



Australian Energy Market Commission

**National Electricity Amendment (Economic
Regulation of Transmission Services
Undertaken by Distributors) Rule 2008**

Draft Rule Determination

10 April 2008

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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Abbreviations

ACT	Australian Capital Territory
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
Commission	see AEMC
CPI	Consumer Price Index
DFA	Dual Function Assets
DNSP	Distribution Network Service Provider
EA	EnergyAustralia
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NSW	New South Wales
RAB	Regulatory Asset Base
Rules	National Electricity Rules
TNSP	Transmission Network Service Provider
WACC	Weighted Average Cost of Capital

Summary

EnergyAustralia lodged a Rule Change Proposal with the Australian Energy Market Commission (Commission) to confer on a Distribution Network Service Provider (DNSP) the option to apply to the Australian Energy Regulator (AER) to have assets defined as transmission network assets subject to the same economic regulatory arrangements as its distribution network. In addition, the proposal sought to confer discretion on the AER to determine whether the costs of assets forming part of the transmission network and approved for regulation within a distribution determination should be recovered according to prices set in accordance with an approved transmission pricing methodology. EnergyAustralia submitted that the Rule Change Proposal would avoid inefficient and duplicative regulatory processes for the benefit of DNSPs as well as for the AER and other stakeholders more generally.

Taking into account the Form of Regulation Factors and the Revenue and Pricing Principles, the Commission is satisfied that the draft Rule will promote the National Electricity Objective (NEO) and has decided to make a draft Rule under section 99 of the National Electricity Law (NEL). The Commission considers the draft Rule will satisfy the NEO as it:

- will facilitate good regulatory practice and therefore increase the efficiency of the regulatory process by removing unnecessary duplication for distributors who possess “dual function assets” (DFA); and
- will allow for customers to receive prices reflective of the services they use where a distributor’s DFAs are of a material value.

In coming to this decision, the Commission has considered the Rule Change Proposal, stakeholder submissions and the requirements under the NEL.

The draft Rule reflects several modifications of EnergyAustralia’s original proposed Rule, to the effect that:

- DNSPs are not required to apply to the AER for approval to have their DFAs treated as distribution assets for regulatory purposes; and
- DNSPs must inform the AER of the value of its DFAs as a share of their RAB to enable the AER to determine whether transmission pricing arrangements should apply. If so, the AER is required to make this known to the DNSP in its Framework and Approach paper.

The Commission invites submissions on this draft Rule Determination by 23 May 2008. Submissions may be sent electronically to submissions@aemc.gov.au or by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235
Fax: 02 8296 7899

All submissions should be prepared and lodged in accordance with the Commission's Guidelines for making written submissions on Rule change proposals which is available at the Commission's website at www.aemc.gov.au.

In accordance with s.101 of the NEL, any interested person or body may request that the Commission hold a pre-determination hearing in relation to the draft Rule Determination. Any request must be made in writing and must be received by the Commission by no later than 17 April 2008.

1 EnergyAustralia's Rule Change Proposal

1.1 Background

EnergyAustralia lodged a Rule Change Proposal with the Commission on 21 March 2007 entitled "Incidental transmission services undertaken by DNSPs" (Rule Change Proposal).¹

The Rule Change Proposal sought to confer on a Distribution Network Service Provider (DNSP) the option to apply to the AER to have assets that it owns and operates, but that are defined as part of a transmission network, subject to the same economic regulatory arrangements as its distribution network. In addition, the proposal sought to confer discretion on the AER to determine whether the costs of assets forming part of the transmission network and approved for regulation within a distribution determination should be recovered according to prices set in accordance with an approved transmission pricing methodology. EnergyAustralia also requested that the Rule making process be expedited under section 96 of the National Electricity Law (NEL).

1.2 Problem to be addressed by the Rule Change

The Rule Change Proposal highlighted what EnergyAustralia referred to as a "disconnect" in the National Electricity Rules (Rules) between the definitions of distribution and transmission networks on the one hand and the economic regulation of both networks on the other. EnergyAustralia stated that the Rules:

- specifically provide for certain assets owned by DNSPs to be categorised as part of the transmission network; and
- require the transmission network to be subject to economic regulatory arrangements that differ from those that apply to the distribution network.²

According to EnergyAustralia, the simultaneous application of these provisions results in inefficient and duplicative regulatory processes, because it means that a DNSP with (typically) few transmission network assets is forced to deal with two distinct regulatory determination processes. Other stakeholders as well as the AER are also forced to engage with two sets of regulatory determination processes instead of one. Moreover, due to the definition of "transmission network" in the Rules, assets owned by DNSPs may move in and out of the transmission network classification (even within a regulatory control period) based on the configuration in which they are normally connected. This imposes additional regulatory uncertainty and duplication for DNSPs as well as for the AER and other stakeholders more generally.

¹ EnergyAustralia, *Rule Change Proposal: Incidental transmission services undertaken by DNSPs*, 21 March 2007.

² Rule Change Proposal, p.4.

Finally, EnergyAustralia predicted that while the problem was presently inherent in EnergyAustralia's network, it would also affect other distribution businesses either now or in the future. Having said that, EnergyAustralia noted that the problem it identified was of marginal significance in the context of the overall market.³

1.3 Proponent's proposed solution

As EnergyAustralia viewed the problem as localised to distribution network regulation and lacking direct impact on other market participants, it proposed a solution that it said did not seek to alter the technical operation of the network or market or materially change customer pricing arrangements.⁴ EnergyAustralia's Rule Change Proposal sought to address the problem by:

- specifically recognising that assets built for the purpose of operating the distribution network may serve a function of supporting the transmission network (these are to be known as "dual function assets" or "DFAs");
- where such assets exist, providing the option for a DNSP to apply to the AER to have DFAs subject to the same economic regulatory arrangements as the rest of the DNSP's network;
- requiring the AER to approve the application if certain criteria relating to the role of the DFAs and their impacts are satisfied; and
- allowing the AER discretion to determine whether assets forming part of the transmission network and approved for regulation under the Rules for distribution should be 'priced' separately under the transmission pricing Rules.⁵

1.4 Proponent's proposed changes to the Rules

EnergyAustralia's Rule Change Proposal incorporated an Appendix with suggested drafting of the changes it requested. EnergyAustralia had originally drafted its proposed changes as an amendment to the existing Rule 6A.1.4 combined with the insertion of a new Schedule 6A.4. However, following recent changes to chapter 6 of the Rules to allow for new and transitional distribution regulatory arrangements, EnergyAustralia suggested in a submission that the changes it sought should be implemented in the general chapter 6 of the Rules.⁶

The new and transitional changes to the Rules referred to by EnergyAustralia are contained in the *National Electricity (Economic Regulation of Distribution Services) Amendment Rules 2007*, including the *Transitional Provisions for New South Wales and the Australian Capital Territory*. These changes implemented a revised economic

³ Rule Change Proposal, p.4.

⁴ Rule Change Proposal, pp.4-5.

⁵ Rule Change Proposal, p.5.

⁶ EnergyAustralia, *Rule Change Proposal: Economic Regulation of Transmission Services Undertaken by Distributors*, Submission, 11 March 2008, pp.4-5.

regulatory regime for distribution services. The transitional provisions inserted a new Division 2 in Part M of chapter 11 of the Rules, which addresses the problem raised by EnergyAustralia in respect of its own position as well as that of other New South Wales (NSW) and Australian Capital Territory (ACT) DNSPs for the period 2009-2014. The key difference between the provisions for EnergyAustralia and the provisions applying to other NSW and ACT DNSPs is that the arrangements for other DNSPs do not provide for the costs of their transmission assets to be recovered through prices set in accordance with a transmission pricing methodology.⁷

The period 2009-2014 over which the transitional arrangements are to apply is equivalent to EnergyAustralia's (as well as other NSW and ACT DNSPs') next regulatory control period. As this period is finite and the transitional arrangements only apply to DNSPs in two jurisdictions, EnergyAustralia urged the Commission to effect a modified version of the transitional arrangements as a permanent solution in chapter 6 of the Rules.⁸ However, EnergyAustralia did not provide a revised draft of its proposed Rule change with its latest submission.

⁷ cf Rule 6.1.6 (applicable only to EnergyAustralia) and Rule 6.1.5 (applicable to other NSW and ACT DNSPs).

⁸ EnergyAustralia, *Rule Change Proposal: Economic Regulation of Transmission Services Undertaken by Distributors, Submission*, 11 March 2008, pp.2-4.

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2 Draft Rule Determination

In accordance with section 99 of the NEL, the Commission has determined, to make the draft Rule set out in Attachment 1 of this draft Rule determination.

2.1 Commission's considerations

In coming to its decision in favour of the draft Rule, the Commission has considered:

- the Rule Change Proposal and the proposed Rule originally put forward by EnergyAustralia;
- submissions received from stakeholders; and
- the requirements under the NEL (see section 3 below).

The Commission has applied the statutory Rule-making test in the NEL and for the reasons set out in section 5 of this draft Rule determination, is satisfied that the draft Rule is likely to satisfy this test. In brief, the Commission considers that the draft Rule will increase the efficiency of the regulatory process, while ensuring participants face appropriate price signals for the use of network services where such signals are likely to impart a material benefit.

2.2 Intent of the draft Rule

In summary, the draft Rule achieves the following:

- define the transmission network assets of most DNSPs as “dual function assets” or “DFAs”;
- define DFAs as distribution assets for the purposes of chapters 6 and 6A, in order to allow one regulatory determination to apply to DNSPs;
- define services provided by means of DFAs as distribution services – either standard control services or negotiated services;
- ensure that to the extent DFAs are required to provide services that would be negotiated transmission services, the arrangements governing negotiated distribution services (i.e. Part D of chapter 6) apply;
- require a DNSP to inform the AER of the value of its DFAs as a share of its regulatory asset base (RAB). The purpose of this is to enable the AER to determine whether the costs of DFAs used to provide standard control distribution services ought to be recovered through a transmission pricing methodology;
- require the AER to determine if the transmission pricing Rules in Part J of chapter 6A ought to apply to the recovery of the costs of DFAs. The key criterion for the AER in making this decision is whether the application of transmission pricing

(as opposed to distribution pricing) is likely to change network prices to the extent that participants' consumption, production and investment decisions are likely to be materially affected;

- ensure that if transmission pricing arrangements are to apply, the AER must inform the DNSP in its Framework and Approach paper (see Rule 6.8.1) and also carve out a share of the DNSP's allowed regulated revenue to be recovered through transmission prices;
- allow for Part J of chapter 6A to apply to the carved-out amount, with necessary changes being made to facilitate its application; and
- where Part J is to apply, make any required changes to the process requirements, such as requiring DNSPs to submit a pricing methodology for the application of Part J.

The above changes would be included in chapter 6 of the Rules.

2.3 Key differences between the draft Rule and the Rule Change Proposal

As noted in section 1 above, the advent of the new and transitional changes to the Rules have altered the mechanism by which the proponent considers that its Rule Change Proposal should be implemented. EnergyAustralia (and Integral Energy) now believes that its proposal should be effected in the body of chapter 6 rather than through a specific schedule.

Putting aside the mechanism for change, the key respects in which the draft Rule departs from EnergyAustralia's original proposed Rule are:

- The draft Rule provides for transmission network assets owned or operated by a DNSP to be automatically subjected to regulation under the DNSP's distribution determination rather than requiring the DNSP to apply to the AER to approve this approach; and
- The draft Rule provides for the DNSP to inform the AER of the value of its DFAs as a share of the DNSP's RAB. This is in order to enable the AER to determine whether transmission pricing arrangements should apply to the recovery of the cost of those assets. If so, the AER is required to inform the DNSP in the AER's Framework and Approach paper, so that the DNSP has reasonable notice of this decision.

Section 5 provides the Commission's reasoning in favour of the draft Rule.

3 Requirements Under the NEL

This section sets out the Rule change requirements contained in the NEL.

3.1 Draft Rule Determination requirements

Section 99 of the NEL sets out the obligation for the Commission to make a draft Rule determination prior to making a final Rule determination. The draft Rule determination must explain why the Commission believes the proposed Rule satisfies the National Electricity Objective (NEO). The NEO, which replaced the NEM Objective pursuant to recent changes to the NEL,⁹ is reproduced and discussed below.

In those cases where the Commission has substituted a 'more preferable' Rule in place of the proponent's originally proposed Rule, the Commission must explain why it has done this.

Section 99 also requires the Commission to explain, where relevant, how it has taken into account the following matters in coming to its decision:

- the form of regulation factors;
- the revenue and pricing principles; and
- any relevant Ministerial Council on Energy (MCE) statement of policy principles.

All of these matters are discussed in more detail below.

Finally, the Commission is required to include a draft of any Rule to be made in any draft Rule determination.

3.2 Rule-making test

Many of the requirements in section 99 are duplicated under the Rule-making test.

Under section 88 of the NEL, the Commission may make a Rule only if it is satisfied that the Rule will or is likely to contribute to the achievement of the NEO.

The recent changes to the NEL also introduced some further elements into the Rule-making test. In relation to Rule changes such as those considered in this draft Rule determination, the Commission must also take into account:

- the form of regulation factors in section 2F of the NEL (see section 88A NEL); and

⁹ See *National Electricity (South Australia) (National Electricity Law – Miscellaneous Amendments) Amendment Bill 2007*. [DN: I could not find the Act on the MCE website.]

- the revenue and pricing principles in section 7A of the NEL (see section 88B NEL).

These matters are discussed below following the discussion on the NEO.

3.3 National Electricity Objective

The NEO is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

- price, quality, safety, reliability and security of supply of electricity; and
- the reliability, safety and security of the national electricity system.¹⁰

As previously explained with respect to the NEM Objective, the Commission considers that the NEO is founded on the concepts of economic efficiency (including productive, allocative and dynamic dimensions), good regulatory practice (which refers to the means by which regulatory arrangements are designed and operated) as well as reliability, safety and security priorities.¹¹

3.4 Form of regulation factors

As noted above, the form of regulation factors in section 2F of the NEL were introduced as part of the Rule-making test pursuant to recent changes to the NEL.¹² In brief, the form of regulation factors refer to the presence of market imperfections in the provision of electricity network services, such as barriers to entry and externalities. The Commission is required to have regard to the form of regulation factors where it is considering making a Rule that either specifies (or confers discretion on the AER to specify through a regulatory determination) a network service as a direct control or negotiated service. The Commission's interpretation of this obligation is that economic regulation of network services under the Rules should only apply if and to the extent that market forces are unlikely to yield competitive provision of those services.

Section 5 below considers the application of the form of regulation factors to the present Rule change.

3.5 Revenue and pricing principles

As noted above, section 7A of the NEL lists a number of principles that need to be taken into account by the Commission in making certain types of Rule changes. The

¹⁰ See NEL, section 7.

¹¹ See, for example, *National Electricity Amendment (Abolition Of Snowy Region) Rule 2007*, 30 August 2007, pp.7-8.

¹² *National Electricity (South Australia) (National Electricity Law – Miscellaneous Amendments) Amendment Bill 2007* [DN: I cannot find the Act on the MCE website.]

types of Rules changes for which the revenue and pricing principles must be taken into account are those for or with respect to matters or things specified in items 15 to 25 and items 25 to 26J in Schedule 1 of the NEL.¹³ These items refer to matters such as the regulation of DNSPs' revenue and prices and the relevant economic frameworks and methodologies used by the AER in determining those regulated revenues and prices.

The revenue and pricing principles broadly fall under two categories:

- those that seek to ensure that network service providers have incentives for efficient investment in the network and efficient provision of network services (section 7A(2), (3)(a) and (b), (4), (5) and (6)); and
- those that seek to ensure efficient utilisation of networks and of direct control network services (section (3)(c) and (7)).

The present Rule change is of a type that clearly activates these principles, as it deals with matters specified in the relevant part of Schedule 1 to the NEL.

The implications of the revenue and pricing principles for the assessment of the proposed Rule change are discussed further in section 5 below.

3.6 Other NEL requirements – MCE statement of policy principles

In making any Rule, the Commission must also have regard to any relevant MCE statement of policy principles.¹⁴ In the present case, the MCE made a Statement on NEM Electricity Transmission in May 2005. However, apart from foreshadowing the MCE's reference to the Commission on the economic regulation of transmission services, the statement makes no other specific reference to matters relating to network regulation.

¹³ NEL, section 88B.

¹⁴ NEL, section 33.

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4 Consultation Process

4.1 Submissions on the Rule Change Proposal

On 5 April 2007, the Commission published a notice under section 95 of the NEL commencing initial consultation on the Rule Change Proposal.¹⁵ The Commission decided not to expedite the Rule Change Proposal as it did not consider the matter to be either urgent or non-controversial. The closing date for submissions on the Rule Change Proposal was 7 May 2007. Submissions were received from the AER, Country Energy, Energex, EnergyAustralia, Energy Networks Association and Integral Energy. These are collectively referred to as the “2007 submissions”.

Due to the relevance to the Rule Change Proposal of the revised Chapter 6 Rules for the regulation of distribution services (which did not commence until 1 January 2008), the Commission published two notices under Section 107 of the NEL extending the period for publication of the draft Rule determination. The due date for the preparation of the draft Rule determination is now 10 April 2008.

As a result of the extensions attributable to the implementation of the revised Rules for the regulation of distribution services, the Commission provided a further opportunity for stakeholders to make submissions on the Rule Change Proposal by 7 March 2008. Additional submissions were received from EnergyAustralia and Integral Energy. These are referred to as the EnergyAustralia and Integral Energy “2008 submissions”, respectively.

4.2 Matters raised in 2007 submissions and the proponent’s response

All of the 2007 submissions except for the AER fully supported the Rule Change Proposal. For example, Country Energy contended that the proposal would significantly reduce compliance costs for DNSPs, the AER, and other stakeholders while correctly emphasising the service being offered rather than technical definitions.¹⁶ Energex stated that the benefits of applying a single regulatory determination process to the entire network would outweigh any costs to the market and customers.¹⁷ Integral Energy¹⁸ and the Energy Networks Association¹⁹ both commented that the proposed changes would increase the certainty and

¹⁵ Now referred to as a Rule proposal for the Economic Regulation of Transmission Services Undertaken by Distributors.

¹⁶ Country Energy, *Economic Regulation of Transmission Services Undertaken by Distributors, Submission*, 7 May 2007.

¹⁷ Energex, *Rule Change Proposal: Incidental Transmission Services undertaken by DNSPs, Submission*, 18 May 2007.

¹⁸ Integral Energy, *Rule Change Proposal: Economic Regulation of Transmission Services Undertaken by Distributors, Submission*, 7 May 2007.

¹⁹ Energy Networks Association, *Rule change proposal: Incidental transmission services undertaken by DNSPs, Submission*, 9 May 2007.

transparency of the regulatory treatment of DNSPs, reduce compliance costs and thereby promote efficient investment in electricity services.

The AER supported the first 'limb' of the Rule Change Proposal – allowing DNSPs to apply to the AER for a single regulatory determination process to apply in respect of all of their assets, including DFAs. The AER considered that this would enable the streamlining of regulatory processes and result in significant administrative cost savings.²⁰

However, the AER did not support the second limb of the Rule Change Proposal – allowing DNSPs to recover the costs of DFAs through transmission pricing methodology. The AER considered that this would only defer, rather than avoid, the need to engage in a cost allocation process between the two asset bases (transmission and distribution). While a deferral of this process could provide some benefits, the AER considered that such an arrangement would offer few advantages over the status quo and it would be far preferable to implement a Rule change comprising only the first limb. The AER said that the benefits of continuing to recover the costs of DFA assets through transmission prices were minimal, given that the Rules provided considerable flexibility to DNSPs in setting prices.²¹

In response, EnergyAustralia stated that the Rule Change Proposal would offer significant benefits through a single regulatory process, as well as a more appropriate assessment and consultation process and a more appropriate consideration of the allocation of generic assets and expenditure.²² Importantly, EnergyAustralia noted that the application of transmission pricing arrangements to DFAs would only occur if the AER believed there was a benefit in doing so. Although, in theory, EnergyAustralia could set distribution prices to reflect the current combined distribution and transmission prices through a 'back-solving' process, EnergyAustralia submitted that this would create substantial administrative difficulties. Moreover, EnergyAustralia commented that its customers had been subject to separate (distribution and transmission) arrangements for almost 10 years and had thus become accustomed to the current regime.²³

4.3 Matters raised in 2008 submissions

As noted above, additional submissions on the Rule Change Proposal were recently received from Integral Energy²⁴ and EnergyAustralia²⁵. The substance of both

²⁰ Australian Energy Regulator, *Rule Change Proposal – Economic regulation of transmission services undertaken by distributors*, AER observations, 4 May 2007, pp.1-2.

²¹ Australian Energy Regulator, *Rule Change Proposal – Economic regulation of transmission services undertaken by distributors*, AER observations, 4 May 2007, pp.3-4.

²² EnergyAustralia, *Rule Change Proposal: Economic Regulation of Transmission Services Undertaken by Distributors*, Submission, 11 May 2007, pp.1-2.

²³ EnergyAustralia, *Rule Change Proposal: Economic Regulation of Transmission Services Undertaken by Distributors*, Submission, 11 May 2007, pp.2-3.

²⁴ Integral Energy, *Economic regulation of transmission services provided by distributors*, Submission, 7 March 2008.

submissions was that in light of the transitional arrangements for DNSPs in NSW and ACT in Division 2 of Part M of the Rules (see section 1 above), it would be appropriate to implement the proposed Rule change through a carrying over of the transitional arrangements into the general chapter 6 Rules.²⁶

The key difference between the submissions was that Integral Energy suggested that the current transitional arrangements for EnergyAustralia (in Rule 6.1.6) could be made applicable to all DNSPs in the NEM, while EnergyAustralia suggested that the application of transmission pricing methodology to other DNSPs should depend on them making an application to the AER.

²⁵ EnergyAustralia, *Rule Change Proposal: Economic Regulation of Transmission Services Undertaken by Distributors, Submission*, 11 March 2008.

²⁶ See Integral Energy, *Economic regulation of transmission services provided by distributors, Submission*, 7 March 2008, pp.1-2; EnergyAustralia, *Rule Change Proposal: Economic Regulation of Transmission Services Undertaken by Distributors, Submission*, 11 March 2008, pp.4-5.

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5 The Commission's Assessment Against the NEL Criteria

This section sets out the Commission's reasons for its draft Rule determination against the NEL criteria outlined in section 3 above. Those criteria effectively reduce to:

- the NEO;
- the Form of Regulation Factors; and
- the Revenue and Pricing Principles.

In undertaking the assessment of any Rule change against the NEL criteria, the first step is to consider the relevant counterfactual arrangements to which the change is being compared. In the present case, the appropriate counterfactual would be the continuation of the present arrangements under which DNSPs owning or operating DFAs are required to submit to separate distribution and transmission regulatory processes (including submitting a transmission pricing methodology).

Taking into account the Form of Regulation Factors and the Revenue and Pricing Principles, the Commission is satisfied that the draft Rule will promote the NEO. In summary, the Commission considers this is because the draft Rule:

- will facilitate good regulatory practice and therefore increase the efficiency of the regulatory process by removing unnecessary duplication for distributors who possess DFAs; and
- will allow for customers to receive prices reflective of the services they use where a distributor's DFAs are of a material value.

The remainder of this section will provide the Commission reasons in relation to its assessment. In addition, the Commission has explained the rationale for differences between the draft Rule and the original Rule put forward by the Rule change proponent.

5.1 National Electricity Objective

As noted in section 3 above, the NEO is concerned with the promotion of economic efficiency, good regulatory practice, safety, security and reliability in relation to the power system and electricity supply. In the Commission's view, the draft Rule will not have any direct impact on the physical operation of the power system, including system and supply security and safety.

In its Rule Change Proposal, EnergyAustralia explained why it considered that its proposed Rule would promote the NEO. In brief, EnergyAustralia referred to the following positive attributes of its proposal:

- the removal of ambiguity surrounding the regulation of DFAs;

- regulation based on the nature of the service provided rather than on the physical type or configurations of assets;
- elimination of duplication of regulatory obligations and processes; and
- minimal impact on customers.²⁷

On the final point, EnergyAustralia explained that its proposed Rule change enabled customer impacts to be minimised by requiring the AER to allow for a separate (transmission) pricing framework to apply in relation to DFAs even if they had been subject to a single (distribution) regulatory process for the determination of regulated revenues. In EnergyAustralia's view, this would minimise price shocks to those large customers that are connected to its (currently-defined) transmission network.²⁸

The Commission has separated its consideration of the impact of the draft Rule on the NEO into three parts as follows:

- avoidance of unnecessary regulatory duplication;
- maintenance of efficient network pricing; and
- comparison of the draft Rule with the proponent's original proposed Rule.

5.1.1 Avoidance of unnecessary regulatory duplication

Generally speaking, the Commission agrees with much of EnergyAustralia's justification for its proposed Rule change. In the Commission's view, the principal beneficial impacts of the draft Rule would be to:

- clarify the nature of services provided by, and hence the regulatory treatment of, assets ordinarily forming part of a transmission network that are owned or operated by DNSPs; and
- rationalise and simplify the regulatory process applicable to DNSPs, thereby reducing the resources expended by the DNSPs, the AER and other stakeholders in complying with regulatory arrangements within the Rules.

These impacts should lower the costs of electricity network services and ultimately serve the long term interests of consumers by promoting lower prices for electricity services. They should also promote good regulatory practice by reducing the degree of duplication of regulatory processes.

Nevertheless, to ensure that the proposed Rule change does not remove *appropriate* regulatory duplication, it is necessary for the Commission to consider if there are any drawbacks from the application of distribution regulation to services provided by

²⁷ EnergyAustralia, *Rule Change Proposal: Incidental transmission services undertaken by DNSPs*, 21 March 2007, pp.19-21.

²⁸ EnergyAustralia, *Rule Change Proposal: Incidental transmission services undertaken by DNSPs*, 21 March 2007, pp.16-17.

DFAs. In this context, the Commission notes that the draft Rule substitutes the regulated remuneration in respect of DFAs under Part C of chapter 6A (applicable to prescribed transmission services) with the regulated remuneration under Part C of chapter 6 (applicable to distribution standard control services). One of the key differences between the chapter 6 and 6A arrangements is that regulation under chapter 6 limits a DNSP's remuneration by capping prices for distribution services, whereas chapter 6A caps a TNSP's regulated revenues. This means that, to the extent a TNSP over- or under-recovers its allowed revenue in a given year, that is to be reflected in its allowed revenue (and prices) in the following year. The result is a slightly different risk-reward trade-off for TNSPs compared with DNSPs – DNSPs tend to face slightly higher risks of not recovering their allowed revenues over a regulatory control period, but also tend to receive a slightly higher regulated rate of return on their RAB in compensation.

More broadly, however, these sets of regulatory arrangements are very similar. Both:

- are based on a building blocks approach to determining maximum remuneration, which allows regulated businesses to recover the efficient capital and operating costs of providing network services, and in which capital costs are calculated according to a roll-forward model for the business's regulated asset base;
- employ a CPI-X form of incentive regulation incorporating an efficiency benefit-sharing scheme, whereby regulated businesses are permitted to profit (for a period) from reducing their costs below those that have been forecast; and
- utilise a post-tax revenue model to calculate the allowable level of regulated remuneration for each year of the regulatory control period.

While there may be some differences in some of the parameters between chapters 6 and 6A of the Rules, the Commission notes that DNSPs have developed DFAs primarily to provide distribution services rather than to provide transmission services or to support the main transmission system. Therefore, to the extent that the regulatory frameworks under chapters 6 and 6A differ, the Commission believes that the application of the chapter 6 arrangements to DFAs is appropriate. This conclusion is also relevant to the Commission's discussion of the revenue and pricing principles below.

5.1.2 Maintenance of efficient network pricing

A desirable aspect of the the proposed Rule change is that it allows for the costs of DFAs to be recovered according to a transmission pricing methodology where the AER considers that this would promote economic efficiency. Contrary to the view expressed by EnergyAustralia, the Commission does not consider that the key benefit of this provision is the avoidance of price shocks for customers connected to a DNSP's (current) transmission network. After all, DNSPs enjoy sufficient flexibility under Part I of chapter 6 of the Rules to structure distribution prices in ways that could avoid any potential price shocks caused by the recovery of DFA costs through a distribution pricing methodology.

Rather, the key benefit of this aspect of the Rule change is that it allows the AER to make a judgment about whether the application of a transmission pricing methodology to recover DFA costs is likely to promote material efficiency gains compared with the application of the DNSP's distribution pricing methodology. Such gains may arise from the fact that the Rules governing transmission pricing methodologies must have regard to principles such as:

- the desirability of consistent pricing structures and approaches across the NEM; and
- the role of pricing structures in signalling efficient investment and network utilisation decisions to network users.²⁹

Transmission prices must also be set in ways that recover the costs of network assets directly attributable to the provision of the services, with the locational element of prescribed Transmission Use of System (TUoS) service charges to reflect the customer's 'proportionate use' of the network on a CRNP or similar basis.³⁰

By contrast, the pricing principles for distribution services refer to the need for distribution tariffs to lie between avoidable and standalone costs and to take account of long-run marginal costs of the service.³¹

It could be argued that these requirements are not greatly dissimilar – prices that signal efficient investment and utilisation could reflect the long-run marginal costs of the service. However, the Rule requirements for transmission prices place a greater emphasis on locational signalling than the requirements for the pricing of direct control distribution services. Consequently, the recovery of DFA costs according to a transmission pricing methodology instead of a distribution pricing methodology could promote more efficient investment and consumption decisions by actual or potential (off-take) network customers.

The signals that are evident in the transmission pricing regime allow for those customers who benefit from the use of transmission assets to face prices that reflect their use of the assets. In the context of DNSPs with DFAs, allowing for the transmission pricing regime to apply will ensure that customers outside of a particular distribution region will still face a transmission price that reflects the transmission assets they are using.

In summary, the proposed Rule change ensures that the economic signalling value of applying a transmission pricing methodology to recover the costs of DFAs would not be lost in those cases where it is likely to be of material value.

²⁹ Rule 6A.25.2.

³⁰ Rule 6A.23.3.

³¹ Rule 6.18.5.

5.1.3 Comparison of draft Rule with proponent's original proposed Rule

As noted in section 3, it is necessary under section 99 of the NEL for the Commission to explain why it considers that the draft Rule is preferable to the proponent's original proposed Rule to the extent they differ. The differences between the Commission's draft Rule and EnergyAustralia's original proposed Rule were highlighted in section 2. To reiterate, these are:

- the draft Rule provides for transmission network assets owned or operated by a DNSP to be automatically subjected to regulation under the DNSP's distribution determination rather than requiring the DNSP to apply to the AER to approve this approach; and
- the draft Rule provides for the DNSP to inform the AER of the value of assets normally comprising part of a transmission network (ie DFAs) as a share of the DNSP's RAB, in order to enable the AER to determine whether transmission pricing arrangements should apply to the recovery of the costs of those assets. If so, the AER is required to inform the DNSP in the AER's Framework and Approach paper, so that the DNSP has reasonable notice.

These differences reflect an improvement in the draft Rule against the original proposed Rule change by:

- avoiding the need for a DNSP to apply to the AER specifically for the application of a distribution determination to DFAs – most DNSPs own few DFAs and these tend to be incidental to DNSPs' function of operating distribution networks. Therefore, deeming the application of distribution regulatory arrangements to DFAs maintains the status quo and is likely to reduce regulatory costs, thereby promoting the NEO; and
- ensuring the AER is notified where transmission pricing arrangements may be appropriate – the original proposed Rule did not provide a mechanism to alert the AER where transmission pricing may be appropriate because it required the AER to approve the application of distribution regulatory arrangements. In the absence of an approval process (given that the draft Rule effectively deems DFAs to be regulated under distribution arrangements), it is appropriate for the AER to be notified so it can determine if Part J of chapter 6A should apply to the recovery of DFA costs. This will help to ensure that the AER will require DFA costs to be recovered via a transmission pricing methodology where this is likely to promote the NEO.

5.2 Form of Regulation Factors

As noted in section 3 above, the Commission must have regard to the form of regulation factors in section 2F of the NEL where it is considering making a Rule that specifies (or allows the AER to specify) a network service as a direct control or negotiated network service.

In the present case, the effect of the draft Rule is not to alter the *form of regulation* that applies to the services provided by the relevant network assets. The Commission

acknowledges that the relevant network services exhibit sufficient economies of scale and externalities such that they warrant the imposition of a direct control, building block form of regulation. Rather, the effect of the proposed Rule change is only to alter the *form of price control* that applies to the regulation of those services. More specifically, both the Rule Change Proposal as well as the draft Rule seek to change the classification of network services provided by DNSPs that are *already* the subject of regulation under the Rules, rather than to specify hitherto unspecified services as direct control or negotiated network services. The draft Rule does this by reclassifying prescribed transmission services and negotiated transmission services as standard control and negotiated distribution services, respectively. Therefore, the appropriate counterfactual to the Rule change is not the absence of direct control regulation of the services in question but a different form of price control in relation to those services. In this context, having regard to the form of regulation factors has not materially influenced the Commission's assessment of the Rule Change Proposal and the draft Rule.

5.3 Revenue and Pricing Principles

As noted in section 3, the present Rule change is of a type that clearly activates the revenue and pricing principles listed in section 7A of the NEL. To reiterate, these principles emphasise the promotion of efficient *investment* in both the network and network services and the efficient *utilisation* of the network and network services by network users.

As discussed above in the context of the form of regulation factors, the draft Rule does not seek to alter the *form of regulation* applicable to services provided by DFAs. It only serves to alter the *form of price control* that applies to services provided by DFAs. Under the draft Rule, services that are presently subject to a revenue-capping form of price control (applicable to the provision of prescribed transmission services) would become subject to a price-capping form of price control (applicable to the provision of prescribed distribution services). Importantly, both of these regimes were developed cognisant of the need to promote efficient investment in, and efficient operation and use of, electricity networks. For example, in the final Rule determination for the regulation of transmission services, the Commission said:

A CPI-X revenue cap approach allows for the recovery of efficient costs while providing incentives for future cost efficiency, consistent with the requirements of the NEL.³²

This suggests that a shift in the form of price control from revenue- to price-capping is unlikely to have impacts that offend the revenue and pricing principles.

Furthermore, in line with the Commission's NEO assessment of the proposed Rule change, to the extent that the Rule change involves a switch in the form of price control for services provided by DFAs, this is likely to be appropriate under the revenue and pricing principles. This is because the assets that are the subject of

³² p.40.

changed regulatory arrangements under the proposed Rule change (DFAs) were primarily built to provide distribution services and not to support the higher-voltage transmission network. Therefore, it is appropriate for the regulatory arrangements in respect of DFAs to be the same as those applying to DNSPs' regular distribution assets. Consistency in the regulatory treatment of all of a DNSP's assets should promote efficient investment in, and efficient provision of, the direct control network services provided by that DNSP. Consistency should also help ensure that the DNSPs receives a return commensurate with the risks involved in the provision of those services. All of these outcomes are compatible with the revenue and pricing principles.

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