over the remainder of the current regulatory control period, the annual revenue requirements for the remaining regulatory years of the current regulatory control period need to be

² The treatment of inflation is a relevant implementation consideration that is inherent within the meaning of 'net present value' that would be embodied within the PTRM modelling supporting any remade decision of the AER.

reduced so as to spread a portion of the adjustment amount into the next regulatory control period. The expected subsequent adjustment amount represents the proportion of the adjustment amount that is to be recovered through the building blocks in the subsequent determination for the subsequent regulatory control period.

The expected subsequent adjustment amount is based on the default position determined by dividing the adjustment amount by 5 and allocating 1/5 to each year of the 5 year allocation period starting from the year the remade 2015 determinations are in place.

For example, if the remade 2015 determinations are in place for the last year of the current regulatory control period, the expected subsequent adjustment amount would be based on 4/5, or 80%, of the adjustment amount being recovered in the subsequent regulatory control period and 1/5, or 20%, of the adjustment amount being recovered in the current regulatory control period.

The expected subsequent adjustment amount is equivalent in net present value terms to:

- the adjustment amount;
- multiplied by the factor determined as follows:
 - Five less the number of remaining regulatory years in the current regulatory control period; divided by five, as expressed by the following formula.

$$\text{Expected subsequent adjustment amount} = \text{Adjustment Amount} \times \frac{\text{(Five less the number of remaining years in the current regulatory control period)}}{\text{five}}$$

For example:

- If the AER's remade 2015 determinations are in place for the last year of the current regulatory control period, and assuming the adjustment amount equals \$100, the expected subsequent adjustment amount would be calculated as follows:

$$\begin{aligned} \text{Expected subsequent adjustment amount} &= \$100 \times \frac{(5-1)}{5} \\ &= \$100 \times 80\% = \$80 \end{aligned}$$

- If, however, the AER remade 2015 determinations are in place for the second last year of the current regulatory control period, and assuming the adjustment amount equals \$100, the expected subsequent adjustment amount would be calculated as follows:

$$\begin{aligned} \text{Expected subsequent adjustment amount} &= \$100 \times \frac{(5-2)}{5} \\ &= \$100 \times 60\% = \$60 \end{aligned}$$

Once the expected subsequent adjustment amount is determined, it is instructive to calculate the expected current adjustment amount for recovery in the current 2014-2019 regulatory control period, which is the difference between the adjustment amount and the expected subsequent adjustment amount as calculated above.

$$\text{Expected current adjustment amount} = \text{Adjustment Amount} \text{ Minus } \text{Expected subsequent adjustment amount}$$

For example:

- If the remade 2015 determinations are in place for the last year of the current regulatory period, and assuming the adjustment amount equals \$100 and the expected subsequent adjustment amount equals \$80, the expected current adjustment amount would be calculated as follows:

$$\begin{aligned} \text{Expected current adjustment amount} &= \$100 \quad \text{Minus} \quad \$80 \\ &= \$100 - \$80 = \$20 \end{aligned}$$

- If, however, the remade 2015 determinations are in place for the last two years of the current regulatory period, and assuming the adjustment amount equals \$100 and the expected subsequent adjustment amount equals \$60, the expected current adjustment amount would be calculated as follows:

$$\begin{aligned} \text{Expected current adjustment amount} &= \$100 \quad \text{Minus} \quad \$60 \\ &= \$100 - \$60 = \$40 \end{aligned}$$

The allocation of the expected subsequent adjustment amount from the current regulatory control period to the subsequent regulatory control period takes place via the pricing proposal process described in Step 2 below.

The recovery of the expected subsequent adjustment amount in the subsequent regulatory control period takes place via the building block process in the subsequent determination described in Step 3.

STEP 2 – Recover revenues through the pricing proposal process

Once the expected subsequent adjustment amount has been calculated, it flows through to higher or lower network prices to manage pricing volatility through the annual pricing proposal process in each remaining year of the current regulatory control period.

- A **pricing proposal** submitted by a NSW DNSP for each remaining regulatory year of the current regulatory control period may only seek to recover:
 - The annual revenue requirement determined in the remade 2015 determination for that regulatory year; less
 - The annual adjustment amount or varied annual adjustment amount.
- In the adjustment amount allocation determination, the AER is required to determine the **annual adjustment amount** for each regulatory year remaining in the current regulatory control period.

The **annual adjustment amount** represents the offset to the annual revenue requirements in the current regulatory control period via the pricing proposals for the proportion of the adjustment amount that is to be recovered in the subsequent determination for the subsequent regulatory control period.

- The annual adjustment amount is equivalent in net present value terms³ to:
 - The expected subsequent adjustment amount; divided by
 - The number of remaining regulatory years in the current regulatory control period.

³ To be indexed by the appropriate discount rate to preserve net present value.

This can be expressed by applying the following formula:

$$\text{Annual Adjustment Amount} = \frac{\text{Expected Subsequent Adjustment Amount}}{\text{No. of years the remade determination is in place in the current regulatory control period}}$$

For example:

- If the AER's remade 2015 determinations are in place for the last year of the current regulatory control period, and assuming the expected subsequent adjustment amount is \$80 as per the earlier example, the annual adjustment amount that is to be offset from the Year 5 annual revenue requirement and recovered in the subsequent regulatory control period would be calculated as follows:

$$\begin{aligned} \text{Annual Adjustment Amount} &= \$80 \text{ Divided by } 1 \text{ Year} \\ &= \$80 / 1 = \$80 \end{aligned}$$

- If the AER's remade 2015 determinations are in place for the last two years of the current regulatory period, and assuming the expected subsequent adjustment amount is \$60 as calculated above, the annual adjustment amount for both Year 4 and Year 5 would be calculated as follows:

$$\begin{aligned} \text{Annual Adjustment Amount} &= \$60 \text{ Divided by } 2 \text{ Years} \\ &= \$60 / 2 = \$30 \end{aligned}$$

- For clarity, the annual adjustment amount calculation as illustrated above represents the proportion of the adjustment amount included in annual revenue requirements in the AER's remade 2015 determination that is targeted to be recovered in the subsequent regulatory control period. As such, the annual adjustment amount needs to be removed from the annual revenue requirements in the AER's remade 2015 determinations through the pricing proposal in Year 4 and or Year 5 (as relevant) to avoid double counting.

For the avoidance of doubt, the proposed participant derogation **provides for adjustments to the pricing proposals to be made only in the current regulatory control period** (i.e. adjustments to the pricing proposals cannot be made in the subsequent regulatory control period as revenue smoothing will be undertaken by the AER in its final decision for that period).

STEP 3 – Include the subsequent adjustment amount in the subsequent determination

The final step in the proposed participant derogation process is to require the AER to include any revenue increment or decrement (as applicable) arising from the pricing proposal process discussed above in the subsequent determination through an adjustment to the building block revenues the subsequent regulatory control period as described below.

In each subsequent determination, the AER must:

- Determine the **subsequent adjustment amount** for each NSW DNSP; and
- Include the subsequent adjustment amount as a revenue increment (if positive) or decrement (if negative) in the building blocks determined under clause 6.4 of the NER for the first regulatory year of the subsequent regulatory control period.

The subsequent adjustment amount is the sum of all annual adjustment amounts or varied annual adjustment amounts that applied in the current regulatory control period. It is the adjustment amount for the subsequent regulatory control period that was actually applied during in the current regulatory control period, which may or may not be equal to the expected subsequent adjustment amount as determined by the AER in the allocation adjustment amount decision (i.e. the two amounts would be equal unless a varied annual adjustment amount was proposed by a NSW DNSP and accepted by the AER, or revised by the AER).

Including the subsequent adjustment amount as a revenue increment or decrement in the building blocks in the subsequent determination⁴ provides maximum flexibility for the AER to calculate X factors and to address potential price shocks within the subsequent regulatory control period.

The determination by the AER of the subsequent adjustment amount is taken to be a constituent decision for the purposes of clause 6.12.1 of Chapter 6 of the NER.

Finally, the participant derogation is proposed to **expire** at the end of the subsequent regulatory control period.

4.1.1 Circumstances in which the annual adjustment amount can be varied

In the pricing proposal process for a regulatory year in the current regulatory control period, a NSW DNSP may propose and the AER may revise (with or without a proposed variation from the NSW DNSP) an annual adjustment amount so that it is different from the annual adjustment amount determined by the AER in its adjustment amount allocation determination (a **varied annual adjustment amount**) if the proposed annual adjustment amount would better minimise price variation between regulatory years and regulatory control periods than the annual adjustment amount referred to above taking into account:

- The change in annual revenue requirements between the fourth and fifth regulatory years of the current regulatory control period ending on 30 June 2018 and 30 June 2019 respectively as a result of the remade 2015 determination;
- The known and forecast revenues recovered or to be recovered by the relevant NSW DNSP at the time of the remade 2015 determination; and
- Any other relevant factor.

The AER must accept the varied annual adjustment amount proposed by the NSW DNSP if it is **satisfied** that the proposed varied annual adjustment amount would better minimise variations in network charges for that NSW DNSP's. For clarity, if the AER is not satisfied that the varied annual adjustment amount would better minimise pricing volatility, it is not required to accept the NSW DNSP's proposed variation.

The AER may revise an annual adjustment amount (with or without a proposed variation from the NSW DNSP) on the same basis as it may accept a proposed varied annual adjustment amount.

In proposing or revising a varied annual adjustment amount, the NSW DNSP or the AER (as applicable) needs to take into account:

⁴ To be indexed by the appropriate discount rate to preserve net present value.

- The pricing volatility that would otherwise arise based on the change in annual revenue requirements between the fourth and fifth years of the current regulatory control period (2017-2018 and 2018-2019);
- The known and forecast revenues recovered or to be recovered in the current regulatory control period; and
- Any other relevant factor.

In addition to seeking to manage pricing volatility by spreading the adjustment amount over two regulatory control periods, the NSW DNSPs are also seeking to ensure that the actual or forecast revenues collected by the businesses in the lead up to the remade 2015 determinations do not lead to unacceptable pricing volatility, even in the absence of a material adjustment amount. This is due to the following:

- Clause 6.5.9 of the NER requires that the AER sets X factors in its determinations to, amongst other things, “equalise (in terms of net present value) the revenue to be earned by the [DNSP] from the provision of standard control services over the regulatory control period with the provider’s total revenue requirement for the regulatory control period”.
- The level of actual or forecast revenues collected in Years 1 to 4 of the current regulatory control period is expected to impact on the Year 5 annual revenue requirement in the remade 2015 determinations.
- The actual or forecast revenues collected by each NSW DNSP in the lead up to the remade 2015 determinations would be expected to be included by the AER in its Post Tax Revenue Model (PTRM) when it undertakes its revenue smoothing.
- While the 2015 determinations being set aside by the Tribunal renders the concept of any “under- or over-recovery” moot in the lead up to the remade 2015 determinations, the actual or forecast revenues collected in the first four years of the current regulatory control period nonetheless may impact on the level of the annual revenue requirement in Year 5;
- Even in the absence of a material adjustment amount, it is not inconceivable that the variation in the annual revenue requirements in the remade 2015 determinations between the fourth and fifth years could lead to significant pricing volatility.

Therefore, there is merit in providing flexibility to the AER to accept a varied annual adjustment amount proposed by a NSW DNSP in its pricing proposals in the current regulatory control period that takes into account actual or forecast revenues collected, the annual revenue requirements in Years 4 and 5 of the current regulatory control period or any other relevant consideration that may affect pricing volatility.

The approach of adjusting the annual revenue requirement by the annual adjustment amount to calculate an adjusted annual revenue requirement for each remaining regulatory year in the current regulatory control period has the effect of leaving the remade 2015 determinations untouched, while:

- Providing a mechanism where each NSW DNSP in its annual pricing proposal sets network tariffs based on revenues that are lower (in the case of a positive adjustment amount) than that annual revenue requirement contained in the remade 2015 determination, which would *a priori* reduce network prices in the current regulatory control period;
- Reducing the annual revenue requirement by the annual adjustment amount is deemed to be a permitted variation from the pricing principles in clauses 6.18.5(e) to 6.18.5(j) of the NER; and

- Confirming that any variation in proposed tariffs caused by the remade 2015 determination and the reduction to the annual revenue requirement by the adjustment amount will be deemed to be explained by this derogation for the purposes of clause 6.18.8(a)(2).

As discussed in section 4.1.2 below, if the AER ceases to be under an obligation to remake the 2015 determination for a NSW DNSP, the annual adjustment amount is deemed to be zero, a NSW DNSP is also able to propose a varied annual adjustment amount if it would better minimise pricing volatility.

A more fulsome description of these considerations is provided in the proposed participant derogation drafting provided at Appendix 1.

4.1.2 If AER ceases to be under an obligation to remake the 2015 determinations

The proposed participant derogation also applies if the AER ceases to be under an obligation to remake the 2015 determinations. This situation could arise if the Full Federal Court finds in favour of the AER in its ADJR application, thereby negating the need for the AER to remake the 2015 determinations or if the Tribunal is required to remake its decisions and in doing so finds that there are no grounds for review and that the AER's 2015 determinations are to be reinstated.

In either of these events, the proposed participant derogation provides for the smoothing of the annual revenue requirements across regulatory control periods to minimise potential pricing volatility even if the AER is not required to remake the 2015 determinations.

Potential pricing volatility may occur even if the 2015 determinations are not required to be remade because, under a revenue cap form of regulation, controls are placed on the total revenue a DNSP is allowed to earn over a regulatory control period (currently a five year regulatory control period in the case of the NSW DNSPs).

Therefore if, as an example, a NSW DNSP has collected higher or lower revenues (as applicable) vis-à-vis the original 2015 determination over the first four years of the current regulatory control period, then the allowed revenue in the fifth year of the current regulatory control period will necessarily need to be reduced or increased (as applicable) to meet the total revenue requirement allowed by the AER in its 2015 determination (in net present value terms⁵) over the five year regulatory control period.

This scenario is set out in more detail in Box 1 (section 4.3) and highlights that flexibility would appear desirable to manage pricing volatility even if the AER is no longer under an obligation to remake the 2015 determinations.

The operation of the proposed participant derogation if the AER is not required to remake the 2015 determinations would occur for each NSW DNSP as follows:

1. The AER is **not** required to make an adjustment amount allocation determination for that NSW DNSP; however
2. As the adjustment amount, expected subsequent adjustment amount and annual adjustment amount are each required for the operation of the proposed participant derogation in order to minimise pricing volatility, **each of these amounts is deemed to be zero** for that NSW DNSP.

⁵ To be indexed by the appropriate discount rate to preserve net present value.

The **deeming of the annual adjustment amount, expected subsequent adjustment amount and annual adjustment amount to be zero** has been included in the proposed participant derogation as a necessary procedural step to allow each NSW DNSP to propose and the AER to revise an annual adjustment amount that is not equal to zero if this would better minimise pricing volatility during the pricing proposal process.

4.1.3 Recovery of revenue if the remade 2015 determinations are made by the AER on or after the commencement of the final year of the current period

The proposed participant derogation also applies if the remade 2015 determinations are made by the AER on or after 1 March of the penultimate regulatory year of the current regulatory period. In this circumstance the AER must:

- At the time of making the remade 2015 determination, determine an adjustment amount in the same manner as outlined in section 4.1 above; and
- **Make or remake** the subsequent determinations (as applicable) so that the adjustment amount is included as a revenue increment (if positive) or decrement (if negative) in the building blocks determined under clause 6.4 of the NER for the first regulatory year of the subsequent regulatory control period that follows the publication of the remade 2015 determinations.
- The determination by the AER of the adjustment amount is taken to be a constituent decision for the purposes of clause 6.12.1 of Chapter 6 of the NER.

4.2 How the proposed participant derogation resolves the issue

The proposed participant derogation resolves the potential for significant price volatility by enabling a portion of the adjustment to the annual revenue requirements for the current regulatory control period to be spread into the subsequent regulatory control period, rather than requiring the adjustment amount to be recovered exclusively in the current regulatory control period.

At the same time, the proposed participant derogation leaves the rules for the AER's remaking of the 2015 determinations untouched.

A feature of the proposed participant derogation is that its starting point is the annual revenue requirements contained in the AER's remade 2015 determinations – therefore the rules setting out how the AER is to remake the Determinations remain unchanged.

The proposed adjustments to minimise pricing volatility are as follows:

- Any adjustments required in the current regulatory control period are given effect through the **pricing proposal process**; and
- Any corresponding adjustments in the subsequent regulatory control period are given effect through increments or decrements (as applicable) to the **building block revenues** (section 6.4 of the NER) in the subsequent determination.

Since, *a priori*, lower revenues flow through to lower network prices, recovering a portion of any revenue increase over two regulatory control periods will assist in minimising any network price increase that would otherwise occur in 2017-2018 and 2018-2019 in the absence of the rule change.

The default position of a mechanistic approach to resolving any revenue adjustment provides certainty to customers, retailers and network service providers regarding future pricing trends, while also providing the AER with a transparent and administratively simple approach to implementing the rule change.

As discussed in section 4.3 below, flexibility is incorporated into the proposed rule change through the ability to propose a varied annual adjustment amount to ensure that the objective of avoiding pricing volatility can be achieved under a wide range of circumstances.

The following chart illustrates the revenue and pricing effects of recovering a proportion of the adjustment amount in the subsequent regulatory control period by allocating the adjustment amount over two regulatory control periods assuming equal recovery over five years (the default position).

All other assumptions are consistent with those underpinning the “without a rule change” case illustrated in Figures 2 and 3.

Note: It is not a requirement that the subsequent adjustment amount will only be recovered during the first 3 or 4 years of the subsequent regulatory control period, as it is included in the building blocks for the first year of the subsequent regulatory control period and may be recovered over the whole of the subsequent regulatory control period through the setting of X factors by the AER as a result.

Figure 6 – Illustrative annual revenue change WITH a rule change (positive adjustment amount)

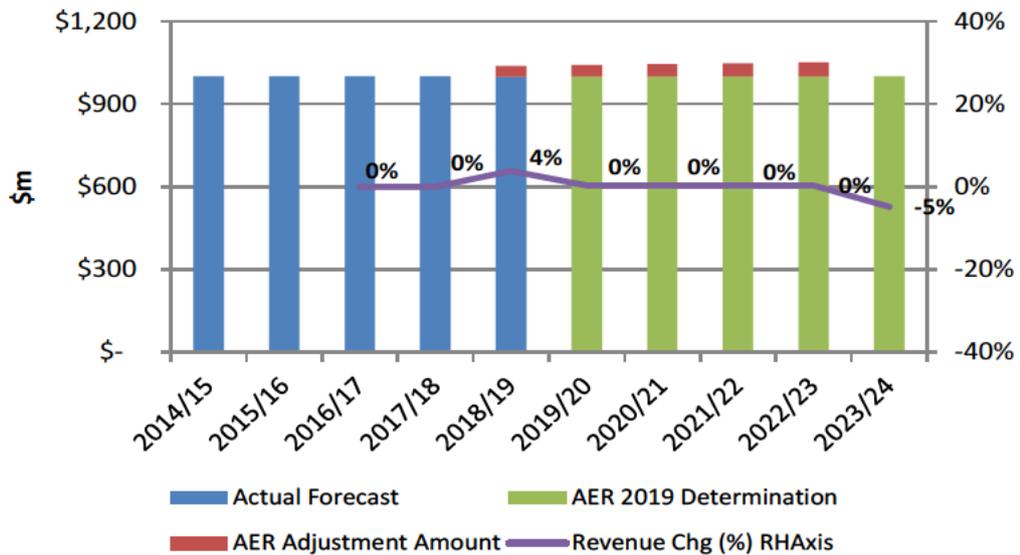
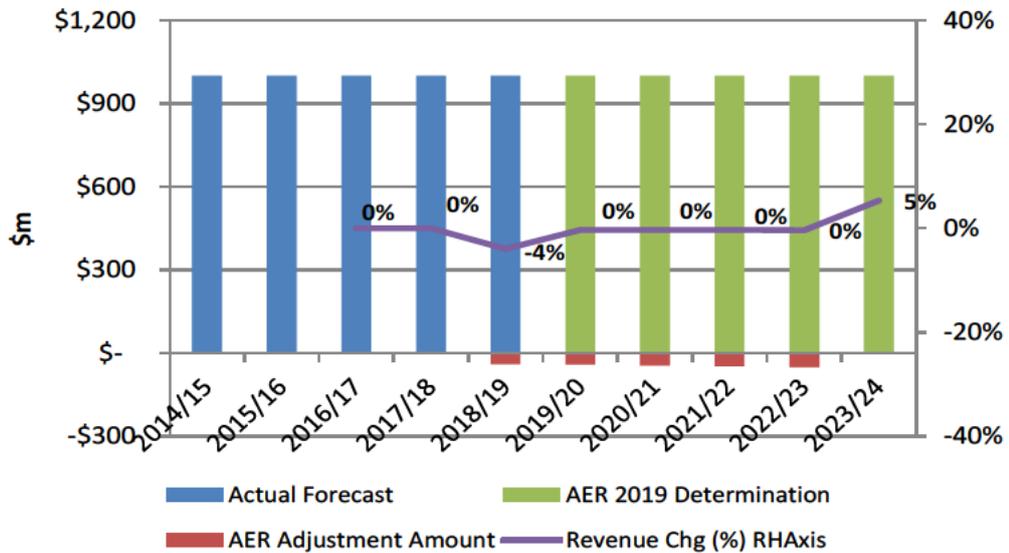


Figure 7 – Illustrative annual revenue change WITH a rule change (negative adjustment amount)



As illustrated above, recovering any positive or negative adjustment amount (assuming one quarter of the contested amounts from the Tribunal’s decision) over two regulatory periods avoids the situation where revenues and consequently network charges would otherwise need to:

- Increase or decrease significantly (as applicable) in the last year of the current regulatory control period; then
- Decrease or increase significantly (as applicable) in the first year of the subsequent regulatory control period once a new determination takes effect.

The annual revenue changes (in percent) for the scenarios “with” and “without” the proposed rule change and assuming the default allocation position are summarised in Table 1 below:

Table 1 – Illustrative nominal revenue changes (%) WITH and WITHOUT a rule change

	Adjustment Amount	2018/19 Revenue Change (%)	2019/20 Revenue Change (%)
WITHOUT a rule change	Positive	+20%	-16%
	Negative	-20%	+24%
WITH a rule change	Positive	+4%	0%
	Negative	-4%	0%

As summarised in Table 1, the “saw tooth” pricing trajectory in the absence of a rule change that was evident in Figures 2 and 3 are not evident in the presence of a rule change as illustrated in Figures 6 and 7.

The above figures and analysis have been based on the change in total annual revenue requirements assuming the default position of allocating 1/5 of any adjustment amount in the current regulatory period and 4/5 in the subsequent regulatory control period. The analysis does not represent the impact customers might expect to see on their bills,

given that the absolute level of customer bills will be driven by the revenue outcomes contained both in the remade 2015 determinations and the subsequent determinations.

However, in order to provide customers with an indication of an illustrative impact that the proposed rule change might have on their future bills, each NSW DNSP has assessed the dollar impact of the rule change compared to the status quo (i.e. no rule change).

The following table highlights the illustrative change in bills (in dollars) that an average residential customer consuming 5 MWh p.a. in each of the network areas could expect in 2018-2019 (i.e. FY19) and the offsetting changes in the following four years as a direct result of the proposed rule change assuming the default position:

Table 2 – Indicative bill reduction for a residential customer consuming 5 MWh pa due to the rule change

	Illustrative <u>revenue</u> adjustment amount (\$millions) (a)	Illustrative <u>bill Impact</u> due to rule change	
		2018-2019 (\$) (b)	Avg 4 years from FY20 (\$) (c)
NSW DNSP			
Ausgrid	+/- \$440m	-/+ \$100	+/- \$25
Endeavour Energy	+/- \$130m	-/+ \$105	+/- \$25
Essential Energy	+/- \$57m	-/+ \$30	+/- \$10

Table 2 provides:

- The illustrative revenue adjustment amount (in \$millions) associated with a revenue increase or decrease (as applicable) assuming an illustrative revenue adjustment as shown in column (a);
- The illustrative change in an indicative residential customer's annual bill in 2018-2019 associated with a positive or negative annual adjustment (as applicable), as shown in column (b). For clarity, these amounts do not reflect the expected annual network bill for a residential customer; rather they illustrate the indicative change in a 2018-2019 annual bill solely as a result of recovering the adjustment amount over two regulatory control periods as opposed to one regulatory control period;
- The average change in an indicative residential customer's average bill over the first four years of the subsequent regulatory control period as a result of the proposed participant derogation, as shown in column (c). The illustrative bill changes in column (c) are offsetting movements to those shown in column (b). That is, if there is a bill change in 2018-2019 as a result of a positive or negative adjustment amount (as applicable) as shown in column (b), there would need to be an offsetting change to bills in the four years from 2019-2020 (i.e. FY20) as a result of the rule change to ensure there is no double counting.

Table 2 highlights that with a positive adjustment amount, the rule change results in a bill reduction in 2018-2019 relative to a "no rule change" scenario, followed by offsetting average bill increases over the next four years. Similarly, with a negative adjustment amount, the rule change results in a bill increase in 2019-2020 relative to a "no rule change" scenario followed by offsetting average bill decreases over the next four years.

As illustrated above, the proposed rule change has the potential to significantly reduce pricing volatility compared to a scenario without the proposed rule change.

For the avoidance of doubt, the bill impacts in Table 2:

- Are indicative only and are for the purposes of providing the reader with illustrative outcomes associated with the proposed rule change;
- Only relate to the impact of the proposed rule change; and
- Do not represent absolute bill levels.

4.3 The need to provide flexibility for unforeseen circumstances

Under some circumstances, the strict application of the rule change and the recovery of the adjustment amount over five years across two regulatory periods from the time of the AER’s remade 2015 determinations (the default position) with no flexibility would not lead to the intended outcome of minimising pricing volatility for NSW consumers.

Consider the example in Box 1:

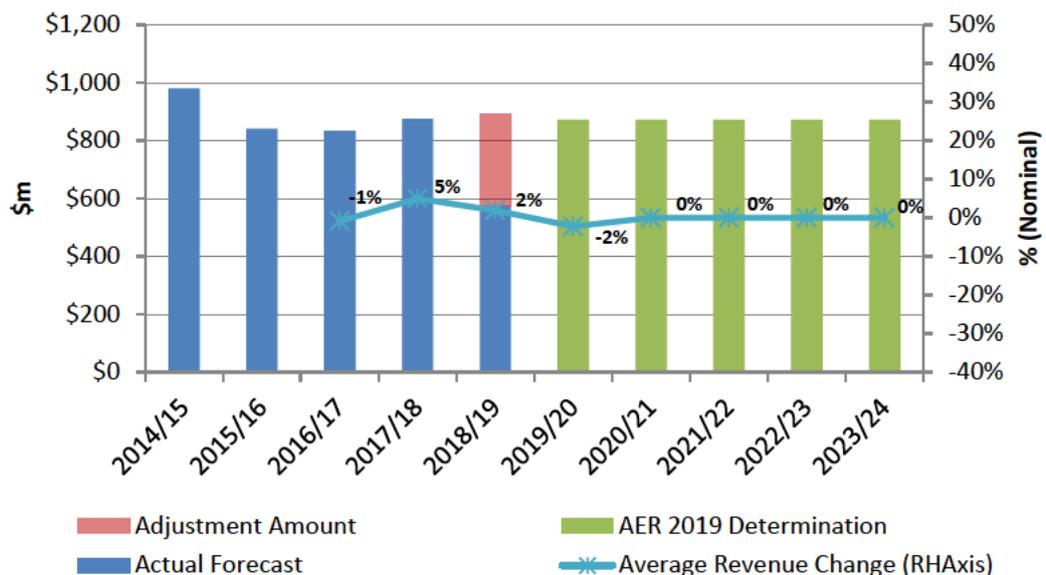
Box 1: A NSW DNSP recovers higher actual (or forecast) annual revenues in the first four years of the regulatory control period than those envisioned in the 2015 determinations and there is a relatively small (or zero) adjustment amount arising.

In this example the rule change would require the NSW DNSP to set network prices to recover the annual revenue requirement from the remade 2015 determinations in Year 5. The combination of relatively high revenues in Years 1 to 4 and a small (or zero) adjustment amount, would lead to network prices needing to be reduced in Year 5 to meet the overall revenue outcomes in the AER’s remade 2015 determination.

To highlight the potential impact, the example below assumes that one half (50 percent) of the contested amounts from the Tribunal’s decision are reflected in the AER’s remade 2015 determinations.

This example is illustrated in Figure 8 below:

Figure 8 – Revenue change Without a Rule Change – 50 percent scenario



The figure above illustrates the adjustment amount (red column) that represents both:

- The maximum adjustment amount that could be applied in the current regulatory control period without the need for some recovery in the subsequent regulatory control period; and
- In the case of a small (or zero) adjustment amount, a different annual adjustment amount that could be proposed by the NSW DNSP to minimise pricing volatility otherwise in Year 5 (the blue columns) in the current regulatory control period. Any such adjustment would then become an offsetting revenue adjustment (in net present value terms) in the subsequent determination.

This example demonstrates that it is possible to achieve pricing stability under a range of circumstances by adjusting revenues in the final year of the current regulatory control period to minimise the pricing volatility. There may be some circumstances where allocating 1/5 of the adjustment amount to the current regulatory control period (the default position) may not minimise pricing volatility and, in fact may lead to greater pricing volatility than not deferring any proportion of the adjustment amount to the subsequent regulatory control period.

The analysis also suggests that providing each NSW DNSP with the ability to propose a variation to, and for the AER to revise, the annual adjustment amount (e.g. recover a higher or lower proportion of the adjustment amount in the current regulatory control period than the default position would imply) would better minimise variations in network charges compared to both the default position or the status quo (i.e. no rule change).

The flexibility to enable an adjustment to the pricing proposals to facilitate the smoothing of prices in these circumstances would appear desirable.

Next consider the example in Box 2:

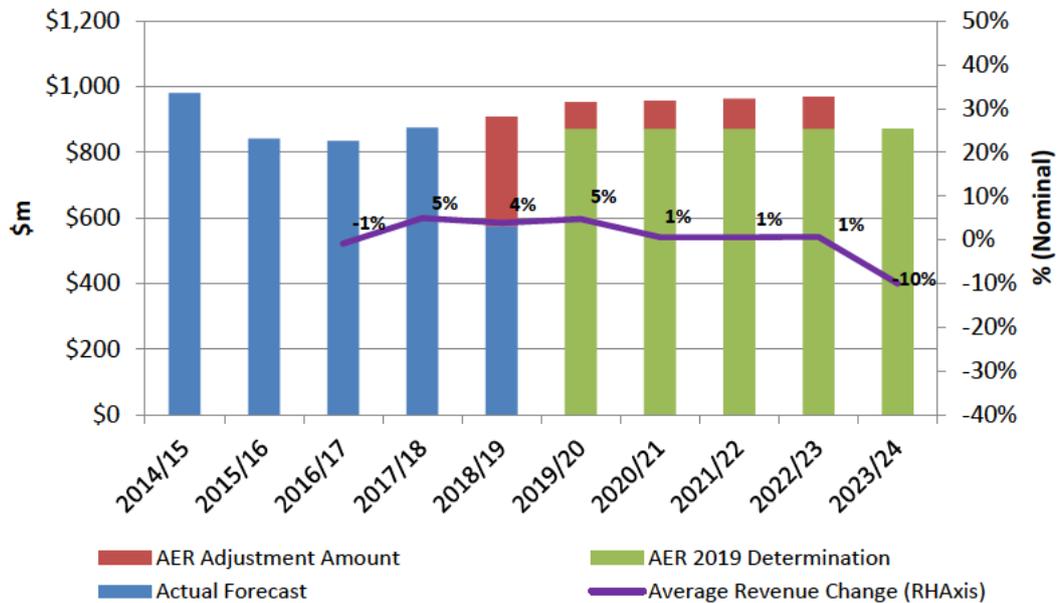
Box 2: *A NSW DNSP recovers higher actual (or forecast) annual revenues in the first four years of the regulatory control period than those envisioned in the 2015 determinations and there is a relatively large adjustment amount arising from the remade 2015 determination.*

In this example, which builds on the scenario in Box 1, the adjustment amount is sufficiently large such that some allocation to the subsequent regulatory control period is desirable to minimise pricing volatility.

The application of an equal recovery of the adjustment amount over the remaining regulatory years of the current regulatory control period and the subsequent regulatory control period for each year of the allocation period (the default position) in this example would not be optimal in reducing volatility.

As highlighted in Figure 9 below, revenue volatility could be minimised if flexibility was provided to the NSW DNSP to propose a variation to, and for the AER to revise, the default position that could better minimise the annual revenue requirement variations, such as by allocating a greater proportion of the adjustment amount to the current regulatory control period.

Figure 9 – Revenue change WITH rule change and variable recovery between periods



In this example, an allocation of the adjustment amount between regulatory control periods that brings forward a greater proportion of the adjustment amount to the current regulatory control period, with a lesser allocation to the subsequent regulatory control period would be preferable in minimising regulatory volatility.

The participant derogation provides flexibility for the NSW DNSPs to propose, and for the AER to accept, a variation to the annual adjustment amount in the annual pricing proposal to address any change in annual revenue requirements between Years 4 and 5 of the current regulatory control period if greater pricing stability can be achieved.

In the absence of visibility of the timing or quantum of the AER’s remade 2015 determinations, a pragmatic approach is one that provides sufficient flexibility for the NSW DNSPs to propose, and for the AER to accept, varied annual adjustment amounts to minimise price volatility under a wide range of circumstances.

4.4 NER does not address this issue

The NER does not clearly permit a portion of any higher or lower revenues (as applicable) arising from the remade 2015 determinations to be recovered in the following regulatory control period as a result of the setting of X-factors.

To enable the recovery of higher or lower revenues (as applicable) in the following regulatory control period, the AER would have to set X-factors that result in smoothed revenues for the regulatory control period, the total of which is less than the total revenue requirement for the current regulatory control period.

Clause 6.5.9 of the NER does not permit the AER to set such an X-factor. Clause 6.5.9 of the NER requires the X-factors to be set so as to smooth the total revenue requirement for a regulatory control period within that regulatory control period.

Clause 6.4.3 of the NER provides for unders and overs to be included in the building blocks, but these unders and overs must be as a result of the control mechanism. The control mechanism for standard control services is a year-on-year revenue cap, which caps allowed revenue.

The current rules are unlikely to assist the AER in managing the pricing volatility in the last year of the current regulatory period in the absence of the proposed rule change because prices generally must be set to recover allowed revenues.

The NER, therefore, does not clearly address the implications of an extended merits review process on the recovery of allowed revenue within and between regulatory control periods.

4.5 Participant derogation vs wider rule change

The NSW DNSPs consider that the present circumstances suggest that a rule change applying only to the proponents is more appropriate than a wider rule change that would apply to all distribution network service providers.

The combination of a number of events have prolonged the likely determination of annual revenues for the current regulatory control period and have led to the potential for pricing volatility for NSW customers. These events include:

- The 2014-2015 “transitional” regulatory control period;
- The findings of the Tribunal in its merits review decision;
- The potential size of difference between in annual revenue requirements between the 2015 determinations and the remade 2015 determinations;
- The likely time for the AER to remake the determinations; and
- the AER’s application for judicial review of the Tribunal’s decision.

These matters in aggregate only apply to the NSW DNSPs (and ActewAGL) and not all DNSPs operating in the national electricity market (NEM).

The short period of time available for the recovery of any additional revenue allowed by the AER’s remade decision is unprecedented and caused, in part, by the “transitional” regulatory control period commencing for the NSW DNSPs in the year prior to the 2015 determinations as a result of the transitional provisions inserted for the *National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*.

It is not envisioned that a similar one year delay arising from similar transitional arrangements intended to apply a wider rule change to the NSW DNSPs (and ActewAGL) is likely to occur again.

An unforeseen consequence of these transitional provisions was a delay in resolving the merits review brought by the NSW DNSPs (and ActewAGL) leading to the potential price shock referred to above.

The findings of the Tribunal whereby the determinations were remitted to the AER to remake, the extended time period signalled by the AER to remake its determinations and the AER’s application for judicial review of the Tribunal’s decision could all impact on the ability to minimise price shocks for customers within the current regulatory control period.

It would seem appropriate that consideration of whether a participant derogation or wider rule change is to apply should be tested against a set of criteria. The NSW DNSPs consider that the following criterion should be applied, each of which has contributed to the potential pricing volatility for NSW customers:

- **Criterion 1** – Was a transitional determination in place in the year prior (but impacting on) the current regulatory control period, thereby extending the normal determination process by one year and reducing the available recovery period to manage price shocks to customers?

- **Criterion 2** – Did the business seek leave to appeal by the Tribunal of the AER’s determinations under section 71C of the NEL (**Merits Review**) and was that leave granted?
- **Criterion 3** – Did the Tribunal establish grounds for review in its merits review decisions and set aside the AER’s determinations for remaking?
- **Criterion 4** – Are there potential price shocks or impacts on the operations of the business arising from the remade 2015 determinations that are significant?
- **Criterion 5** – Has the AER signalled a lengthy process for the remaking of the determinations with remade 2015 determinations not expected until at least the penultimate year or final year of the current regulatory control period?
- **Criterion 6** – Is the AER seeking judicial review of the Tribunal’s merits review decision, which may require matters to be remitted to the Tribunal to re-determine?

The NSW DNSPs (and ActewAGL) are the only electricity distribution network service providers where the answer to each of the above questions is “yes”. Furthermore, it is not envisioned that this issue is likely to arise again with all (or even most) of the criteria above not being relevant to the majority of DNSPs.⁶

A participant derogation modifies or varies the application of a provision of the rules to a person or class of person.

Accordingly, a participant derogation applying only to the proponents, rather than a wider rule change applying to all electricity distribution network service providers, is appropriate to deal with this issue given the limited number of network service providers that are likely to experience similar circumstances.

The additional time and complexity associated with consulting across industry to pursue a broader rule change that caters for all conceivable eventualities is likely to be unwarranted in the current circumstances, when the specific circumstances are well understood and upon us.

For clarity, the NSW DNSPs are not seeking to change the rules to apply to any DNSP that seeks to appeal an AER determination; rather, the businesses are seeking to address the present circumstance in NSW where an AER determination is unlikely to be in place until the fifth year of the current regulatory period and the pricing volatility this is likely to cause.

5 Contribution to the NEO

The NEL sets out the framework that the AEMC must apply when considering a rule change proposal.

The AEMC may only make the proposed participant derogation if it is satisfied that the participant derogation will or is likely to contribute to the NEO. The AEMC may give such weight to any aspect of the NEO as it considers appropriate in all the circumstances, having regard to any relevant MCE statements of policy principles.

⁶ Note that SA Power Networks (SAPN) also had a transitional arrangement, and as at the time of lodging this rule change request has been granted leave to appeal (i.e. had satisfied Criteria 1 and 2). We understand that hearings will commence in August 2016 regarding the SAPN merits review application. It is unknown whether the other circumstances (i.e. Criteria 3 to 6) will apply to SA Power Networks and their customers and, if so, whether this is likely to lead to remade determinations in the last year of the current regulatory control period.

The AEMC must also take into account the revenue and pricing principles in the NEL in making the proposed participant derogation, as they relate to distribution system revenue and pricing or regulatory economic methodologies.

Broadly, the revenue and pricing principles are concerned with:

- Allowing distribution and transmission network service providers a reasonable opportunity to at least recover their efficient costs;
- Providing effective incentives to promote efficient investment in transmission and distribution networks;
- Providing certainty with regard to the value of previous investments (in particular the value of the existing regulatory asset bases) providing returns commensurate with the regulatory and commercial risks associated with investment in the transmission and distribution networks; and
- Having regard to the costs and risks associated with under- and over-investment and utilisation of the distribution and transmission networks.

Revenue increments or decrements (as applicable) applied to the AER's efficient revenues in the subsequent regulatory control period are a key feature of the participant derogation in order to manage price shocks to NSW consumers. The impacts on revenues and associated network prices that are set either above efficient levels (leading to inefficient under-utilisation of the network) or below efficient levels (leading to inefficient over-utilisation of the network) in the subsequent regulatory period and the impact of "smoothed" revenues in the last year of the subsequent regulatory period being set materially above (or below) the AER's "unsmoothed revenues have been considered by the NSW DNSPs and are discussed further below.

The NSW DNSPs consider that the proposed derogation contributes to the NEO taking into account the revenue and pricing principles for the reasons set out below.

5.1 Minimise price shock

The revenue that the NSW DNSPs are entitled to recover may increase if the 2015 determinations are remade by the AER. The proposed participant derogation will allow for this revenue to be recovered while minimising price shock for NSW consumers. The proposed participant derogation also applies to minimise pricing volatility if revenues decrease in the remade 2015 determinations.

The lessening of price shocks and the associated greater pricing stability ensures that consumers of electricity are given balanced incentives relating to the use of electricity services consistent with the NEO.

In particular, with the remade 2015 determinations and without the proposed participant derogation, NSW consumers may face changes in network charges in the final regulatory year of the current regulatory control period followed by similarly large offsetting changes in network charges in the first year of the subsequent regulatory control period.

The short term variations in price are likely to be caused by the remaking of the 2015 determinations late in the current regulatory control period combined with revenue recovery in the first four years of the period. **The variations in price are not caused by increases in cost** and are likely to lead to inefficient use of electricity and inefficient investment in alternative means of supply or generation, which is contrary to the NEO.

5.2 NSW DNSPs can recover revenue that they are entitled to

The proposed participant derogation allows the NSW DNSPs to recover the revenue that they are entitled to collect arising from the remade 2015 determinations.

The remade 2015 determinations must be made by the AER in accordance with the Tribunal's directions and the NEL, and therefore must contribute to the NEO.

It follows that allowing the NSW DNSPs to recover this revenue contributes to the NEO as it will promote the efficient investment in electricity services for the long term benefit of consumers.

5.3 Certainty

The proposed participant derogation provides certainty over both the likely increase in the annual revenue requirements that may occur year-on-year, which will flow through to customer pricing through clause 6.18 and Chapter 6B of the NER and the ability of the NSW DNSPs to recover the revenue that they are entitled to following the AER's remade 2015 determinations.

The increase in regulatory certainty will substantially improve the regulatory regime for consumers and the NSW DNSPs by enabling the NSW DNSPs to invest efficiently in, and consumers to efficiently use, electricity services having regard to the AER's remade 2015 determinations.

5.4 Minimised administration costs

There are limited administration costs from the proposed participant derogation.

The adjustment amount will only be determined if there is an adjustment to be made. The AER will not be required to remake the 2015 determinations if the AER's appeal of the Tribunal's Decision is successful and the proposed participant derogation will have no effect on its terms.

The calculation of the adjustment amount, the expected subsequent adjustment amount and the annual adjustment amount will be undertaken as part of a separate decision to be issued at the same time as the AER's broader process in remaking its 2015 determinations. The information to be included in the allocation amount decision will be available to the AER at the time it remakes the 2015 determinations.

The annual adjustment amount will then flow through to the annual pricing proposals in the current regulatory control period. That is, a new regulatory process is not created by the participant derogation.

The subsequent adjustment amount would be applied as a revenue increment or decrement (as applicable) in the subsequent determination. Again, a new regulatory process is not created by the participant derogation. The ability for the NSW DNSPs to propose a varied adjustment amount does not create a new process, but instead is an additional option in the existing pricing proposal process.

There would be no administration costs associated with the application of the participant derogation to other DNSPs.

5.5 Revenues set above or below efficient levels

The operation of the participant derogation would necessarily result in network revenues being set above the efficient levels determined by the AER in order to recover the adjustment amount in a manner that minimises pricing volatility for NSW consumers.

In the case of a positive adjustment amount, the main impacts arising from revenues and associated network prices that are set above efficient levels for a short period include the potential for lower usage and inefficient under-utilisation of the network, which could lead to:

- Increased uptake of other energy sources (e.g. gas or renewable energy) based on comparisons of network charges that are above efficient levels in the short term;
- The purchase of equipment by customers to avoid higher network costs (e.g. battery storage / load control) based on inefficient short term pricing arrangements could lead to customers not receiving the expected payback on their investment and or the inefficient bypass of the network once prices return to more efficient levels; and
- Future network price increases to meet the requirements of the AER's revenue cap form of price control if the networks are under-utilised.

Conversely, the main impacts arising from revenues and associated with a negative adjustment amount whereby network prices that are set below efficient levels for a short period include the potential for increased usage and inefficient over-utilisation of the network, which could lead to:

- Increased capital investment to meet increased demand growth and corresponding future network price increases for customers;
- Reduced uptake of other energy sources based on inefficient short term price comparisons that may be efficient in the longer term; and
- Customers not investing in equipment (e.g. battery storage / load control) that could otherwise lead to the efficient avoidance of future network charges.

The NSW DNSPs have also considered the impact of "smoothed" revenues in the last year of the subsequent regulatory period being set materially above (or below) the AER's "unsmoothed" revenues and the impact this may have on "inter-period" pricing volatility into the following regulatory period.

In each of the above cases, a balance has been struck between the objectives of minimising pricing volatility and the setting of efficient prices to ensure economic usage decisions.

The NSW DNSPs consider that the proposed participant derogation addresses these concerns in the following ways:

- Allocating the adjustment amount between the current regulatory control period and subsequent regulatory control period on the basis of a five year horizon as the default position is consistent with the "usual" five year regulatory control period and is consistent with incentive elements contained in the regulatory framework (e.g. the five year penalty / reward period for the Efficiency Benefit Sharing Scheme and the Capital Expenditure Sharing Scheme) that may also result in revenue increments or decrements (as applicable) compared to the AER's building block revenues in a given regulatory control period;
- In the absence of the participant derogation, much higher or lower network price changes (as applicable) may occur in the current regulatory control period if the full adjustment amount is recovered over one year (as opposed to a portion of the adjustment amount recovered in that year in the current regulatory control period and the remaining portion of the adjustment amount recovered in the subsequent regulatory control period), which is likely to lead to a greater risk of inefficient usage of the network (higher or lower) and the associated risks and impacts discussed above materialising; and
- Communication of the potential effects of the participant derogation to customers through each business's stakeholder engagement activities and the AEMC's consultation process will assist in alleviating the risks of uneconomic decisions arising from short term pricing arrangements.

Providing a mechanism to minimise pricing volatility by allocating any adjustment amount between the current and subsequent regulatory control periods based on a five year default position with the ability for each NSW DNSP to propose a varied annual adjustment amount is seen by the NSW DNSPs as an appropriate balance between setting a longer recovery period to address the potentially significant short term price shocks that could arise from the AER's remade 2015 determinations and a shorter recovery period to avoid inefficient consumption and usage decisions.

6 Expected benefits and costs, and potential impacts of the change

The expected benefits of the proposed participant derogation are set out in section 5 above. In short, the proposed participant derogation contributes to the NEO by ensuring that the NSW DNSPs can recover the revenue that they are entitled to while also minimising price shock for NSW consumers.

The administrative costs of achieving these benefits as discussed in section 5.4 are limited because the requirements on the AER in the proposed participant derogation are incorporated within existing regulatory processes that will be largely carried out in any event.

APPENDIX 1

Proposed participant derogation

Part 14 Derogations granted to Ausgrid, Endeavour Energy and Essential Energy

8A.14 Derogation for the current regulatory control period and subsequent regulatory control period to address revenue recovery following the Australian Competition Tribunal's decision

8A.14.1 Overview

- (a) This *participant derogation*, rule 8A.14, provides for:
- (1) the smoothing of the recovery by each NSW DNSP of the difference between the *annual revenue requirements* for each *regulatory year* in the current regulatory control period set out in:
 - A. the 2015 determination; and
 - B. the remade 2015 determination,with such adjustments as may be necessary to best minimise variations of network charges between *regulatory years* and *regulatory control periods*; and
 - (2) if the AER ceases to be under an obligation to remake the 2015 determination, the smoothing of the recovery of the *annual revenue requirements* set out in the 2015 determination by each NSW DNSP taking into account the forecast unders and overs account balance at the end of the fourth *regulatory year* of the current regulatory control period being the *regulatory year* ending on 30 June 2018.
- (b) If the remade 2015 determination is made by the AER prior to 1 March of the penultimate *regulatory year* of the current regulatory control period or the AER ceases to be under an obligation to make the remade 2015 determination, then:
- (1) clause 8A.14.3 will apply; and
 - (2) the smoothing of revenue referred to in clause 8A.14.1(a) will be over:
 - A. each remaining *regulatory year* of the current regulatory control period; and
 - B. the subsequent regulatory control period.
- (c) If the remade 2015 determination is made by the AER on or after 1 March of the penultimate *regulatory year* of the current regulatory control period, then:
- (1) clause 8A.14.4 will apply; and
 - (2) the smoothing of revenue referred to in clause 8A.14.1(a) will be over only the subsequent regulatory control period.
- (d) Definitions for this *participant derogation* are set out in clause 8A.14.5.

8A.14.2 Expiry

This *participant derogation* expires at the end of the subsequent regulatory control period.

8A.14.3 Recovery of revenue in the current regulatory control period and subsequent regulatory control period

General

- (a) This clause 8A.14.3 applies if:
- (1) the remade 2015 determination is made by the AER prior to the commencement of the final *regulatory year* of the current regulatory control period; or
 - (2) the AER ceases to be under an obligation to make the remade 2015 determination.

Determination of adjustment

- (b) At the time of making the remade 2015 determination, the AER must make an adjustment amount allocation determination for each NSW DNSP that satisfies the requirements of clause 8A.14.3(c):
- (c) The adjustment amount allocation determination must determine:
- (1) the adjustment amount for the relevant NSW DNSP;
 - (2) the expected subsequent adjustment amount for the relevant NSW DNSP; and
 - (3) the annual adjustment amount for each remaining regulatory year of the current regulatory control period for the relevant NSW DNSP.
- (d) If the AER ceases to be under an obligation to remake the 2015 determination for a NSW DNSP, then:
- (1) for the avoidance of doubt, the AER is not under an obligation to make an adjustment amount allocation determination for that NSW DNSP; and
 - (2) the adjustment amount, annual adjustment amount and expected subsequent adjustment amount are deemed to be zero for the purposes of this clause 8A.14.3 for that NSW DNSP.

Recovery in the current regulatory control period

- (e) A pricing proposal submitted by a NSW DNSP for a *regulatory year* in the current regulatory control period may only seek to recover:
- (1) the *annual revenue requirement* determined in the remade 2015 determination for that *regulatory year*, less
 - (2) the annual adjustment amount or varied annual adjustment amount determined in accordance with clause 8A.14.3(g) for that *regulatory year*.
- (f) A NSW DNSP may propose in a pricing proposal for a *regulatory year* in the current regulatory control period an annual adjustment amount for that *regulatory year* that is different from:
- (1) the annual adjustment amount determined by the AER in its adjustment amount allocation determination; or
 - (2) the deemed annual adjustment amount under clause 8A.14.3(d)(2),
- (as applicable) if the proposed annual adjustment amount would better minimise price variation between *regulatory years* and *regulatory control periods* than the annual adjustment amount referred to in subclauses (1) and (2) taking into account:

- (3) the change in *annual revenue requirements* between the fourth and fifth *regulatory years* of the current regulatory control period ending on 30 June 2018 and 30 June 2019 respectively as a result of the remade 2015 determination;
 - (4) the known and forecast revenues recovered or to be recovered by the relevant NSW DNSP at the time of the remade 2015 determination; and
 - (5) any other relevant factor.
- (g) In determining whether to approve a pricing proposal for a NSW DNSP for a *regulatory year* in the current regulatory control period under clause 6.18, the AER:
- (1) must accept the annual adjustment amount proposed by the NSW DNSP under clause 8A.14.3(f) if it is satisfied that the proposed annual adjustment amount would better minimise variations in network charges between *regulatory years* and *regulatory control periods* for that NSW DNSP's customers than the annual adjustment amount for that *regulatory year* set out in the adjustment amount allocation determination or the deemed annual adjustment amount under clause 8A.14.3(d)(2) (as applicable);
 - (2) may revise the annual adjustment amount proposed by the NSW DNSP under clause 8A.14.3(f) if it is satisfied that the revised adjustment amount would better minimise variations in network charges between *regulatory years* and *regulatory control periods* for that NSW DNSP's customers than the annual adjustment amount proposed by the DNSP, and amount annual adjustment amount for that *regulatory year* set out in the adjustment amount allocation determination or the deemed annual adjustment amount under clause 8A.14.3(d)(2) (as applicable); and
 - (3) may revise the annual adjustment amount if the NSW DNSP has not proposed an adjustment amount under clause 8A.14.3(f) and the AER is satisfied that a revised adjustment amount would better minimise variations in network charges between *regulatory years* and *regulatory control periods* for that NSW DNSP's customers than the annual adjustment amount for that *regulatory year* set out in the adjustment amount allocation determination or the deemed annual adjustment amount under clause 8A.14.3(d)(2) (as applicable),
- taking into account the factors specified in clause 8A.14.3(f)(3) to (5).
- (h) For the purposes of clauses 8A.14.3(e) and 8A14.3(g), Chapter 6 is amended for the remainder of the current regulatory control period as follows:
- (1) each NSW DNSP is not required to comply with clauses 6.18.1A(c) or 6.18.1C to the extent necessary to allow the reduction or increase of the *allowed revenue requirement* by the annual adjustment amount for a *regulatory year* in accordance with clause 8A.14.3(e) or the varied annual adjustment amount for a *regulatory year* in accordance with clause 8A.14.3(g) (as applicable);
 - (2) the reference to 'any applicable distribution determination' in clauses 6.18.2(b)(7), 6.18.2(b)(8), 6.18.8(a)(1) and 6.18.8(c) will be interpreted to mean the remade 2015 determination as adjusted by the annual adjustment amount for each *regulatory year* in accordance with clause 8A.14.3(e) or the varied annual adjustment amount in accordance with clause 8A14.3(g) (as applicable);

- (3) the change to the *annual revenue requirement* by the annual adjustment amount for a *regulatory year* in accordance with clause 8A.14.3(e) or the varied annual adjustment amount for a *regulatory year* in accordance with clause 8A.14.3(g) (as applicable) is deemed to be a permitted variation from the pricing principles set out in clauses 6.18.5(e) to 6.18.5(j);
- (4) the reference to ‘the Distribution Network Service Provider’s annual revenue requirement’ in clause 6.18.7(d)(1) will be interpreted to mean the NSW DNSP’s annual revenue requirement in the remade 2015 determination as adjusted by the annual adjustment amount or the varied annual adjustment amount (as applicable) for the relevant *regulatory year*;
- (5) any variation in proposed tariffs caused by the remade 2015 determination and the change to the *annual revenue requirement* by the annual adjustment amount or the varied annual adjustment amount (as applicable) will be deemed to be explained by this derogation for the purposes of clause 6.18.8(a)(2); and
- (6) if the AER amends a pricing proposal pursuant to clause 6.18.8(b)(2) or 6.18.8(c), then in addition to the requirements in clause 6.18.8(c1), the AER must have regard to:
 - A. any variation in proposed tariffs caused by the remade 2015 determination and the change to the *annual revenue requirement* by the annual adjustment amount or the varied annual adjustment amount (as applicable) pursuant to this derogation; and
 - B. whether the annual adjustment amount or the varied annual adjustment amount (as applicable) in the amended pricing proposal better minimises variations in network charges between *regulatory years* and *regulatory control periods* relative to the pricing proposal submitted by the NSW DNSP,

and all references to these clauses of the NER must be interpreted as references to those provisions as amended by this clause 8A.14.3(h).

- (i) For the purposes of clause 8A.14.3(e) and 8A.14.3(g), for the remainder of the current regulatory control period the reference to ‘a Distribution Network Service Provider’s distribution determination’ in clause 6B.A2.3 will be interpreted to mean the remade 2015 determination as adjusted by the annual adjustment amount or varied annual adjustment amount (as applicable) for the relevant *regulatory year* and all references to clause 6B.A2.3 of the NER must be interpreted as references to that provision as amended by this clause 8A.14.3(h).

Recovery in the subsequent regulatory control period

- (j) Except as otherwise set out in this clause 8A.14.3, Chapter 6 (other than clause 6.5.9(b)(2)) governs the making of the subsequent determination for each NSW DNSP.
- (k) In each subsequent determination, the AER must:
 - (1) determine the subsequent adjustment amount for each NSW DNSP; and
 - (2) include the subsequent adjustment amount as a revenue increment (if positive) or decrement (if negative) in the building blocks determined under clause 6.4 for the first *regulatory year* of the subsequent regulatory control period.

- (l) The determination by the AER of the subsequent adjustment amount under clause 8A.14.3(k)(1) is taken to be a constituent decision for the purposes of clause 6.12.1 of Chapter 6.

8A.14.4 Recovery of revenue in the subsequent regulatory control period only

General

- (a) This clause 8A.14.4 applies if the remade 2015 determination is made by the AER on or after the commencement of the final *regulatory year* of the current regulatory control period.

Determination of the adjustment

- (b) The AER must:
- (1) at the time of making the remade 2015 determination for each NSW DNSP, determine the adjustment amount.
 - (2) make or remake the subsequent determination (as applicable) for each NSW DNSP in accordance with clauses 8A.14.4(d) and 8A.14.4(e).
- (c) The determination by the AER of the adjustment amount under clause 8A.14.4(b)(1) is taken to be a constituent decision for the purposes of clause 6.12.1 of Chapter 6.

Recovery in the subsequent regulatory control period

- (d) Except as otherwise set out in this clause 8A.14.4, Chapter 6 (other than clause 6.5.9(b)(2)) governs the making or remaking of the subsequent determination for each NSW DNSP.
- (e) In the subsequent determination or remade subsequent determination (as applicable), the AER must include the adjustment amount as a revenue increment (if positive) or decrement (if negative) in the building blocks determined under clause 6.4 for the first *regulatory year* of the subsequent regulatory control period that follows the publication of the remade 2015 determination.

8A.14.5 Definitions

In this *participant derogation*, rule 8A.14:

2015 determination means, for each NSW DNSP, each of the following distribution determinations (as applicable):

- (a) the distribution determination for the current regulatory control period published by the AER on 30 April 2015 (as corrected by the AER on 20 May 2015) in respect of Ausgrid;
- (b) the distribution determination for the current regulatory control period published by the AER on 30 April 2015 (as corrected by the AER on 20 May 2015) in respect of Endeavour Energy; and
- (c) the distribution determination for the current regulatory control period published by the AER on 30 April 2015 (as corrected by the AER on 20 May 2015) in respect of Essential Energy.

adjustment amount, for each NSW DNSP, means:

- (a) the sum of the *annual revenue requirements* approved by the AER in the remade 2015 determination for each *regulatory year* of the current regulatory control period; less

(b) the sum of the *annual revenue requirements* approved by the AER in the 2015 determination for each *regulatory year* of the current regulatory control period,

subject to such modifications as are necessary to ensure that:

(c) the sum of the sum of the *annual revenue requirements* for each *regulatory year* of the current regulatory control period approved by the AER in the 2015 determination and the adjustment amount,

is equivalent in net present value terms to:

(d) the sum of the *annual revenue requirements* for each *regulatory year* of the current regulatory control period approved by the AER in the remade 2015 determination.

adjustment amount allocation determination means the determination made by the AER in accordance with clause 8A.14.3(b).

annual adjustment amount means the amount for each *regulatory year* remaining in the current regulatory control period that is equivalent in net present value terms to:

(a) the expected subsequent adjustment amount; divided by

(b) the number of remaining *regulatory years* in the current regulatory control period.

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.

expected subsequent adjustment amount means the amount that it is equivalent in net present value terms to:

(a) the adjustment amount; multiplied by

(b) the factor determined as follows:

(1) five less the number of remaining *regulatory years* in the current regulatory control period; divided by

(2) five.

NSW DNSP means each of the following Distribution Network Service Providers:

(a) Ausgrid, the energy services corporation of that name (formerly known as EnergyAustralia), which is constituted under section 7 of the Energy Services Corporations Act 1995 (NSW) and specified in Part 2 of Schedule 1 to that Act, or any successor to its business (including any 'authorised distributor' of Ausgrid's 'network infrastructure assets' (as those terms are defined in the in the Electricity Network Assets (Authorised Transactions) Act 2015 (NSW)) following the transfer of the whole or part of those network infrastructure assets to the private sector);

(b) Endeavour Energy, the energy services corporation of that name (formerly known as Integral Energy), which is constituted under section 7 of the Energy Services Corporations Act 1995 (NSW) and specified in Part 2 of Schedule 1 to that Act, or any successor to its business (including any 'authorised distributor' of Endeavour Energy's 'network infrastructure assets' (as those terms are defined in the in the Electricity Network Assets (Authorised Transactions) Act 2015 (NSW)) following the transfer of the whole or part of those network infrastructure assets to the private sector); and

(c) Essential Energy, the energy services corporation of that name (formerly known as Country Energy), which is constituted under section 7 of the Energy Services Corporations Act 1995 (NSW) and specified in Part 2 of Schedule 1 to that Act, or any successor organisation.

remade 2015 determination means, for each NSW DNSP, the 2015 determination of that NSW DNSP as remade by the AER following the Tribunal's decision.

subsequent adjustment amount means the amount that is equivalent in net present value terms to the sum of the annual adjustment amounts and/or varied annual adjustment amounts (as applicable) for each relevant *regulatory year* in the current regulatory control period.

subsequent determination means, for each NSW DNSP, the distribution determination of that NSW DNSP for the subsequent regulatory control period made by the AER.

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.

Tribunal's decision means the decision of the Australian Competition Tribunal in relation to the 2015 determination of each NSW DNSP delivered on 26 February 2016, as varied or remade as a consequence of a decision of the Federal Court or Australian Competition Tribunal applying the outcome of the judicial review of Australian Competition Tribunal's decision delivered on 26 February 2016.

varied annual adjustment amount means an annual adjustment amount accepted or revised by the AER in accordance with clause 8A.14.3(g).



NSW DNSPs' Revenue Smoothing Rule Change *Draft Proposal*

Summary of key issues raised
by stakeholders

13 July 2016

Summary of key issues

The three electricity network businesses in NSW met with a number of representatives from consumer and industry groups, retailers and regulators to discuss the rationale for our proposed price smoothing rule change (participant derogation) application to the Australian Energy Market Commission.

We undertook those discussions so we could consider potential changes to our rule change proposal and to enable effective and informed discussions as part of the formal AEMC consultation.

Rationale for the rule change proposal

The rule change is attempting to solve the problem of applying the revenue and pricing outcomes of the 2014-19 regulatory determinations in the final one or two years of the current five year regulatory control period.

We believe this problem is unique to NSW and the ACT because of a number of factors such as the transitional period in year one of the regulatory period, the merits review outcome, and the federal court proceedings. These all result in a prolonged time before remade determinations are made by the AER.

These circumstances would create potential pricing volatility for NSW electricity customers and revenue instability for NSW businesses.

The proposed solution is this revenue smoothing rule change proposal which will allow us to spread any impact from the AER's re-made determination over the two regulatory periods i.e. 2014-19 and 2019-24. This will produce a more stable pricing and revenue outcome, regardless of whether it involves a positive or negative price adjustment.

The proposed rule change in the form of a participant derogation limits the rule change to NSW and has been designed so that it preserves the AER's normal building block calculations in net present value terms in its revenue decision, while ensuring there will be no windfall loss or gain as a result of the rule change.

Summary of key issues

Summary of stakeholder views

Stakeholder representatives understood the intent of the proposed rule change but have made some comments and raised various issues about some aspects of the proposal.

In some cases, consumer representatives supported the principle of the proposal to limit a large one off price adjustment.

In other cases the cumulative impact of smaller price adjustments was seen as more detrimental than a one-off, large change, particularly to vulnerable customers who were more exposed to the impact of higher fixed charges proposed as part of the future tariff structures in NSW.

It was put that the need for the rule change itself could be negated depending on the outcome of the re-made determination. Another view was put that the 2014-19 outcome could be smoothed over the next two regulatory periods (rather than one period). It was also put that the re-made determination could be subject to review.

The choice to limit the rule change to NSW via a participant derogation, rather than a wider rule change was questioned.

The potential precedent created from the rule change was also raised, with a concern that it would become more common practice as part of regulatory determinations as a way to recover higher costs.

The presentation of scenarios averaged out from a revenue perspective was also questioned. It was suggested that the potential scenarios could be presented from the perspective of the customers' bill, so that the benefits or disadvantages of the rule change could be better judged from the perspective of customers.

There was also some discussion about how the rule change would affect the current regulatory assessment process for the AER. In particular that net present value would be maintained as part of the rule change.

Summary of key issues

Key Issue 1: Consumer representatives asked if scenarios could be provided that showed the end bill impact of the proposal. It was acknowledged that network businesses couldn't provide accurate modelling. It was suggested that scenarios could be provided based on low, medium and high energy consuming households, showing the impact of one or two possible outcomes from a re-made determination with the rule change, and without the rule change.

This would allow consumer groups and others to understand potential impacts on customer bills, not just from an averaged revenue perspective.

Response 1: The three businesses discussed the difficulty of providing accurate modelling based on a customer's final bill. However, it was agreed that even some indicative numbers would assist consumer representatives and the AEMC to understand the potential benefits or disadvantages from the rule change proposal. An indicative impact on a customer's bill will be provided based on a nominal outcome, as part of the rule change application. A separate briefing to interested stakeholders will be offered to discuss various customer bill impact scenarios.

Summary of key issues

Key issue 2: Some consumer groups raised concerns about the potential cumulative impact of several small price changes, particularly if they are applied disproportionately to the fixed component of a customer bill. It was put that this would have a detrimental impact on vulnerable customers who were more exposed to the impact of higher fixed charges.

Response 2: The network businesses acknowledge and understand this concern. It is mostly directed at the tariff structures suggested by the NSW businesses in their proposed tariff structure statements that will apply from 2017.

However, this concern will equally apply without the rule change proposal, if the network businesses have to apply the AER's re-made determination in the final one or two years of the 2014-19 period. We view it as a comment on the broader principles of the tariff structures. This is a matter that can be considered further as the businesses engage in the development of tariff structure statements (e.g. when considering residual costs) for the current and subsequent regulatory periods.

We do not believe this issue negates the overall benefit of the revenue smoothing rule change proposal, by limiting potential price shocks for customers and is preferable to the impacts on tariffs in the absence of a rule change.

Summary of key issues

Key Issue 3: There was some discussion about the merits of the rule change being considered as a participant derogation, rather than a wider rule change. It was also put that the rule change could create a precedent for businesses to pursue higher costs in future determinations.

Response 3: Other network businesses were asked if there was a potential need for them to join the rule change application. Apart from ACTEWAGL, no other business expressed a desire to potentially join the application. The NSW businesses understand the rationale behind customer representatives' concerns about the precedent the rule change could potentially create.

However, we believe that the specific circumstances in NSW surrounding the legal uncertainty of the 2014-19 determination outcome, exacerbated by the transitional period in the first year of the five year period, creates the driver for the rule change application only in this jurisdiction. We also believe that by limiting the rule change to NSW and the ACT and only to 2014-19 determination means that it will not become a standard tool in the tool kit for network businesses in future determinations.

Summary of key issues

Key Issue 4: There was a view put that the need for the rule change itself could be negated depending on the outcome of the remade determinations. It was also put that the re-made determinations are potentially subject to review.

Response 4: The businesses acknowledge that court proceedings and the remade determination could produce an outcome that produced little pricing volatility for customers and therefore there would be no need for the rule change. The rule change proposal, however, has been drafted to allow for this potential result. It has been specifically designed so that it preserves all existing powers of the AER in its building block approach and to prevent any windfall gain or loss to the network businesses. We believe that while this scenario could occur, it does not warrant the status quo being maintained.

We acknowledge that the remade determination is potentially subject to appeal, however we suggest that it is not the intent of the network businesses to pursue a result that leads to another legal appeal.

Summary of key issues

Key Issue 5 There was some discussion about the appropriate discount rate to apply to the calculation of any adjustment amount that is recovered over two regulatory periods and whether the proposed rule change would (or should) preserve 'net present value' (NPV) or be maintained in 'real' or 'nominal' terms.

Response 5: The businesses acknowledge that the approach to calculating the adjustment amount in the current and next regulatory period may result in higher or lower network revenues depending on whether adjustment amounts are based on maintaining NPV neutrality or are indexed using inflation.

From a 'first principles' perspective, the proposed rule change seeks to ensure there are no windfall gains or losses arising from the recovery of revenues across two regulatory periods, with the proposed rule change following the normal practice in the rules of ensuring allowed revenues are maintained in NPV terms.

The treatment of inflation is a relevant implementation consideration that is inherent within the meaning of 'net present value' that would be embodied within the PTRM modelling supporting any remade decision of the AER.

Summary of key issues

Key Issue 6: Consumer representatives requested to see the final draft of the rule change proposal prior to it being lodged.

Response 6: The network businesses will provide interested stakeholders with a copy of the proposed rule change on the same day it is provided to the AEMC.

Key issue 7: Network businesses should consider the smoothing effect to be applied over two regulatory periods (10 years) to minimise the potential size of any price increase or decrease.

Response 7: The businesses acknowledge that smoothing the rule change over an additional regulatory period has the potential to minimise the size of any price adjustment, but that this needs to be weighted against: (1) the impacts on efficient pricing of the adjustment amount being spread over a longer period; and (2) the implications of locking in a process that impacts on three regulatory reviews over potentially three regulatory periods (the current 2014-19 regulatory period, the 2019-24 regulatory period and the 2024-29 regulatory period).

The rule change as proposed already has the potential to smooth revenues for up to seven years (depending on the timing of the AER's remade determination and how the AER applies its X factors in the next period). This is seen as an appropriate balance between the above factors.

Summary of key issues

Organisations who participated in briefing sessions

Public interest Advocacy Centre
EWON
NSW Council of Social Services
Energy Consumers Australia
Ethnic Communities' Council of NSW
NSW Irrigators' Council
Cotton Australia

Australian Energy Regulator
Origin Energy
Lumo Energy/Red Energy
AGL
Australian Energy Market Commission

The network businesses thank the stakeholder representatives who have provided feedback on the rule change proposal and taken part in our discussions. We have undertaken those discussions to help all stakeholders provide us with valuable feedback and to assist them in participating in the AEMC consultation process.