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4 May 2007

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Australian Energy Market Commission
Level 16
1 Margaret Street
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MARS/PRISM:

Dear Dr Tamblyn 

Rule Change Proposal – Economic regulation of transmission services undertaken by distributors


The AER appreciates the opportunity to comment on EnergyAustralia's Rule change proposal regarding the regulation of transmission services as distribution. Please find attached a submission outlining the AER's observations on the Rule change proposal.

The AER engaged Network Advisory Services to assist its understanding of the implications of the Rule change proposal. Network Advisory Services' report is attached.

The AER supports the objective of streamlining regulatory processes, and considers that the first limb of the proposal, which will facilitate a single regulatory decision, is consistent with this objective. The second limb of the proposal, providing for two separate pricing regimes to be administered, appears to the AER to mitigate some of the savings in the regulatory reset process gained under the first limb.

Should you wish to discuss the proposal, please contact Helen Fletcher on (02) 6243 1245.

Yours sincerely


Michelle Groves
Chief Executive Officer

Rule change proposal: Economic regulation of transmission services undertaken by distributors - AER observations

The AER notes that the Rule change proposal consists of two limbs:

1. The first limb allows a distribution network service provider (DNSP) to apply to the AER to have specified transmission assets (dual function assets) treated under Chapter 6 (rather than Chapter 6A) for revenue determination purposes. This would facilitate a single revenue determination process, in place of the separate processes that are currently undertaken for transmission and distribution.
2. The second limb allows a DNSP to apply to price dual function assets under Chapter 6A, notwithstanding the fact that they are treated as distribution assets under the first limb. This will enable a DNSP to continue to price those assets in the manner it would price them under the status quo.

EnergyAustralia states that the benefits of the Rule change proposal arise in two key areas:

- Administrative benefits arising from a single regulatory determination - under a single revenue determination process, there would be no need to allocate costs between transmission and distribution assets for the purposes of preparing revenue proposals. Administrative benefits would also arise as a result of a single application, single consultation process, and single determination.
- The prevention of price shocks – it is suggested that price shocks for EnergyAustralia’s customers would arise if EnergyAustralia did not continue to price its dual function assets under Chapter 6A.

Ambiguities of the proposal

There are a number of possible interpretations of the effects of the proposal on prices and the resulting cost allocation process. The AER has made several assumptions in analysing the outcomes of the proposal, but notes the possibility of other assumptions. The AER’s understanding of how the revenue determination and pricing would be undertaken under the proposal is illustrated in Appendix 1. Scenario 1 outlines the current status quo, scenario 2 outlines the regulatory process under the full application of the proposal, and scenario 3 outlines the process if the first limb of the proposal is invoked without the second limb.

A cost allocation will be required to determine tariffs regardless of which scenario in Appendix 1 eventuates. Under scenario 3 (Figure 3), the AER has assumed that the allotment of costs to tariff classes is the only cost allocation that occurs. Under scenario 2 (Figure 2), the AER has assumed that an additional cost allocation is undertaken for the purposes of allocating the revenue to transmission and distribution services, before costs are allocated to tariff classes.

The AER notes that while the proposal suggests changes to Chapter 6A of the Rules, there may be relevance for parallel changes to Chapter 6 to ensure the proposed Chapter 6A

changes are workable. Such changes may include the need to allow the determination of a single aggregate annual revenue requirement under Chapter 6 to cover both distribution and dual function assets.

Administrative benefits of the proposal

The AER supports the proposal's broad objective of streamlining regulatory processes. The AER notes that it is the first limb of the proposal that seeks to streamline the regulatory decision making process. The second limb is designed to minimise changes to current pricing methodologies.

Administrative benefits under the first limb of the proposal

Analysis of the first limb of the proposal is set out in figure 3. The AER agrees that there are two administrative savings arising from the first limb of the proposal; the application and consideration of a single revenue or price determination for both classes of asset, and the removal of a level of cost allocation.

EnergyAustralia indicates that an administrative benefit of the Rule change proposal will be the removal of the resource intensive requirement to allocate the network into two asset bases:

The outcome of this is that the AER assesses the network once, rather than arbitrarily allocating the network into two notional asset bases and reviewing each base separately. It is our experience that under the latter approach, considerable resource and effort is dedicated to whether the allocation of the network into respective asset bases is appropriate, rather than whether network investment overall is appropriate.¹

The AER considers the benefits of removing one level of cost allocation are significant.

The second administrative saving under the first limb of the proposal is the streamlining of regulatory processes through the possibility for a single revenue application and determination. EnergyAustralia submits:

Undertaking two separate revenue cap application and determination processes increases (unnecessarily) the regulatory burden, resulting in increased compliance and administration costs. At the same time, the decision-making resources and capacity of relevant regulators, as well as other market participants, are inefficiently absorbed as a result of the duplicated processes.²

The AER understands that a single revenue determination applying to a transmission and a distribution network would not decrease the number or complexity of issues to be considered. However, stakeholders could provide one, rather than two submissions, and the AER could release one, rather than two, determinations, generating administrative savings.

Potential costs associated with the first limb need to be considered alongside the benefits. EnergyAustralia considers the costs associated with the application of scenario 3 are significant, and involve costs due to the complex restructuring of tariffs for dual function assets into distribution pricing models.

¹ EnergyAustralia, Rule change proposal – Incidental transmission services provided by DNSPs, March 2007 p. 13

² Ibid, p. 10

EnergyAustralia refers to the reactions of large customers to price rises as an unfavourable result of scenario 3, as well as recent metering rollouts on the transmission network which would be made redundant should the first limb of the proposal solely apply. The AER understands that costs arise from the removal of dual function assets from the status quo transmission pricing model, and from the need for a subsequent recalculation of distribution and transmission loss factors. Such costs need to be analysed in greater depth to determine the overall impact of scenario 3.

Administrative benefits under the first and second limb of the proposal

If the second limb of the proposal is invoked, two pricing regimes will be administered: one under Chapter 6 for distribution assets, and one under Chapter 6A for dual function assets. In these circumstances, the network will still need to be allocated into two asset bases in order to apply two separate pricing regimes. It appears that the allocation of the network into separate asset bases is to be performed *after* the revenue determination under the proposal, rather than *before* the revenue determination under the status quo. The result is a deferral, rather than elimination, of the need to allocate costs.

Although the cost allocation will be deferred under the proposal rather than eliminated, there may be some benefits associated with a deferral (albeit lower than the benefits of completely eliminating the need for a cost allocation). Such benefits may include a more limited consultation process with stakeholders and interested parties.

However, given that the cost allocation will be deferred rather than eliminated, the key benefits of the proposal are associated with reviewing two asset bases at the same time.

While there may be some benefits under scenario 2, the administrative gains in the revenue reset process will be the highest under scenario 3.

Will the proposal achieve a streamlining of regulatory processes?

If enacted, the Rule will create an additional regulatory process under which a DNSP may apply to invoke one or both limbs of the Rule, and the AER must make a decision on the application.

The outcomes if both limbs of the proposal are invoked will be:

- the cost allocation will be performed at a later stage in the process than is currently the case; and
- pricing will continue to be undertaken in the same manner as it is currently undertaken.

This outcome is very similar to the status quo. The AER questions whether the objective of streamlining regulatory processes will be achieved by creating an additional regulatory process through a Rule that will achieve an outcome very similar to the status quo.

Preventing price shocks

EnergyAustralia states that the application of Chapter 6 pricing principles to dual function assets will result in price shocks for both distribution and transmission customers. This is the reason provided by EnergyAustralia for seeking to allow DNSPs to continue pricing dual function assets under the transmission pricing provisions.

EnergyAustralia presents analysis of two different kinds of price shock:

- a small one-off price shock for distribution customers - The AER understands that price shocks for EnergyAustralia's distribution customers would occur as a result of the reallocation of transmission revenues currently collected from customers outside of its network to EnergyAustralia's distribution customers.
- a significant one-off price shock for transmission customers - It is not clear why price shocks for transmission customers are expected to occur. Price changes may be attributable to:
 - differences between the requirements of Chapter 6A that relate to transmission services and the requirements of Chapter 6 that relate to distribution services, and/or
 - EnergyAustralia's own internal decisions for allocating its transmission and distribution costs, and for structuring its transmission and distribution prices, independent of the regulatory framework.

Chapter 6 of the NER appears to provide considerable flexibility to DNSPs in setting prices. It is not clear why EnergyAustralia could not achieve the same pricing outcomes by applying Chapter 6 of the NER to all of its assets rather than applying Chapter 6 to some assets and Chapter 6A to other assets.

Further, EnergyAustralia does not indicate whether these price shocks will be due to prices moving towards, or away from, efficient levels. Price shocks that result in more efficient prices than the status quo would be consistent with the NEL objective of efficient pricing.

Conclusion

The AER supports the streamlining of regulatory processes, and considers that a single regulatory determination process would create administrative benefits for the AER, the relevant DNSP and interested parties. However, some of those benefits are mitigated if the second limb of the proposal is invoked.

It is not clear that the benefits associated with the second limb of the proposal are significant in light of the, albeit deferred, cost allocation between transmission and distribution assets. EnergyAustralia has not demonstrated that the one-off price shocks expected to arise are the result of moving away from efficient prices, nor has it been demonstrated that those price shocks could not be managed without invoking the second limb of the proposal. However, costs associated with the proposal in which limb 1 applies without limb 2 are potentially significant, and need to be considered. EnergyAustralia outlines several costs within the proposal which the AER considers to be significant.

Should the AEMC decide the second limb of the proposal is warranted, the AER submits that it should include broad discretion for the AER to decide on a case by case basis if the benefits are such that it should be invoked.

Appendix 1 – Scenario Figures

Figure 1 - status quo (no Rule change)

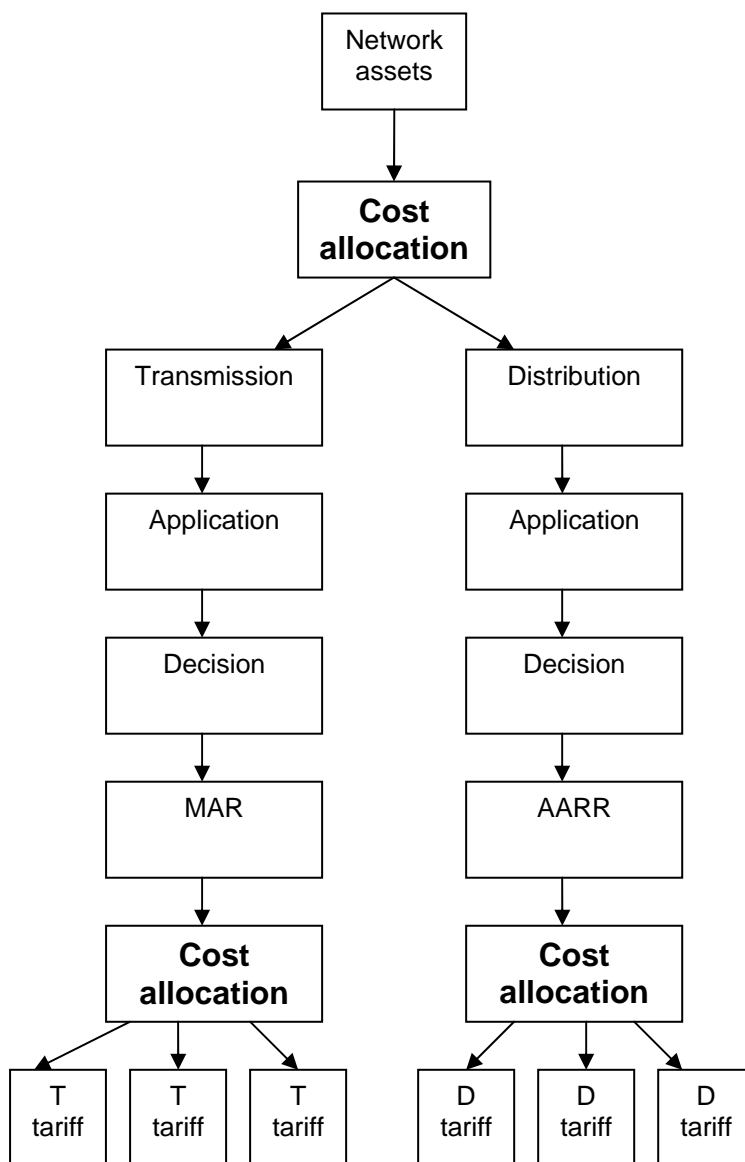


Figure 2 - Rule change with both limbs invoked

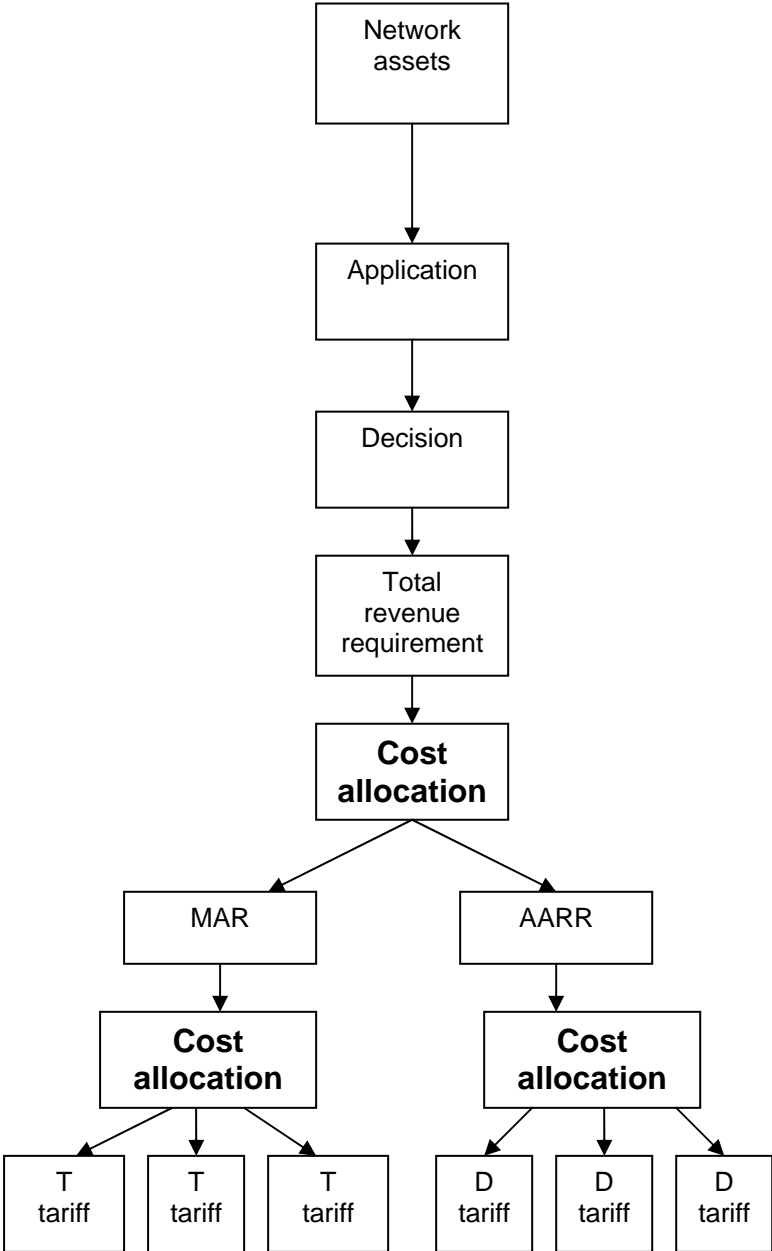
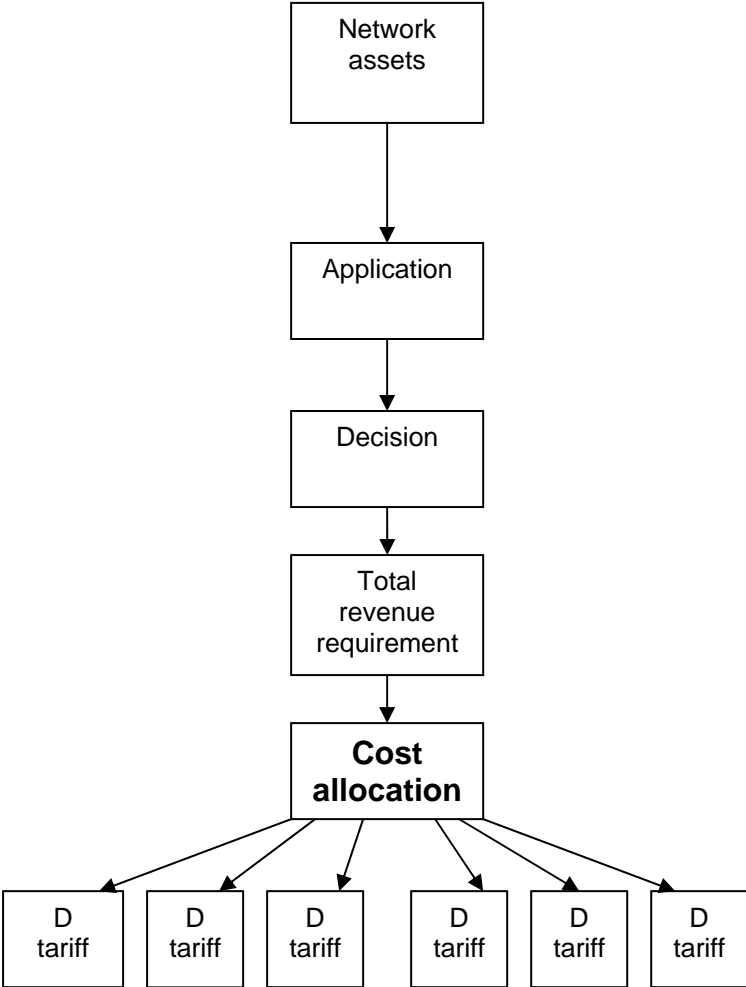


Figure 3 – Rule change with first limb only





Australian Energy Regulator

Review of EnergyAustralia's Rule Change Proposal

April 2007



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1 Executive Summary

EnergyAustralia (EA) submitted a rule change proposal to the Australian Energy Market Commission (AEMC) on 21 March 2007 to amend chapter 6A of the National Electricity Rules (Rules). The rule change proposal relates to Distribution Network Service Providers (DNSP) that own, operate or control transmission networks that operate at nominal voltages between 66 kV and 220 kV in parallel, and provide support, to a higher voltage transmission network.

EA's rule change proposal has two "limbs" under which a DNSP would be able to apply to the AER to have its transmission services:

- Regulated under Chapter 6 of the Rules for the purposes of determining its revenue requirements (Limb 1); and
- Subject to the transmission pricing provisions of Chapter 6A of the Rules (Limb 2).

The Australian Energy Regulator (AER) engaged Network Advisory Services to examine, at a high level, the potential implications and impacts of EA's rule change proposal. Importantly, the reader should be aware that in preparing this report we have not held any discussions with EA, nor have we reviewed any of their internal documentation or models. We have relied solely on publicly available information.

This report compares the current regulatory arrangements (scenario 1) against two scenarios that may arise if EA's rule change proposal was to be adopted:

- Under scenario 2 it is assumed that the AER accepts EA's proposal for both limbs of the rule change proposal to apply, so that the AER would determine a single total revenue requirement and EA's transmission and distribution services respectively would be priced under Chapter 6A and Chapter 6 (or some other approved distribution pricing principles, such as Appendix 13 of the Independent Pricing and Regulatory Tribunal's 2004 Final Determination); and
- Under scenario 3 it is assumed that only the first limb of EA's rule change proposal applies so that the AER would determine a single total revenue requirement and all of EA's services would be priced under Chapter 6 (or some other approved distribution pricing principles).

In line with our instructions, we compared the potential implications and impact for EA of applying the status quo under scenario 1 with scenarios 2 and 3 on the basis of EA's total revenue requirement, its transmission revenue requirement, the form of price control, the application of various regulatory schemes as well as the prices paid by end customers.

Total Revenue Requirement

At a high level, we found that EA's total revenue requirement could potentially either increase or decrease under scenarios 2 and 3 compared to the status quo by applying Chapter 6 of the Rules to both its distribution and transmission services, rather than applying Chapter 6 to its distribution services and Chapter 6A to its transmission services.

The Standing Committee of Officials (SCO) of the Ministerial Council of Energy (MCE) recently identified 11 key differences between the future economic regulatory arrangements to apply to the transmission and distribution sectors. These differences covered: the scope of services; control setting methodology; form of price control; adjustment to regulatory asset base; depreciation; WACC parameters; cost pass-through; contingent projects; re-opening of determination; service performance indicators; and arbitrator under negotiate/arbitrate.¹

We have not attempted to quantify the magnitude of the change in the total revenue requirement that these differences may result in for EA, although our expectation is that any increase or decrease would generally be at the margin and is likely in any event to be controllable by the AER.

Transmission Aggregate Building Block Revenue Requirement (ABBRR)

We found that EA could potentially have a different ABBRR for its transmission services under scenario 2 compared with the status quo under scenario 1 by:

- Changing the total revenue requirement, as discussed above, while retaining the relative proportions allocated between distribution and transmission services; and
- Changing its cost allocation methodology so as to change the relative proportion of the total revenue requirement applied to transmission and distribution services.

Under scenario 3, there would not be any standalone ABBRR determined for EA's transmission services – there would just be a single AARR determined under Chapter 6 for all services. We therefore found that the amount of revenue recovered by EA from its distribution and transmission services would depend on the nature of the cost allocations used to attribute the AARR between services and to develop up its individual tariffs. Transmission customers would be better off under scenario 3 relative to the status quo if EA's cost allocation methodology recovered less of the AARR through transmission tariffs and worse off to the extent that more of the AARR is recovered through these tariffs.

¹ SCO of the MCE, "Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution – Explanatory Material", Table 2

We would propose that the AER maximise the transparency of the split of EA's revenue requirement between service categories under either scenarios 2 or 3 by approving EA's detailed cost allocation methodology.

Form of Price Control

We understand that the intent of EA's rule change proposal is that its prescribed distribution services (or future direct control network services) would continue to be subject to a weighted average price cap (or some other form of price control determined in accordance with Chapter 6) and its transmission services would be subject to a revenue cap determined under Chapter 6A. This would be the case if scenario 2 was to apply.

However, if a single weighted average price cap was to apply to all of EA's distribution and transmission services under scenario 3 then it could potentially gain or lose financially relative to the status quo. In particular, it could:

- Gain the full upside benefit of any unforecast volume growth or lose revenue if volumes declined;
- Seek to mitigate the downside risks of any volume losses by rebalancing its transmission and distribution tariffs; and
- Pursue increased revenues by rebalancing its transmission and distribution tariffs.

Application of Schemes

It is not clear under either scenario 2 or scenario 3 whether EA would in the future be subject to an efficiency benefit sharing scheme and a service target performance incentive scheme for both its transmission and distribution services. Potentially, EA's revenues could either increase or decrease depending on what arrangements ultimately apply. It is recommended that the future application of these schemes be clarified if EA's rule change proposal is accepted.

Prices

EA's submission to the AEMC and PB Associates' accompanying report indicate that applying the pricing provisions of:

- Chapter 6, or alternative approved arrangements, to both transmission and distribution services could result in price shocks to existing transmission customers; but that
- Chapter 6A to transmission services results in price increases for distribution customers.



EA's submission to the AEMC does not detail why it believes it could not achieve the same pricing outcomes by applying the pricing principles in Chapter 6 of the Rules or Appendix 13 of IPART's Final Determination to its transmission services as it achieves by applying Chapter 6A. If it was able to achieve the same outcomes then there would apparently be no need for Limb 2 of EA's rule change proposal. It is recommended that the AER or the AEMC seek to clarify with EA whether or not this can be achieved and in particular whether it believes any price differences would be attributable to:

- The nature of the regulatory framework; or
- EA's own internal decisions for allocating its transmission and distribution costs, and for structuring its transmission and distribution prices.

If the analysis in EA's rule change proposal and PB Associates' report is correct then the AER would need to consider the nature of any pricing impacts in assessing any application from EA to apply the pricing provisions of Part J of Chapter 6A to its transmission services. In particular, it would need to be satisfied that "Customers would not be materially adversely affected by the application of the alternative pricing arrangements" for the purposes of clause S6A.4.7(a) of the Rule change proposal.

2 Introduction

2.1 Background

EA owns an electricity transmission network and an electricity distribution network in New South Wales. The distinction between the two networks reflects a classification of assets based on the definitions of "transmission network" and "distribution network" in the Rules.

The two networks are the subject of different economic regulatory arrangements. The transmission network is regulated under Chapter 6A of the Rules – this chapter was promulgated on 16 November 2006. The regulation of distribution pricing and revenues is dealt with in Chapter 6 of the Rules, although IPART approved alternative pricing principles in Appendix 13 of its 2004 Final Determination to apply to the NSW DNSPs for the current regulatory control period. The SCO of the MCE recently released an exposure draft of a revised Chapter 6 for public comment dealing with the economic regulation of the distribution sector.

Currently, EA's transmission network is regulated by the AER under a revenue cap form of price control whereas its distribution network is regulated by IPART under a weighted average price cap form of price control.

Both networks are currently the subject of five year regulatory control periods from 2004/05 to 2008/09. As at 1 July 2004, the initial regulatory asset base of the transmission network was \$635.5 million and the initial regulatory asset base of the distribution was \$4,116 million. According to its 2005/06 Network Performance Report, EA's transmission system was 821 kilometres in length and comprised 39 transmission substations as at 30 June 2006.²

The AER will in the future assume responsibility for the economic regulation of all electricity distribution networks in the National Electricity Market (NEM), so that it will regulate both EA's transmission and distribution networks.

EA submitted a rule change proposal to the AEMC on 21 March 2007 to amend chapter 6A of the Rules. The rule change proposal relates to DNSPs that own, operate or control transmission networks that operate at nominal voltages between 66 kV and 220 kV in parallel, and provide support, to a higher voltage transmission network. Under EA's proposal, a DNSP would be able to apply to the AER to have its transmission services:

- Regulated under Chapter 6 of the Rules for the purposes of determining its revenue requirements; and

²

[http://www.energy.com.au/energy/ea.nsf/AttachmentsByTitle/Network+Performance+Report+05+06/\\$FILE/NPROct06_FINAL.pdf](http://www.energy.com.au/energy/ea.nsf/AttachmentsByTitle/Network+Performance+Report+05+06/$FILE/NPROct06_FINAL.pdf)

- Subject to the transmission pricing provisions of Chapter 6A of the Rules.

EA's rule change proposal provides various statements of what it considers to be the problem with the current regulatory arrangements. For example, it states that:

...the problem is the inefficiency of duplicate regulatory processes that EnergyAustralia is subject to as a result of a technical classification of part of its network.³

The regulatory imposts are high considering a large part of the revenue preparation, submission and assessment is redundant between the two regimes.⁴

...while the proposed change to the existing Rules will remove significant duplication and improve efficiencies in the regulatory process (thus promoting the NEM Objective), the marginal benefit is likely to be minimal for the wider National Electricity Market.⁵

Neither EA, nor PB Associates whom it engaged to prepare an independent report to accompany its rule change proposal, quantify in dollar terms or personnel numbers the magnitude of the "problem" or the benefit that would be derived from the rule change proposal. PB Associates does, however, state in its report that "the introduction of a single regulatory review would increase process efficiency and reduce costs – both for the regulator and the network business".⁶ It is unclear on what basis this conclusion has been drawn.

EA indicates that the circumstances that it faces are, or are likely to be, experienced by other DNSPs in similar circumstances, although it is unclear whether other DNSPs support EA's rule change proposal.

2.2 Purpose of this document

The AER engaged Network Advisory Services to assist the AER to assess, at a high level, aspects of EA's rule change proposal, and to document our findings in this report.

This report compares the current regulatory arrangements (scenario 1) against EA's rule change proposal, which has two key "limbs".

³ EnergyAustralia, "Rule Change Proposal: Incidental transmission services undertaken by DNSPs", 21 March 2007, page 4

⁴ Energy Australia, page 21

⁵ Energy Australia, page 16

⁶ PB Associates, "Economic Regulation of Transmission Services Undertaken by DNSPs", March 2007, page 1

- Under Limb 1 of its proposal EA would apply to the AER to have it determine a single total revenue requirement for its transmission and distribution services; and
- Under Limb 2 of its proposal EA would apply to the AER to use the transmission pricing provisions of Chapter 6A to price its transmission services. It would continue to price its distribution services under the distribution pricing provisions of Chapter 6 or alternative approved pricing principles of the kind provided for in Appendix 13 of IPART's 2004 Final Determination.

The application of both limbs of EA's Rule Change Proposal is referred to as scenario 2 in this report.

It is possible that the AER only approves Limb 1 of EA's rule change proposal, either because EA does not apply to have Limb 2 applied or because the AER does not approve an application that is made to use Limb 2. In this case, all of EA's transmission and distribution services would be priced under the distribution pricing provisions of Chapter 6 of the Rules or alternative approved pricing principles. This is referred to as Scenario 3 in this report.

There are a variety of ways in which EA's rule change proposal could be interpreted and applied. While Scenarios 2 and 3 discussed in this report represent our best understanding of EA's proposal, it is acknowledged that alternative interpretations could be drawn. These alternative interpretations could alter some of the conclusions that have been made in this report about the implications and impact of the application of EA's rule change proposal.

2.3 Limitations of this Report

Network Advisory Services has only had access to publicly available documentation in preparing this report. Within this limitation, we reviewed:

- EA's letter to the AEMC dated 21 March 2007 and the accompanying document entitled "Rule Change Proposal: Incidental transmission services undertaken by DNSPs"; and
- PB Associates' report dated March 2007 entitled "Economic Regulation of Transmission Services Undertaken by DNSPs", which was prepared for EA.

Importantly, as agreed with the AER, in preparing this report we have not:

- Spoken with EA about its rule change proposal;
- Spoken with PB Associates about the report it prepared for EA in support of its rule change proposal;

- Reviewed any of EA's internal documentation or models, such as its cost allocation methodologies or its transmission or distribution pricing models; nor
- Sought to quantify the revenue or pricing impacts of EA's rule change proposal, including under scenarios 2 or 3.

Furthermore, this report does not:

- Consider whether EA's rule change proposal should be expedited under the Rules; or
- Seek to provide a full assessment of the merits of EA's rule change proposal.

2.4 Structure of this document

The remainder of this document is structured as follows:

- Section 3 compares, at a high level, the regulatory arrangements under the existing Rules that would apply to scenario 1 to those that EA has suggested under its rule change proposal, and which would apply under scenarios 2 and 3; and
- Section 4 examines, at a high level, the potential implications and impacts of scenarios 2 and 3.

2.5 Disclaimer

The contents of this report rely upon publicly available information and a number of assumptions have been made as part of our analysis. Our conclusions may not be valid if there is any change in the facts, circumstances or assumptions that have been relied upon. Accordingly, while we believe that the statements made in this report are accurate, no warranty of accuracy or reliability is given.

Neither Network Advisory Services nor any employee of Network Advisory Services takes responsibility arising in any way whatsoever to any person (other than the Australian Energy Regulator) in respect of this document, for any errors or omissions herein, arising through negligence or otherwise however caused. This document is not to be used for any purpose than those specified herein, nor may extracts or quotations be made without our express approval.



2.6 About Network Advisory Services

Network Advisory Services specialises in advising regulators, Governments and utilities on the economic regulation and reform of the energy and other infrastructure industries. We have considerable experience in advising on revenue and price setting for electricity distribution and transmission network service providers inside and outside of the National Electricity Market.

3 Comparison of Regulatory Arrangements

This section compares, at a high level, the regulatory arrangements under the existing Rules, which would apply under scenario 1, to those that would apply under scenarios 2 and 3.

3.1 Scenario 1 - Current Regulatory Arrangements

Currently, EA's distribution network is regulated under chapter 6 of the Rules, albeit that IPART approved alternative pricing principles in Appendix 13 of its 2004 Final Determination for the current regulatory control period, and its transmission network is regulated under Chapter 6A of the Rules. While the two regulatory frameworks differ in the detail of their economic regulatory requirements, they currently provide for the following key steps for regulating a network service provider's, such as EA's, revenues and prices:

- *Step 1* – EA would prepare separate revenue submissions to:
 - IPART / AER for its distribution services; and
 - The AER for its transmission services.

In order to prepare these separate submissions, EA must determine the underlying costs for its distribution and transmission services, which would in turn require an allocation of overall costs, assets and activities to be conducted by EA.

- *Step 2* – IPART / AER would make a determination under Chapter 6 of the Rules in relation to EA's distribution services that details (amongst other things):
 - The annual aggregate revenue requirement (AARR); and
 - The weighted average price cap constraints, or alternative form of price control based on the Rules.
- *Step 3* – The AER would issue a determination under Chapter 6A of the Rules in relation to EA's transmission services that details (amongst other things):
 - The annual building block revenue requirement (ABBRR);
 - The maximum allowed revenue (MAR).

- *Step 4* – EA would apply the:
 - Distribution pricing principles in Appendix 13 of IPART's 2004 Final Determination to its distribution services in order to recover, through tariffs and tariff components, the distribution AARR, and would escalate these tariffs throughout the regulatory period consistent with the weighted average price cap constraints and any applicable side constraints; and
 - Transmission pricing principles under chapter 6A of the Rules to its transmission services in order to recover the transmission AARR, consistent with the MAR.

3.2 Scenario 2 – Limbs 1 and 2 of EA's Rule Change Proposal

EA's suggested drafting for its rule change proposal is set out in Appendix 1 of its submission to the AEMC.

EA's rule change proposal would alter the current arrangements for DNSPs that own, operate or control transmission networks operating at nominal voltages between 66 kV and 220 kV that operate in parallel, and provide support, to a higher voltage transmission network. Under the rule change proposal, a DNSP would be able to apply to the AER to have its transmission services:

- Regulated under Chapter 6 of the Rules for the purposes of determining its revenue requirements (i.e. Limb 1); and
- Subject to the transmission pricing provisions of Chapter 6A of the Rules (i.e. Limb 2).

If the rule change proposal is adopted and the AER agreed to apply both limbs following an application from a DNSP, such as EA, then its revenues and prices would be regulated under the following key steps:

- *Step 1* – EA would make a single submission to the AER under Chapter 6 of the Rules for its distribution and transmission services, detailing:
 - A combined AARR for transmission and distribution services; and
 - The cost allocation method for splitting the AARR between distribution and transmission services.
- *Step 2* – The AER would make a single determination under Chapter 6 of the Rules in relation to the combined AARR for the DNSP's distribution and transmission services;

- *Step 3* – The AER's single determination under Chapter 6 of the Rules would detail:
 - The AARR and weighted average price cap (or some other form of price control) for the distribution services; and
 - The ABBRR and MAR for the transmission services.

In order to prepare these revenue requirements and forms of price control, there would be a need to allocate the AARR determined under step 2 between EA's distribution and transmission services.

- *Step 4* – EA would apply the:
 - Distribution pricing principles under chapter 6 of the Rules, or alternative approved pricing principles of the kind provided for in Appendix 13 of IPART's 2004 Final Determination, to its distribution services in order to derive tariffs and tariff components to recover the distribution AARR, consistent with the weighted average price cap; and
 - Transmission pricing principles under chapter 6A of the Rules to its transmission services in order to recover the transmission ABBRR, consistent with the MAR.

3.3 Scenario 3 – Limb 1 of EA's Rule Change Proposal

Scenario 3 would involve the AER making a single revenue determination for a DNSP's, such as EA's, transmission and distribution services under Chapter 6 of the Rules. However, EA would be required to price these services on a common basis by only applying the distribution pricing provisions of Chapter 6 of the Rules or alternative approved pricing principles of the kind provided for in Appendix 13 of IPART's 2004 Final Determination.

This scenario could transpire if EA:

- Only proposed to the AER to apply Limb 1 of the rule change proposal relating to a single revenue determination and did not seek to apply Limb 2 relating to the pricing of transmission services under Chapter 6A; or
- Did seek to have both Limb 1 and Limb 2 apply, but the AER only accepted the application of Limb 1.

This scenario would therefore involve the same first two steps as for scenario 2 in order for the AER to arrive at a single AARR and weighted average price cap (or some other form of price control) for all of EA's transmission and distribution services. The AER would not determine a standalone AARR for EA's distribution services and a standalone ABBRR or MAR for its transmission services.

3.4 Differences between Scenarios

The following table highlights the difference in the Rules that will be used under the three scenarios.

Scenarios		EA revenue proposal	AER revenue determination	EA Pricing
1	Transmission	Chapter 6A	Chapter 6A	Chapter 6A
	Distribution	Chapter 6	Chapter 6	Chapter 6 / Alternative
2	Transmission	Chapter 6	Chapter 6	Chapter 6A
	Distribution	Chapter 6	Chapter 6	Chapter 6 / Alternative
3	Transmission	Chapter 6	Chapter 6	Chapter 6 / Alternative
	Distribution	Chapter 6	Chapter 6	Chapter 6 / Alternative

The key difference between the revenue setting process under the status quo (scenario 1) and those for scenarios 2 and 3 relate to the timing of the application of EA's cost allocation methodology between its distribution and transmission services:

- Under the current arrangements, EA would need to allocate its costs and assets between its distribution and transmission services in order to prepare its separate revenue submissions. This would clearly need to occur before EA made its submissions to the AER / IPART;
- Under scenario 2 the allocation would need to occur after the combined AARR had been determined, in order to establish the revenue requirements and price controls to apply to the distribution and transmission services. Under this scenario, we understand that EA would not change its current:
 - Cost allocation methodology; or
 - Pricing approach as it would continue to apply the relevant provisions of Chapter 6 (or approved alternative pricing provisions) and Chapter 6A of the Rules. We note that care would need to be taken at the end of each year of the regulatory control period in order to ensure that any over or under recoveries from transmission services were correctly translated into the following year's tariffs where 'under and overs' provisions apply.
- Under scenario 3 there would be no allocation of revenues as there would be a single revenue requirement and price control for the distribution and transmission services. Under this scenario, we understand EA's pricing approach would change from that under scenarios 1 and 2 by virtue of applying the distribution pricing arrangements under Chapter 6 (or approved alternative pricing provisions) to transmission services.

3.5 Issues for further consideration

Based on our high level analysis, and our discussions with the AER, there are several issues arising from the submission that EA has presented to the AEMC in making its case for a rule change that we consider warrant further consideration. These are set out below.

Cost Allocation Principles

EA's proposed new clause S6A.4.7(c)(2) states that:

The Annual Building Block Revenue Requirement referred to in sub-clause (c)(1) must be determined by allocating a proportion of the revenue requirement determined for all services the subject of the revenue determination (other than those solely attributable to services other than prescribed transmission services) to each building block component attributable to the revenue associated with approved dual function assets on a basis which is consistent with the cost allocation principles in Clause 6A.19.2.⁷

The cost allocation principles under clause 6A.19.2 of the Rules relate to transmission only, not to distribution. It is not clear from the submission why EA considers it appropriate that its total distribution and transmission AARR developed under Chapter 6 of the Rules be split using cost allocation principles provided for under Chapter 6A of the Rules, rather than cost allocation principles under Chapter 6.

We note that the cost allocation principles in chapter 6A of the Rules are high level in nature, and that significantly more information would likely be required by the AER than is provided in clause 6A.19.2 about the detail of the cost allocation arrangements in order to understand, in a practical sense, how a network service provider is actually attributing or allocating its costs.

For this reason, the Rules require the AER to develop detailed cost allocation guidelines and for a TNSP to prepare a cost allocation methodology in accordance with these guidelines for the AER's approval. This cost allocation methodology would set out in detail how a network service provider will allocate its costs for the purposes of developing up its MAR, but will not be used to break down the MAR to determine prices for individual transmission services.

We suggest that the AER address this matter in its Cost Allocation Guideline.

⁷ EnergyAustralia, page 28

Cost Allocation Methodology

As noted in section 3.2, a key difference between the current revenue and pricing regulatory arrangements under scenario 1 and those that would apply under scenarios 2 and 3 relates to the timing of when the cost allocation is performed: The timing of when the cost allocation is undertaken would change from at the time of preparing the revenue submission under scenario 1 to:

- The time of splitting the single AARR between distribution and transmission services under scenario 2; and
- The time of determining the tariffs for individual services, albeit to recover a single AARR, under scenario 3.

We note that EA's submission does not clearly set out the nature of the cost allocation methodology that it will apply. It states that:

Undertaking two separate revenue cap application and determination processes increases (unnecessarily) the regulatory burden, resulting in increased compliance and administration costs. At the same time, the decision-making resources and capacity of relevant regulators, as well as other market participants, are inefficiently absorbed as a result of the duplicated processes.

Under this regime, far more scrutiny is required in preparing and assessing what amounts to an arbitrary allocation of costs into respective network classes, rather than focusing on the underlying costs themselves. This regulatory arrangement is therefore not only duplicative and inefficient; it challenges the integrity of the underlying regulatory framework.⁸

Later in its submission EA further states that:

The Rules will need to allow for the building block revenues built up under a distribution determination to be apportioned between transmission and distribution components for the purposes of pricing. This will require extracting the revenue associated with transmission for each building block component using an appropriate allocation methodology. The allocation process would resemble what is currently done now, but would be done after the review of expenditure and the calculation of building blocks is made not before.⁹

⁸ EnergyAustralia, page 10

⁹ EnergyAustralia, page 18

While we have not reviewed EA's current methodology, it is unclear why EA believes that its cost allocation approach will change from "arbitrary" now to "appropriate" in the future, when EA has indicated that the future approach will "resemble" the current approach. We would expect that if EA's approach is currently appropriate then it should continue to be relevant in the future, given that there will be a continuing need to allocate costs between transmission and distribution activities.

As further support, we note that in its report for EA, PB Associates states that:

Under the EA proposals, the single regulatory review for EA would be followed by an allocation of allowed revenues (based on a number of alternative methodologies) and then a separate process for the development of distribution and transmission prices – based on existing methodologies.¹⁰

PB Associates also states that:

.....in order to maintain the cost reflective characteristics of prices and to avoid considerable price disturbance, PB recommends that EA continues with the allocation of costs between transmission and distribution at the building block level.¹¹

This, on the face of it, appears to support a view that EA's cost allocation will not change materially from what it currently uses and highlights the need to ensure that the AER approves the detailed cost allocation methodology that is to apply. This will maximise transparency of the basis on which the AARR is to be split between distribution and transmission services.

Parallel Changes to Chapter 6

Currently, we understand that EA is only proposing changes to Chapter 6A of the Rules to give effect to its proposal. However, it would seem that Chapter 6 would also need to be changed in parallel with Chapter 6A in order for the AER to use Chapter 6 to regulate transmission services. In particular, in order to be effective, we consider that EA's proposal will need to enable:

- A single AARR to be determined under Chapter 6 that covers both distribution and transmission services;
- The total AARR determined under Chapter 6 to be allocated between distribution and transmission services. Presumably, this allocation will need to occur using cost allocation principles approved under Chapter 6 so that, at the

¹⁰ PB Associates, page 9

¹¹ PB Associates, page 11

very least, a AARR is determined for distribution services that is consistent with Chapter 6; and

- Prices to be determined on a basis consistent with Chapter 6, (or approved alternative pricing provisions), recognising that:
 - Under scenario 2, the prices for distribution services would be determined under the distribution pricing principles in Chapter 6 (or approved alternative pricing provisions) and the prices for transmission services would be determined under the transmission pricing principles in Chapter 6A; whereas
 - Under scenario 3, the prices for both distribution and transmission services would be determined under the distribution pricing principles in Chapter 6 (or approved alternative pricing provisions).

We note that EA has not raised the prospect of needing to amend Chapter 6 in its rule change proposal. We recommend that the AER, and / or the AEMC, examine this matter further as part of its consideration of EA's proposal.

4 Potential Impact and Implications of EA's Proposal

This section examines the potential implications and impact of EA's rule change proposal. Scenarios 2 and 3 are compared against the retention of the status quo under scenario 1. Under both scenarios 2 and 3, EA would make a single submission to the AER and the AER would make a single determination for its distribution and transmission services. However, under:

- Scenario 2 the AER would allow EA to price its transmission services under the transmission pricing provisions of Chapter 6A and its distribution services under the distribution pricing provisions of Chapter 6 (or approved alternative pricing provisions); whereas
- Scenario 3 the AER would require all services to be priced under the distribution pricing provisions of Chapter 6 of the Rules (or approved alternative pricing provisions).

4.1 Scenario 2 – Limbs 1 and 2 of EA's Rule Change Proposal

Scenario 2 is EA's preferred option as it allows the AER to determine a single revenue requirement but for EA to continue to price its distribution and transmission services on the current basis – both the revenue setting and pricing "limbs" of EA's rule change proposal are therefore applied.

The potential implications and impact of this scenario have been considered having regard for EA's total revenue requirement, its transmission revenue requirement, the form of price control, the application of various regulatory schemes as well as the prices paid by end customers.

Total Revenue Requirement

EA could gain or lose financially under this scenario compared to the status quo if its total revenue requirement approved by the AER for its distribution and transmission services changes by applying Chapter 6 of the Rules to both its distribution and transmission services, rather than applying Chapter 6 to its distribution services and Chapter 6A to its transmission services.

We note that in its report for EA, PB Associates identified the weighted average cost of capital (WACC) as the only potential source of difference between the two approaches, although it noted that "the impact of applying a distribution WACC to EA's transmission assets is likely to be negligible and could anyway be easily corrected if required"¹².

¹² PB Associates, page 1

We agree that the WACC could be different under the two approaches and we expect that this will be addressed by the AER's WACC review, which we understand it intends to initiate under the Rules in 2009.

The MCE's explanatory paper that accompanied the recent release of the exposure draft the chapter 6 Rules identified ten key differences other than WACC between the future transmission and distribution regulatory arrangements, which may cause EA's total revenue requirement to change. These covered: scope of services; control setting methodology; form of price control; adjustment to regulatory asset base; depreciation; cost pass-through; contingent projects; re-opening of determination; service performance indicators; arbitrator under negotiate/arbitrate; and regulatory procedure.^{13 14}

It is not possible at this stage to quantify what the magnitude of the difference in the total revenue requirement might be between applying the future Chapter 6 and the current Chapter 6A, although our expectation is that any change would generally be at the margin and is likely in any event to be controllable by the AER.

Transmission ABBRR

The next way in which EA could be positively or negatively affected by applying this scenario 2 compared to the status quo is through its ABBRR.

EA's total revenue requirement could be changed as discussed above, while retaining the relative proportions allocated between the distribution AARR and the transmission ABBRR. This could result in either an increase or a decrease in its transmission revenue requirement.

Additionally, EA could change its cost allocation methodology so as to change the relative proportion of the total revenue requirement applied to transmission services in the ABBRR, relative to that applied to distribution services. As noted in section 3:

- We have not reviewed EA's cost allocation methodology in preparing this report; and
- It is not clear from its rule change proposal how EA's cost allocation methodology will change, if at all, if it was to be applied at the time of preparing its revenue submission compared with at the time of splitting the AARR between distribution and transmission services.

¹³ SCO of the MCE, "Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution – Explanatory Material", Table 2

¹⁴ We note that the explanatory paper accompanying the exposure draft of Chapter 6 of the Rules proposes savings and transitional arrangements in relation to certain of these matters for the NSW distributors, including EA, for their next regulatory control period commencing 1 July 2009.

In order to maximise the transparency of the split of EA's revenue requirement between transmission and distribution service categories, we would suggest that the EA's detailed cost allocation methodology should be approved by the AER.

Form of Price Control

Our understanding of the intent of EA's rule change proposal is that, providing both limbs of the proposal were approved by the AER, EA's:

- Prescribed distribution services (or future direct control network services) would continue to be subject to a weighted average price cap (or some other form of price control determined in accordance with Chapter 6 of the Rules); and
- Transmission services would be subject to a revenue cap determined in accordance with Chapter 6A.

While we understand that EA is not suggesting any new approach, we note that it could potentially be impacted financially if an alternative form of price control was applied to its transmission services or if the revenue cap did not apply in exactly the same way in the future as it does under the current arrangements. For example, if the total transmission and distribution AARR was subject to a weighted average price cap, rather than a revenue cap, EA could:

- Gain the full upside benefit of any unforecast volume growth – this would mean it could retain any over-recoveries on its transmission services as well as its distribution services, rather than needing to hand these back to customers through an “unders and overs” mechanism;
- Mitigate the downside risks of volume losses by rebalancing both its transmission and distribution tariffs so as to maintain (or increase) its revenues; and
- Pursue increased revenues by rebalancing its transmission and distribution tariffs.

Equally, EA could potentially lose the revenue certainty associated with its existing transmission revenue cap if it moved to a weighted average price cap, had to bear the full downside risk of volume reductions, and was unable to “re-balance away” from these outcomes.

While we note that EA has not sought any change, we suggest that the AER clarify the forms of price control that could be applied to a DNSP's distribution and transmission services if the rule change proposal is accepted.

Application of Schemes

There are two schemes that apply to the regulation of prescribed transmission services under Chapter 6A – the efficiency benefit sharing scheme and the service target performance incentive scheme. Both of these schemes have the potential to increase or decrease a TNSP's revenues.

Neither of these schemes currently applies to EA's prescribed distribution services. In its Final Decision for the currently regulatory control period, IPART determined:

- “the hybrid P-nought/glide path approach to be the most appropriate approach for calculating price movements for all DNSPs for the 2004-09 regulatory period.....it has decided against adopting a fixed-term efficiency carryover mechanism in this regulatory period”,¹⁵ and
- That it would introduce “a 'paper trial' S-factor, focusing on service reliability measures (but no monetary S-factor)”¹⁶.

The MCE's exposure draft of Chapter 6 of the Rules provides for both schemes being applied to regulate a DNSP's direct control network services.

On the basis of this information, and the material in EA's rule change proposal, it is not clear whether EA will be subject to an efficiency benefit sharing scheme and a service target performance incentive scheme for both its transmission and distribution services in the future. Given that EA's revenues could either increase or decrease depending on what arrangements ultimately apply, we suggest that the AER clarify what schemes would apply to transmission and distribution services if EA's rule change proposal is accepted.

Prices

Under this scenario 2, EA could price its transmission services based on the pricing provisions of Chapter 6A of the Rules and its distribution services on the relevant approved distribution pricing principles. In effect, we interpret this to mean that EA would continue to price its services as it currently does.

However, in accordance with EA's rule change proposal, the AER would need explicitly to approve EA pricing its transmission services under Chapter 6A before it could do so. Relevantly, clause S6A.4.7(a) of the rule change proposal states that:

- (a) *The AER may determine that the (sic) one or all of the alternative pricing arrangements specified in sub-clause (b) will apply to approved dual function assets if it is satisfied that:*
 - (1)

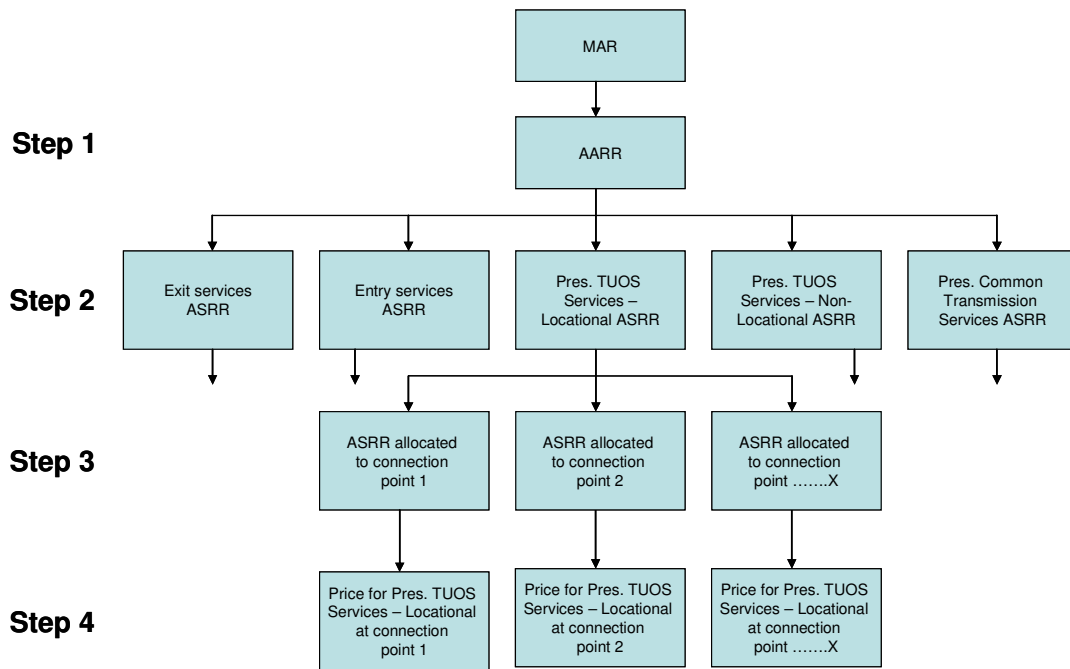
¹⁵ IPART, “Final Decision – NSW Electricity Distribution Pricing 2004/05 to 2008/09” page 79

¹⁶ IPART, page 20

(3) *Customers would not be materially adversely affected by the application of the alternative pricing arrangements.*

The regulation of prices for prescribed transmission services is dealt with in Part J of Chapter 6A of the Rules. A distinction is made in this part between five types of prescribed transmission services: entry services; exit services; prescribed TUOS Services – locational; prescribed TUOS services – non-locational; and prescribed common transmission services.

Clause 6A.23 of the Rules details a four step process for converting the maximum allowed revenue that is set by the AER in its revenue determination for a TSNP into prices for each of these five services. This is illustrated and discussed below.



In step 1, the TNSP derives a AARR under clause 6A.22.1 of the Rules by adjusting the approved maximum allowed revenue for any of the factors detailed in clause 6A.3.2 of the Rules and by subtracting the operating expenditure expected to be attributable to prescribed common transmission services.

Once the AARR has been determined, step 2 entails allocating this amount between each service to get five separate annual service revenue requirements (ASRR). These allocations are to be undertaken in accordance with clause 6A.23.2 of the Rules. They involve applying the attributable cost shares to the AARR, which are ratios of the costs of transmission system assets directly attributable to each service to the total cost of all system assets.

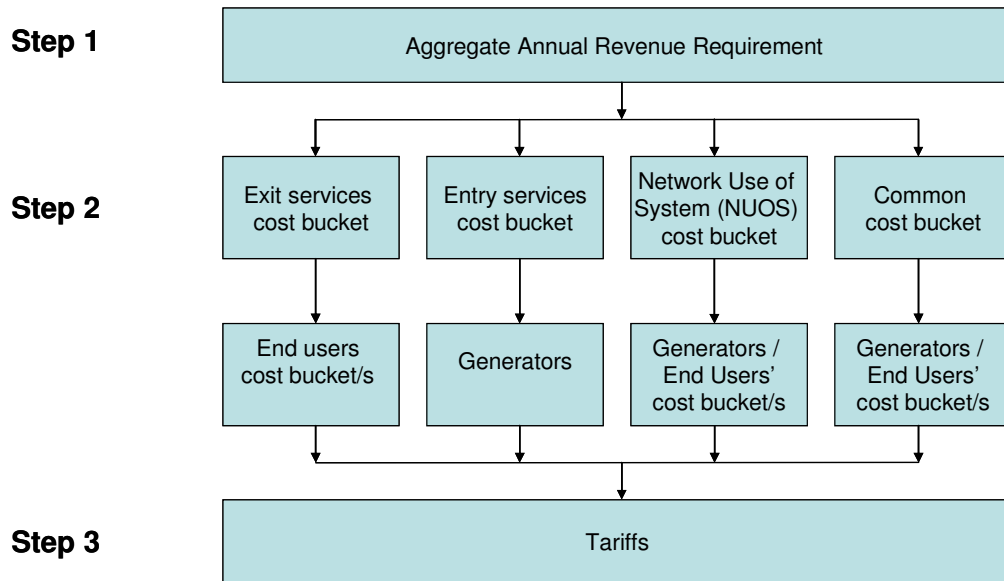
Once the ASRR has been determined for each service type, step 3 then involves the TNSP allocating each ASRR to connection points using “attributable connection point cost shares”. The basis for determining these shares and making these allocations is different for each service type and is set out in clause 6A.23.3 of the Rules. Relevantly, clause 6A.23.3(d)(1) of the Rules provides that, unless an alternative approach is developed under clause 6A.23.3(d)(2), the ASRR for prescribed TUOS services must be allocated equally between locational and non-locational services.

Once the ASRRs have been allocated between the TNSP's connection points, the TNSP is in a position to determine its prices in step 4. Clause 6A.23.4 of the Rules details specific requirements in relation to how a TNSP must structure its prices for each type of service:

- Entry and Exit Services must be fixed annual amounts;
- Prescribed Common Transmission Services and Prescribed TUOS Services – Non-Locational must be priced on a postage stamp basis; and
- Prescribed TUOS Services – Locational must be priced based on demand at times of greatest utilisation of the transmission network and for which network investment is likely to be contemplated.

In effect, the first three steps under Part J involve an allocation of costs to derive and allocate the AARR and step 4 involves the structuring of prices within a defined framework.

The Rules deal with the pricing of prescribed distribution services in Part C (formerly Part E) of chapter 6. A distinction is made between four types of prescribed distribution services: entry services; exit services; distribution use of system services; and common services. Part C details a three step process for determining the DNSP's AARR and converting this amount into prices for the four services. This is illustrated and discussed below.



In step 1, the DNSP must seek a determination from the regulator of its AARR in accordance with Part D. This AARR is then broken up for the purposes of setting distribution prices for each type of service.

Step 2 involves allocating the components of the AARR amongst different assets within classes of distribution service and then to different cost pools in accordance with clause 6.6 of the Rules. These cost pools are then allocated to generators and distribution customers. The outcome of the cost allocation process in this step 2 is a number of cost pools containing allocated annual costs.

Step 3 involves determining the DNSP's distribution prices.

However, IPART established an alternative pricing methodology to apply to NSW DNSPs, including EA, during the current regulatory control period, which replaced the former Part E (now Part C) of Chapter 6 the Rules. This methodology is detailed in clause 12 of IPART's "NSW Electricity Distribution Pricing 2004/05 to 2008/09 – Final Determination". It includes a requirement for the NSW DNSPs to:

- Use their reasonable endeavours to comply with the pricing principles detailed in Annexure 13 of the Final Determination; and
- Prepare a Network Strategy Statement that contains the information in relation to its distribution pricing detailed in Annexure 14 of the Final Determination.

The pricing principles in Annexure 13 are different to those in the former Part E (and now Part C) of the Chapter 6 of the Rules and those in Part J of Chapter 6A of the Rules. This is because Annexure 13 does not require:

- Costs to be allocated in a specified manner, although the Annexure does require that a DNSP's price development incorporate an analysis of the cost of service provision; and
- Prices to be structured in a specific manner, although Annexure 13 does require a DNSP's prices to signal the economic costs of service provision.

EA indicated in its rule change proposal that its preference is to retain the current basis for pricing its transmission and distribution services. This is because it believes some of its transmission customers would face price shocks if it was to apply the distribution pricing principles to all of its services. EA's submission to the AEMC indicates that it undertook a high-level analysis of the likely impact on customers of such a change in pricing principles. It concluded that "Many of the (transmission) customers represented in this analysis would be profoundly impacted"¹⁷ and that "The potential price variability imposed on (transmission) customers as an impact of the Rule change would not be proportionate to the problem identified by EnergyAustralia"¹⁸.

PB Associates also indicated in its report for EA that:

Transmission and distribution pricing, including the allocation of costs to customer prices, will remain unchanged under the proposed framework.

Due to significant differences in transmission and distribution pricing principles any changes in these processes would lead to unacceptably high customer price disturbances.

- *EA's 132kV parallel network is currently modelled by Transgrid as part of the full transmission network supplying the entire state of NSW. As a result, 50% of the allowed transmission revenues for shared assets are retrieved using a postage stamp price while 50% are apportioned on a locational basis.*
- *On its subtransmission network EA uses the transmission cost allocation method. However for the sub-transmission network EA use a 100% locational apportioning.¹⁹*

Furthermore, PB Associates went on to note in its report for EA that:

Currently, because of the cross flows of electricity passing between EA's and Transgrid's networks, about \$20m of EA's transmission revenues are received from other DNSPs. The application of distribution pricing to EA's transmission network would mean that the \$20m previously retrieved from other DNSPs would be retrieved from EA tariff customers.

¹⁷ Energy Australia, page 17

¹⁸ Energy Australia, page 17

¹⁹ PB, pages 11 and 12

Therefore the application of distribution pricing to EA's transmission network would lead to circa 0.5% Po price increase for tariff customers.²⁰

EA's submission to the AEMC does not detail why it believes it could not achieve the same pricing outcomes by applying the pricing principles in Chapter 6 of the Rules or Appendix 13 of IPART's Final Determination to its transmission services as it does by applying Chapter 6A. If it was able to achieve the same outcomes then there would apparently be no need for Limb 2 of EA's rule change proposal. It is therefore recommended that the AER or the AEMC seek to clarify with EA whether or not this can be achieved and in particular whether it believes any price changes would be attributable to differences between:

- The requirements of Part J of Chapter 6A that relate to transmission services and the requirements in Part C of Chapter 6 of the Rules or the pricing principles under Appendix 13 of IPART's Final Determination that both relate to distribution services; and / or
- EA's own internal decisions for allocating its transmission and distribution costs, and for structuring its transmission and distribution prices, independent of the regulatory framework.

If the analysis in EA's rule change proposal and PB Associates' report is correct then applying the pricing provisions of:

- Chapter 6 to both transmission and distribution services could result in price shocks to existing transmission customers; but that
- Chapter 6A to transmission services results in price increases for distribution customers.

The AER would need to consider these pricing impacts in assessing any application from EA to apply the pricing provisions of Part J of Chapter 6A to its transmission services. In particular, it would need to be satisfied that "Customers would not be materially adversely affected by the application of the alternative pricing arrangements" for the purposes of clause S6A.4.7(a) of the rule change proposal.

4.2 Scenario 3 – Limb 1 of EA's Rule Change Proposal

Scenario 3 is not EA's preferred option as described in its submission to the AEMC because, while it allows the AER to determine a single revenue requirement, it provides for its distribution and transmission services to be priced on a common basis by only applying the distribution pricing provisions of chapter 6 of the Rules (or approved alternative pricing arrangements).

²⁰ PB, page 12

As with scenario 2, the potential implications and impact of this scenario have been considered having regard for EA's total revenue requirement, its transmission revenue requirement, the form of price control, the application of various regulatory schemes as well as the prices paid by end customers.

Total Revenue Requirement

EA would have the same potential under this scenario 3 as under scenario 2 to gain or lose financially if the total revenue requirement for its transmission and distribution services approved by the AER was to change by applying Chapter 6 of the Rules to both EA's distribution and transmission services.

As with scenario 2, it is not possible at this stage to quantify what the magnitude of any such difference in the total revenue requirement might be, although our expectation is that any increase would generally be at the margin and is likely in any event to be controllable by the AER.

Transmission ABBRR

Under this scenario 3, there would not be any standalone ABBRR determined for EA's transmission services – there would just be a single AARR determined under Chapter 6 of the Rules. The amount of revenue recovered by EA from its distribution and transmission services would depend on the nature of the cost allocations used to attribute its AARR and to develop up its individual tariffs. To the extent that EA's cost allocation methodology recovers:

- More of the AARR through transmission tariffs then transmission customers will be worse off and distribution customers better off; and
- Less of the AARR through transmission tariffs then transmission customers will be better off and distribution customers worse off.

In order to maximise the transparency of the split of EA's revenue requirement between service categories, it is recommended that the AER explicitly approve EA's detailed cost allocation methodology.

Form of Price Control

It has been assumed that a single weighted average price cap will apply to all of EA's distribution and transmission services under this scenario 3. As a result, EA could potentially benefit financially under this scenario relative to the status quo by:

- Gaining the full upside benefit of any unforecast volume growth – this would mean it could retain the over-recoveries on its transmission services as well as its distribution services, rather than needing to hand these back to customers through an "unders and overs" mechanism;

- Mitigating the downside risks of any volume losses by rebalancing both its transmission and distribution tariffs so as to maintain (or increase) its revenues; and
- Pursuing increased revenues by rebalancing its transmission and distribution tariffs.

Equally, as noted previously, EA could potentially lose the revenue certainty associated with its existing transmission revenue cap if it moved to a weighted average price cap, had to bear the full downside risk of volume reductions and could not use re-balancing provisions to lessen the impact.

Financial modelling would be required in order to quantify the potential magnitude of these potential gains or losses for given volume growth or loss assumptions. We have not undertaken any such analysis for the purposes of this report.

Application of Schemes

As with scenario 2, it is not clear under this scenario 3 whether EA will be subject to an efficiency benefit sharing scheme and a service target performance incentive scheme for both its transmission and distribution services in the future.

Potentially, EA's revenues could either increase or decrease depending on what arrangements ultimately apply. As with scenario 2, it is recommended that the AER seek to clarify what schemes would apply to transmission and distribution services if this scenario 3 was to apply.

Prices

As discussed, EA indicated in its rule change proposal that, based on its high-level analysis, a number of its transmission customers would face price shocks if it was to apply distribution pricing principles (under either Chapter 6 of the Rules or Appendix 13 of IPART's Final Determination) rather than the transmission pricing provisions of Chapter 6A to its transmission services.

We are not privy to how EA determined these impacts, nor have we reviewed its pricing models or cost allocation methodologies. We are therefore not able to comment on the size of the potential price changes.

However, we consider that the causes of any price changes are likely to relate to differences in the basis for allocating costs to connection points and for structuring prices under the alternative pricing arrangements. This could be the result of differences between:

- The requirements of Part J of Chapter 6A that relate to transmission services and the requirements in Part C of Chapter 6 of the Rules or the pricing

principles under Appendix 13 of IPART's Final Determination that both relate to distribution services; and / or

- EA's own internal decisions for allocating its transmission and distribution costs, and for structuring its transmission and distribution prices, independent of the regulatory framework.

We expect that EA could limit the extent of price changes arising from internal matters, as these are by definition within its control. The key issue then becomes to what extent EA could, or could not, accommodate its existing transmission pricing practices and outcomes under the distribution regulatory framework in order to avoid price shocks.

In order to continue its existing transmission pricing practices and outcomes within the distribution regulatory framework, they would need to comply with either:

- The provisions of Part C of Chapter 6 of the Rules; or
- An alternative such as the pricing principles in Appendix 13 of IPART's Final Determination.

As discussed in the assessment of scenario 2, we recommend that the AER or the AEMC seek to clarify with EA why it believes that its current transmission pricing practices and outcomes can not be accommodated under either of these distribution pricing arrangements. If they could be accommodated, then it is possible that any price shocks could be limited or avoided. If they could not, then price shocks may result. We have not undertaken this analysis in preparing this report.