

Australian Energy Market Commission

RULE DETERMINATION

National Electricity Amendment (Changes to Cost Allocation Method) Rule 2013

Rule Proponent

Trans Tasman Energy Group

8 August 2013

For and on behalf of the Australian Energy Market Commission

**RULE
CHANGE**

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About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two main functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

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Summary

The Australian Energy Market Commission (AEMC or Commission) has determined not to make a rule in response to Trans Tasman Energy Group's rule change request regarding the cost allocation method and regulation of negotiated services by distribution network service providers.

Trans Tasman Energy Group submitted a rule change request on 7 December 2012 to the Commission to make a rule that seeks to:

- improve customer engagement in the cost allocation method by requiring the Australian Energy Regulator (AER) to apply the distribution consultation procedures when approving any changes to a cost allocation method;
- increase transparency in the costs of negotiated services by requiring the cost allocation method to include the numeric values of allocators; and
- improve certainty regarding how prices are derived for negotiated distribution services by amending the principles for access to negotiated services.

The Commission is not satisfied that the proposed changes would promote the National Electricity Objective (NEO). This is because the existing rules provide sufficient opportunities for customer engagement and access to relevant cost information for negotiated services. Negotiated services are intended to have a degree of competitive provision and the light handed regulatory framework that currently exists is sufficient.

The proponent is seeking to improve the ability of customers to engage with distribution network service providers with respect to negotiated services. In general, the nature of a negotiated service, and the reason why it is classified as such, means that those negotiating with service providers have adequate negotiating power for these services already. If this is not the case, then it may be appropriate to review the classification of the service. The AER can consider the appropriate classification of a service at each regulatory determination. In the context of this rule change request, the Commission considers that the rules regarding negotiated services are appropriate.

The cost allocation method must be consistent with the cost allocation guidelines, which are consulted on by the AER. Any benefits of additional consultation on changes to the cost allocation method appear to be minimal however the Commission considers that the costs (such as the preparation of public documents) to undertake additional consultation would be material. The Commission considers that the existing approach, which requires consultation on the cost allocation guidelines, appropriately balances stakeholder engagement and regulatory oversight.

Customers of negotiated distribution services have access through the negotiation framework to relevant commercial information from the distribution network service provider to engage in effective negotiation. Therefore, the costs to distribution network service providers and the AER of including numeric values of allocators as part of

revised cost allocation methods are likely to outweigh any potential benefits. Moreover, negotiated services are subject to a light handed regulation regime under which distribution network service providers are not required to provide the same level of detailed disclosure of cost information as they would for direct control services. The Commission views the current role and scope of the cost allocation method in these circumstances to be consistent with such a light handed framework.

The Commission considers that the existing principles for access to negotiated distribution services are appropriate as currently drafted. It gives the AER appropriate flexibility in determining the negotiated service criteria with opportunity for stakeholder engagement. Moving toward defining how costs are to be calculated requires more involvement of the AER and fundamentally changes the nature of the regulatory approach (ie from light handed to more heavy handed regulation). In these circumstances, the Commission considers the current approach to be appropriate.

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1 Trans Tasman Energy Group's rule change request

1.1 The rule change request

On 7 December 2013, Trans Tasman Energy Group (rule proponent) submitted a rule change request to the Commission seeking to make changes to the cost allocation method and its role in the negotiating framework (rule change request).

1.2 Rationale for rule change request

In this rule change request the rule proponent seeks to:

- improve customer engagement with respect to the cost allocation method;
- increase transparency of the cost allocation method; and
- increase certainty regarding how prices are derived for negotiated distribution services.

The rule proponent states that the cost allocation method is a primary input to establishing prices for negotiated distribution services. As such, it argues that as an important part of the negotiation process, the cost allocation method should be open to review so customers can assess the appropriateness of any changes to a distribution network service provider's (DNSP) cost allocation method. It also notes that as a "method", it should fall under the general categories subject to the distribution consultation procedures.¹

The rule proponent is concerned that the current requirements for the cost allocation method in the National Electricity Rules (NER) are not sufficiently transparent to enable effective negotiation of prices under Part D of the NER. The rule proponent is specifically interested in the numeric value of allocators. An allocator is the method by which a cost is split between different categories, and the numeric value is the quantity of costs being added to each category. Without the numeric value included in the cost allocation method, the rule proponent states that customers cannot establish for themselves whether the price offer is compliant with the NER, including whether the same cost was allocated more than once.²

In the rule change request, the rule proponent argues that a default position for how prices must be established is appropriate given the significant imbalance of market power that exists between the DNSP and a negotiating party. However, in response to the draft rule determination, the rule proponent states that the "inclusion of 'significant imbalance of market power' in consideration of this proposed Rule change is misplaced".³ Notwithstanding its comments with respect to market power, the

1 Trans Tasman Energy Group, Proposed Rule Change, 7 December 2012, pp. 2-4.

2 Trans Tasman Energy Group, Proposed Rule Change, 7 December 2012, p. 4.

3 Trans Tasman Energy Group, Draft Determination submission, 5 July 2013, p. 5.

proponent states that it maintains its view that a price charged by the DNSP must be based on the cost incurred in providing that service.⁴ The rule change request also stated that a default methodology should still be in place for cases where the AER needs to set prices to resolve a dispute and will better equip parties in negotiating with a DNSP.⁵

1.3 Solution proposed in the rule change request

The rule proponent proposes to resolve the issues discussed above by making a rule that seeks to:

- require the AER to apply the distribution consultation procedures when approving any changes to a cost allocation method;⁶
- include the numeric value of allocators in cost allocation methods; and⁷
- amend the negotiated distribution service principle for determining a negotiated price such that negotiated prices must be based on the cost of providing the service, determined in accordance with the cost allocation method.⁸

1.4 Commencement of Rule making process

On 14 February 2013, the Commission published a notice under section 95 of the National Electricity Law (NEL) advising of its intention to commence the rule making process and the first round of consultation in respect of the rule change request. A consultation paper was also published with the rule change request. Submissions closed on 14 March 2013.

The Commission received 12 submissions on the rule change request as part of the first round of consultation. They are available on the AEMC's website.⁹ A summary of the issues raised in submissions and the Commission's response to each issue is contained in Appendix B.

1.5 Publication of draft rule determination

On 23 May 2013 the Commission published a notice under section 99 of the NEL and a draft rule determination in relation to the rule change request (draft determination). The Commission's draft determination was to make no rule.

4 Trans Tasman Energy Group, Draft Determination submission, 5 July 2013, p. 5.

5 Trans Tasman Energy Group, Proposed Rule Change, 7 December 2012, p. 4.

6 Trans Tasman Energy Group, Proposed Rule Change, 7 December 2012, p. 7.

7 Trans Tasman Energy Group, Proposed Rule Change, 7 December 2012, p. 7.

8 Trans Tasman Energy Group, Proposed Rule Change, 7 December 2012, p. 7.

9 www.aemc.gov.au

Submissions on the draft determination closed on 4 July 2013. The Commission received six submissions in response to the draft determination. They are available on the AEMC website.¹⁰ A summary of the issues raised in submissions, and the Commission's response to each issue, is contained in Appendix C.

¹⁰ www.aemc.gov.au

2 Final rule determination

2.1 Commission's determination

In accordance with section 102 of the NEL the Commission has made this rule determination in relation to the rule proposed by Trans Tasman Energy Group. In accordance with section 103 of the NEL the Commission has determined not to make a Rule.

The Commission's reasons for making this final Rule determination are set out in section 2.4.

2.2 Commission's considerations

In assessing the Rule change request the Commission considered:

- the Commission's powers under the NEL to make the rule;
- the rule change request;
- the fact that there is no relevant Ministerial Council on Energy (MCE) Statement of Policy Principles;¹¹
- submissions received during first round of consultation and in response to the draft determination; and
- the Commission's analysis as to the ways in which the proposed rule will or is likely to, contribute to the NEO.

2.3 Commission's power to make the rule

The Commission is satisfied that the proposed rule falls within the subject matter about which the Commission may make rules. The proposed rule falls within section 34 of the NEL as it relates to the operation of the National Electricity Market (NEM) (section 34(1)(a)(i)) and the activities of persons (including Registered participants) participating in the NEM or involved in the operation of the national electricity system (section 34(1)(a)(iii)).

Further, the proposed rule falls within the matters set out in Item 26D of Schedule 1 to the NEL as it relates to the economic framework, mechanisms or methodologies to be applied or determined by the AER for the purposes of items 25 and 26. This includes (without limitation) the economic framework, mechanisms or methodologies to be applied or determined by the AER for the derivation of the revenue (whether

¹¹ Under section 33 of the NEL the AEMC must have regard to any relevant MCE statement of policy principles in making a Rule.

maximum allowable revenue or otherwise) or prices to be applied by the AER in making a distribution determination.

2.4 Rule making test

Under section 88(1) of the NEL the Commission may only make a rule if it is satisfied that the Rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is set out in section 7 of the NEL as follows:

“The objective of this Law 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:

- (a) price, quality, safety, reliability and security of supply of electricity;
and
- (b) the reliability, safety and security of the national electricity system.”

The key aim of this rule change request is to enable stakeholders the opportunity to comment on changes to cost allocation methods and to improve the information available to participants in negotiating services. Such changes would contribute towards the achievement of the NEO if they can improve the ability of the parties to negotiate efficient prices without unduly increasing compliance costs.

The Commission is not satisfied that the proposed rule will, or is likely to, contribute to the achievement of the NEO because:

- there is insufficient evidence of a problem with the existing provisions impacting the ability of parties to negotiate efficient prices for negotiated services; and
- adopting the proposed rule will introduce extra costs and a disproportionate regulatory burden.

Appendix A sets out a description of the regulatory framework for developing a cost allocation method and provides a description of negotiated services. For reasons set out in this final determination, the Commission considers that these existing provisions are adequate to address the issues raised by the rule proponent.

The Commission considers that the current approach to stakeholder engagement for the cost allocation method is appropriate. Stakeholder engagement is required during development of, and any subsequent change to, the cost allocation guideline. Stakeholders can have the most influence and impact on the cost allocation method through the guidelines since all cost allocation methods will need to comply with it. Therefore, the current approach appropriately balances stakeholder engagement and regulatory oversight. The benefits associated with additional consultation appear to be unlikely to outweigh the administrative costs (such as the preparation of public

documents) to DNSPs and the AER in undertaking such consultation. This is discussed in detail in section 5.3.1.

It is appropriate and consistent with the purpose of the cost allocation method not to require specific cost information in it. The exclusion of certain numeric values of allocators (or other such cost-related information) from the cost allocation method does not impede effective negotiation. This is because the negotiation framework in the rules provides negotiating parties with access to relevant cost information and is enforceable through the dispute resolution process. For other regulated services, relevant information with respect to costs will be included in regulatory determinations. The costs to DNSPs to prepare and publish revised cost allocation methods more frequently, and to the AER of approving revised cost allocation methods, are therefore likely to outweigh such potential benefits. This is discussed in detail in section 6.3.1.

The Commission considers that the negotiated distribution service principles¹² are appropriate. The principles inform the criteria which are determined by the AER. The negotiation framework and criteria form the basis of obligations on the negotiating parties and requirements for the AER in arbitrating a dispute under the rules. The negotiating framework and criteria form part of a DNSP's regulatory determination and so there is opportunity for stakeholder engagement. The current drafting of the principles give the AER appropriate flexibility in determining the negotiating service criteria. Negotiated services are subject to more light handed regulation as provision of these services are considered to be contestable. The Commission considers that increasing the level of prescription for these services with respect to the required detail and transparency of costs, or how those costs should be calculated, is inappropriate in these circumstances. This is discussed in detail in section 7.3.1.

2.5 Other requirements under the NEL - revenue and pricing principles

In applying the rule making test in section 88 of the NEL, the Commission has taken into account the revenue and pricing principles as required under section 88B of the NEL as the proposed rule relates to matters specified in item 26D of Schedule 1 to the NEL.

The revenue and pricing principles are set out in section 7A of the NEL. They set out a number of principles that concern matters such as the recovery of efficient costs, incentives to promote efficiencies and that prices should reflect returns commensurate with the risks involved in providing services.

Having considered the issues raised by the rule proponent, the Commission has concluded that the changes proposed by the rule proponent do not meet the NEO, including taking into account the revenue and pricing principles. This is because there is insufficient evidence of a problem with the existing provisions impacting the ability of parties to negotiate efficient prices and adopting the proposed rule will introduce extra costs and disproportionate regulatory burden.

¹² NER, clause 6.7.1.

3 Commission's assessment approach

This chapter describes the analytical framework that the Commission has applied to assess the rule change request in accordance with the requirements set out in the NEL (and explained in Chapter 2).

In assessing the rule change request against the NEO the first step is to consider the counterfactual arrangements against which the rule change is being compared. In the present case the counterfactual arrangements are the current provisions under the rules which are summarised in Appendix A.

In assessing the rule change request against the NEO, the Commission has considered the following factors:

- transparency - whether the proposed rule is likely to improve the information consumers receive about the costs of providing negotiated services;
- stakeholder engagement - whether the proposed rule would have an impact on the opportunity for stakeholders to engage and to engage constructively in the regulatory process; and
- regulatory process - whether the proposed rules would create additional regulatory burden for the AER, regulated parties or any other relevant stakeholder.

The key aspect of this rule change is to enable stakeholders the opportunity to comment on changes to cost allocation methods and to improve the information available to participants in negotiating services. Such changes will contribute towards the achievement of the NEO if they can improve the efficiency of prices.

The Commission considers that the above factors are relevant to determining whether the proposed rule will lead to more efficient prices for network services. This is because improving cost information transparency, and stakeholder engagement in order to potentially influence what cost information is available, would enable parties negotiating with DNSPs to be in a strong position. This is consistent with Energex's submission in response to the consultation paper which stated that a relevant consideration is whether the changes will lead to improved information for decision making.¹³

Prior to assessing the rule change request against these factors, the next chapter sets out the current approach to cost allocation and negotiated services.

¹³ Energex, Consultation Paper submission, 14 March 2013, p. 3.

4 Approach to cost allocation and negotiated services

This chapter discusses fundamental elements of the cost allocation method and how prices for negotiated services are determined. A more detailed overview of the regulatory framework of negotiated services and the cost allocation method is included in Appendix A. The subsequent three chapters address each of the three components in the rule change request in detail. The conclusions in this chapter underpin the Commission's approach to the subsequent chapters.

4.1 Negotiated services

It is important to recognise the different characteristics of negotiated services and direct control services.

The AER classifies a service according to the form of regulation factors. Direct control services are used where there are fewer substitutes for the service being sought or insufficient information exists to enable the consumer to effectively negotiate with the service provider; therefore, the service provider has market power. By contrast, services that are classified as negotiated should display these characteristics less strongly. In sum, services should be classified as negotiated where the service provider and those seeking a service are more evenly balanced in terms of their negotiating power.

Where there is some prospect for the competitive provision of a service, regulation is not needed to the same extent to ensure prices remain at efficient levels. As a result, lighter-handed regulation is applied for negotiated services than for direct control services.

The rule change request seeks to impose greater regulatory control over services that have been classified as negotiated. For example, it seeks to have numeric values of allocators for services included in the cost allocation method to provide negotiating parties with greater understanding of the underlying costs.

In fact, the nature of the negotiated service should mean that those negotiating with service providers have adequate negotiating power already. If this is not the case, then it may be appropriate to review the classification of the service. That is, the service may be more appropriately classified as direct control.

The AER can consider the appropriate classification of a service at each regulatory determination. Stakeholders also have the opportunity to comment on the proposed services classification which the AER consults on as part of the regulatory determination process.

A lighter-handed approach to regulation should be retained for negotiated services in these circumstances.

4.2 Cost allocation method

The rules contain a particular framework for cost allocation. Certain principles are set out in the rules. The AER develops and consults on cost allocation guidelines, which must be consistent with the principles. DNSPs then produce their own cost allocation methods, specific to their business, which the AER must check are compliant with its guidelines. The DNSPs then apply their approved cost allocation method when allocating costs.

This framework treats the cost allocation method as a DNSP document, with stakeholder consultation at the level of the AER's guidelines. The framework balances the requirements of DNSPs and consumers.

The rule change request would change the fundamental character and purpose of the cost allocation method and alter the balance between DNSPs and consumers in the framework. Currently, the cost allocation method is a stable document containing principles to be read in conjunction with other compliance documents and revenue determinations. Under the proposed rule, the cost allocation method would shift to a frequently updated document which informs potential customers of the costs of negotiated services under the proposed rule. Such a change would affect the resources of all DNSPs and the AER but the parties who will potentially derive the most value can access relevant cost information under the negotiation framework provisions.

5 Consultation on changes to cost allocation method

In this chapter the Commission considers the proposal set out in the rule change request for introducing consultation on the cost allocation method. The rule change request would require the AER to conduct a public consultation process each time a cost allocation method was submitted for approval.

5.1 Rule proponent's view

Currently, a DNSP's cost allocation method and any subsequent amendments to the method, are subject to the AER's approval. Under the rules, the AER is not required to conduct any public consultation in determining its approval. However, the AER is required to approve a DNSP's cost allocation method if it is compliant with the requirements set out in the guidelines. The guidelines were developed in 2008 with public consultation in accordance with the distribution consultation procedures. Any amendments to the guidelines are also part of the distribution consultation procedures.¹⁴

The rule proponent states that the cost allocation method is an input into negotiated services, and so it should be open to review so customers can assess the appropriateness of it. The rule proponent also states that the rules require consultation in particular circumstances where the AER is developing or amending any guidelines, models or schemes, or reviewing any values or methods. Therefore, the rule proponent states that the rules should require consultation on changes to the cost allocation method as well.¹⁵

In the rule proponent's submission in response to the draft determination, this element of the rule change request was discussed in the context of the publication of numeric allocators and therefore not specifically addressed.¹⁶

5.2 Stakeholder views

Generally, stakeholders do not support the proposed rule change.

The AER is not supportive of the proposed rule change as it states that the guideline stage is more appropriate and effective for consumer engagement (and already subject to consultation). The guidelines detail the process for cost allocation method preparation and provisions for which the AER must assess compliance. The AER approval is mechanistic to check compliance with guidelines. Further, it submits that the benefits of consultation at that stage are unclear.¹⁷

¹⁴ For more detail on the current role and processes in relation to the cost allocation method see Appendix A.2.

¹⁵ Trans Tasman Energy Group, Rule change request, 7 December 2013, p. 2.

¹⁶ Trans Tasman Energy Group, Draft Determination submission, 5 July 2013, pp. 1 - 3.

¹⁷ AER, Consultation Paper submission, 21 March 2013, p. 3.

Generally, DNSPs do not consider that additional consultation is warranted, and that the costs will outweigh any benefit.¹⁸ Jemena submits that it does not object to the addition of consultation, as long as it does not delay the AER approval process, but does not view the additional consultation as necessary.¹⁹ DNSPs submit that additional consultation will add time and resources.²⁰

SP AusNet and Networks NSW submit that stakeholder consultation on the guidelines is the most appropriate stage for consultation as it sets out the principles to be applied to all.²¹ SP AusNet also states that the AER approach to determining cost allocation specific to a regulatory determination is discussed in the framework and approach process, and this is the appropriate point for further consultation and opportunity for stakeholder input.²² DNSPs submit that the distribution consultation procedures are for AER documents, whereas the cost allocation method is a DNSP document.²³

In their submissions to the Consultation Paper, the Government of South Australia and Local Government Association of South Australia support the rule change, specifically that rule changes should enable increased stakeholder engagement.²⁴ The Western Sydney Regional Organisation of Councils support the rule change request as it states the request provides greater transparency and consultation through the regulatory process.²⁵

Submissions received in response to the draft determination from parties other than the rule proponent were supportive of the Commission's decision.²⁶

5.3 Draft determination and analysis

The following subsections provide the Commission's draft determination and analysis in respect of each of the key assessment factors set out in chapter 3.

18 Energex, Consultation Paper submission, 14 March 2013, p. 5; SP AusNet, Consultation Paper submission, 14 March 2013, p. 2; CitiPower & Powercor, Consultation Paper submission, 14 March 2013, pp. 2-3; Ergon Energy, Consultation Paper submission, 14 March 2013, p. 1; SA Power Networks, Consultation Paper submission, 15 March 2013, p. 5; Networks NSW, Consultation Paper submission, 15 March 2013, p. 9.

19 Jemena, Consultation Paper submission, 14 March 2013, p.6.

20 See for example, CitiPower & Powercor, Consultation Paper submission, pp. 2-3; Energex, Consultation Paper submission, 14 March 2013, pp. 5-6.

21 SP AusNet, Consultation Paper submission, 14 March 2013, p. 2; Networks NSW, Consultation Paper submission, 15 March 2013, p. 9.

22 SP AusNet, Consultation Paper submission, 14 March 2013, p. 2.

23 SP AusNet, Consultation Paper submission, 14 March 2013, p. 2; Energex, Consultation Paper submission, 14 March 2013, pp. 3-6.

24 Government of South Australia, Consultation Paper submission, 14 March 2013, p. 1; Local Government Association of South Australia, Consultation Paper submission, 4 April 2013, p. 1.

25 Western Sydney Regional Organisation of Councils, Consultation Paper submission, 26 March 2013, p. 1.

26 AER, Draft Determination submission, 7 June 2013; APA Group, Draft Determination submission, 2 July 2013; Networks NSW, Draft Determination submission, 28 June 2013; Energex, Draft Determination submission, 4 July 2013; SP AusNet, Draft Determination submission, 4 July 2013.

5.3.1 Response to the issues raised by the rule proponent

The rule proponent has stated that the cost allocation method should be open to review by customers since it is an input in the negotiation process. Its argument is that there is insufficient customer involvement in the cost allocation method and as a "method" it should be subject to the distribution consultation procedures.

Current consultation process

Whilst the existing process for approving cost allocation methods does not impose formal consultation requirements on the AER when approving cost allocation methods, there is consultation on the guidelines.

Consultation on the guidelines only is appropriate because the guidelines is the document which drives the approval of cost allocation methods. The AER must approve a cost allocation method if it meets the requirements of the rules and the guidelines. This is consistent with the AER's view that since the guidelines set out the principles for which cost allocation methods must apply, it is appropriate they be subject to consultation requirements.²⁷

The Commission views the existing approach to stakeholder engagement as appropriate. Stakeholder engagement is required at the guideline stage where the most influence and impact can be drawn.

Role of the cost allocation method

The cost allocation method is a document prepared by individual DNSPs specific to their business. The rule proponent has stated that as a "method", cost allocation methods should be part of the distribution consultation procedures.²⁸ However, as noted by DNSPs²⁹, the distribution consultation procedures are for AER documents and the cost allocation method is a DNSP document.

Cost allocation methods are high level documents which set out accounting policy to split shared costs between different classes of services. Each DNSP will have different service classifications, which will affect how costs can be split. Not all DNSPs are structured in the same manner nor are accounting systems consistent between different DNSPs. This means that cost allocation methods are specific to each DNSP and require a fundamental understanding of the business to develop and maintain.

The purpose of the cost allocation method under the rules is for the DNSP to inform the AER of how it will allocate costs between the classes of services it provides. It is also publicly available to notify customers of how costs are allocated between services.

²⁷ AER, Consultation Paper submission, 21 March 2013, p. 3.

²⁸ Trans Tasman Energy Group, Rule change request, 7 December 2013, p. 2.

²⁹ See for example, SP AusNet, Consultation Paper submission, 14 March 2013, p. 2; Energex, Consultation Paper submission, 14 March 2013, pp. 3-6.

However, cost allocation methods are not designed to inform customers about underlying costs for specific services. Rather, the cost allocation method provides a basis for the AER to conduct an audit of the allocation of shared costs between service classifications. When the AER approves a cost allocation method it checks the compliance of it against the guidelines to ensure sufficient clarity to enable the AER to conduct its audits.

The Commission considers that it is appropriate for the cost allocation method to remain a DNSP document in order to be consistent with its business's circumstances and systems. As a result it is more appropriate for consultation to occur at the level of the guidelines rather than the cost allocation method. The Commission is not satisfied that there is evidence of a problem with the existing framework.

5.3.2 Assessment considerations

Transparency

The rule change request states that public consultation will increase the ability for the AER to consider a wider range of views. The proposed rule may increase transparency since the AER's decision as to whether to approve a DNSP's cost allocation method would be publicly documented, which is not currently required. Specifically, the AER's reasons for the approval and any analysis or response to submissions made would be required to be published.

Stakeholder engagement

The addition of a public consultation process will increase the potential for stakeholder engagement. However, the likely benefits would not outweigh the costs of conducting a public consultation process.

Stakeholder engagement in a formal consultation process on cost allocation methods is likely to be minimal because the cost allocation method is generally designed to inform the AER of how costs will be split. Therefore, the cost allocation method does not contain the information relevant for potential or existing customers to ascertain service costs.

There may be a number of ways to allocate costs, some of which may benefit some customers and not others. From a whole of business perspective, the AER is best placed to objectively ascertain whether the overall approach is compliant with the guidelines.

Regulatory process

The costs to the AER of conducting a formal consultation process when there is a change to a cost allocation method would be material.

The distribution consultation procedures set out the requirements for the AER in conducting a public consultation where required under the rules "in making,

developing or amending any guidelines, models or schemes, or in reviewing any values or methods".³⁰ It is a formal set of requirements for the AER in conducting a public consultation. Specifically, it sets out:

- publishing requirements, including explanatory statements (clause 6.16(b)(2));
- consultation periods, including the minimum number of business days for stakeholders to prepare written submissions (clause 6.16(c));
- limitations on time, including when the AER is required to publish its final decision (clause 6.16(e));
- requirements to consider all submissions received, including summarising and responding to each issue (clause 6.16(f)); and
- circumstances where the AER can extend the time required to publish its final decision (clause 6.16(g)).

The formal consultation requirements are significant compared to the informal process between the AER and DNSPs currently in place.³¹ This is because in the formal process decisions must be publicly documented which requires resources in terms of preparing appropriate materials to be published, setting out reasons for decision making and responding to any submissions received.³² In addition, a formal consultation process has participation costs for DNSPs which may or may not exceed the costs of engaging with the AER for approval, for example, the preparation of public submissions.

5.4 Final determination

The aim of the rule proponent's request is to improve the regulatory framework to enable more efficient negotiated service prices. The Commission does not agree that there is a problem with the existing approach to stakeholder engagement with the cost allocation method. The current approach which requires consultation at the guidelines stage appropriately balances stakeholder engagement, regulatory oversight and the DNSP having ownership of its cost allocation method. This view is shared by the AER.³³

Overall, the Commission does not consider that additional consultation will lead to more efficient prices. This is because the benefits appear to be minimal but the costs to undertake additional consultation would be material. Additional consultation will also add to regulatory burden on service providers.

³⁰ NER, clause 6.16(b)

³¹ CitiPower & Powercor, Consultation Paper submission, 14 March 2013, pp. 2-3.

³² NER, clause 6.15.4(c).

³³ AER, Draft Determination submission, 7 June 2013, p.2.

6 Publication of numeric allocators

In this chapter the Commission considers the proposals set out in the rule change request for the publication of numeric values of allocators as part of the cost allocation method. The rule change request would require the AER to amend the cost allocation method guidelines to require DNSPs' cost allocation methods to include all numeric values of allocators.

6.1 Rule proponent's view

The rule proponent states that the cost allocation method does not contain sufficient information to enable effective negotiation and understand the reasonable costs of providing the service. It states that by requiring DNSPs to include the numeric value of allocators in the cost allocation method, it will lead to more efficient prices.³⁴ A numeric value of an allocator is, for example, if the Chief Executive's salary is to be split between two services based on revenue, the numeric value of the allocator would be the proportion of revenue generated by each service.

In response to the draft determination, the rule proponent submits that numeric allocators are required in order to meet the requirements of the negotiation framework under clause 6.7.5(3). In general, these provisions require the service provider to identify and inform the applicant of the reasonable costs of providing a service, demonstrate that the charges reflect those costs and have appropriate arrangements for assessment and review of the charges.³⁵

6.2 Stakeholder views

Generally, the majority of stakeholders do not support the proposed rule change.³⁶ However, the Local Government Association of South Australia, Government of South Australia and Western Sydney Regional Organisation of Councils support the rule change request.³⁷

The AER submits that the cost allocation method is intended to be principles-based. The nature of principles-based means that the cost allocation method can be stable and consistent over time to enable comparisons and minimise regulatory burden.³⁸

³⁴ Trans Tasman Energy Group, Rule change request, 7 December 2013, p. 4.

³⁵ Trans Tasman Energy Group, Draft Determination submission, 5 July 2013, pp. 1-2.

³⁶ Jemena states that it is not opposed to including numeric allocators in the cost allocation method at the time it is approved but noted that by their nature they will change (Jemena, Consultation Paper submission, 14 March 2013, p. 2).

³⁷ Local Government Association of South Australia, Consultation Paper submission, 4 April 2013, p. 1; Government of South Australia, Consultation Paper submission, 14 March 2013, p. 1; Western Sydney Regional Organisation of Councils, Consultation Paper submission, 27 March 2013, p. 1.

³⁸ AER, Consultation Paper submission, 21 March 2013, p. 3.

The AER also states that the existing negotiated service framework provides a more direct way of accessing relevant information.³⁹ DNSPs also stated that it is more efficient to provide information during a negotiation, rather than include the numeric values of allocators in the cost allocation method.⁴⁰

DNSPs submit that the numeric values of allocators are unlikely to provide sufficient or relevant information to assess whether offers are NER compliant.⁴¹ DNSPs also state concern that it may raise commercially sensitive figures (eg value of unregulated services).⁴²

DNSPs also submit that other processes address compliance concerns. For example, the Regulatory Information Notice process includes an audit to ensure compliance with the cost allocation method.⁴³ DNSPs also state that while some of the allocators are stable and the AER does require these to be in the cost allocation method, most change frequently.⁴⁴

Submissions in response to the draft determination other than from the rule proponent were supportive of the decision not to make the rule.⁴⁵

6.3 Draft determination and analysis

The following subsections provide the Commission's draft determination and analysis in respect of each of the key assessment factors set out in chapter 3.

6.3.1 Response to the issues raised by the rule proponent

The rule proponent has stated that the cost allocation method does not contain sufficient information to enable effective negotiation and understand the reasonable costs of service. Its argument is that because negotiated service pricing is to be based on the costs derived in accordance with the cost allocation method, the cost allocation method should contain all numeric values of allocators.

³⁹ AER, Consultation Paper submission, 21 March 2013, pp. 2-3.

⁴⁰ Networks NSW, Consultation Paper submission, 15 March 2013, p. 2; SA Power Networks, Consultation Paper submission, 15 March 2013, p. 1

⁴¹ See for example, Jemena, Consultation Paper submission, 14 March 2013, p. 6; SP AusNet, Consultation Paper submission, 14 March 2013, p. 3; SA Power Networks, Consultation Paper submission, 15 March 2013, p. 6.

⁴² See for example, Energex, Consultation Paper submission, 14 March 2013, p. 6; SA Power Networks, Consultation Paper submission, 15 March 2013, p. 6.

⁴³ Jemena, Consultation Paper submission, 14 March 2013, pp. 1-2.

⁴⁴ See for example, Jemena, Consultation Paper submission, 14 March 2013, p. 2; SA Power Networks, Consultation Paper submission, 15 March 2013, p. 6; Energex, Consultation Paper submission, 14 March 2013, p. 6; Networks NSW, Consultation paper submission, 15 March 2013, p. 9.

⁴⁵ AER, Draft Determination submission, 7 June 2013; APA Group, Draft Determination submission, 2 July 2013; Networks NSW, Draft Determination submission, 28 June 2013; Energex, Draft Determination submission, 4 July 2013; SP AusNet, Draft Determination submission, 4 July 2013.

Negotiated services prices

Negotiated services are a lighter-handed form of regulation because they are assessed by the AER as being provided with a greater level of competitive discipline, compared with monopoly services. In this case, the presumption is that the negotiating party will have sufficient countervailing power in terms of the substitutes available to it or will have sufficient information on the costs of providing the service such that the provider will be constrained from exercising monopoly power.

The AER states that:⁴⁶

“Negotiated service prices are set by negotiation between the parties according to a framework set out in the Rules. The AER is available to arbitrate if negotiations stall. This classification relies on both parties possessing sufficient market power for effective negotiations.”

Therefore it should not be necessary for the negotiating party to know with precision what the underlying costs are as its market understanding should assist it to know what the reasonable costs are. Determining the reasonable costs for the price of a service will be the subject of negotiation.

The framework in the rules sets out some principles on how prices should be established, but it is a principles based approach only and essentially up to the parties to interpret those principles and negotiate prices accordingly. This is discussed further in the next chapter. The concept of basing a price on cost is imprecise and does not have a universally accepted interpretation. Indeed, in the economic literature, "cost" can be defined a number of different ways, such as based on a short run or long run approach. This fits with the approach of negotiated services being subject to lighter handed regulation.

The Commission considers that the role of the cost allocation method in negotiated services is to inform the AER of the DNSP's approach to cost allocation and to enable the AER to assess its appropriateness. The cost allocation method is integral for the AER in determining the level of costs to be recovered between the service classifications.

It is the role of the AER to confirm compliance with the cost allocation method and so information is not required for customers to be able to confirm compliance. A number of processes are in place to address compliance concerns, such as the AER requires that accounts are audited for consistency with the cost allocation method.

DNSPs are also required to submit audited Regulatory Information Notices which set out revenues, costs and a number of other items for the AER to check.

⁴⁶ AER, *Stage 1 Framework and approach paper: Ausgrid, Endeavour Energy and Essential Energy*, March 2013, pp. 15-16.

As discussed in the previous chapter, the cost allocation method is not designed as a tool to inform customers of the underlying costs of service. However, there are other mechanisms in the rules to assist customers in obtaining relevant information.

Information to enable effective negotiation

As stated above, the cost allocation method contains information regarding how shared costs are split between service categories. Direct cost information would be required to understand the nature of specific service costs. That is, the cost allocation method does not contain information in relation to the cost of providing specific services. The Commission agrees that the cost allocation method does not contain sufficient information to assess whether a DNSP's price offer is appropriate.

However, other provisions in the rules provide service applicants with access to, and indeed require DNSPs to provide, relevant information on the costs of the negotiated service. For example, the negotiating framework must specify a requirement for the DNSP to provide relevant commercial information to enable effective negotiation, including costs (NER 6.7.5(c)(2)-(3)). A number of stakeholders agreed that these provisions in the rules provide a better and more direct way to access relevant information to enable effective negotiation.⁴⁷ Should a DNSP disagree with a customer's request for such information, it can lodge a dispute with the AER.

The rule proponent submits that the publication of numeric allocators is necessary in order to meet the requirements under clause 6.7.5(c)(3) of the NER. Clause 6.7.5(c)(3) states that the negotiating framework for a DNSP must specify:

“a requirement for the provider:

- to identify and inform a *Service Applicant* of the reasonable costs and/or the increase or decrease in costs (as appropriate) of providing the *negotiated distribution service*; and
- to demonstrate to a *Service Applicant* that the charges for providing the *negotiated distribution service* reflect those costs and/or the cost increment or decrement (as appropriate); and
- to have appropriate arrangements for assessment and review of the charges and the basis on which they are made;”

However, clause 6.7.5(c)(2) requires the negotiating framework to specify:

“a requirement for the provider to provide all such commercial information a *Service Applicant* may reasonably require to enable that applicant to engage in effective negotiation with the provider for the provision of the

⁴⁷ AER, Consultation Paper submission, 21 March 2013, p. 3; Networks NSW, Consultation Paper submission, 15 March 2013, p. 2; SA Power Networks, Consultation Paper submission, 15 March 2013, p. 1.

negotiated distribution service, including the cost information described in subparagraph (3); and”

Negotiating parties therefore already have access to the relevant information through a DNSP's negotiation framework which must comply with the above (and other) requirements. Therefore, it is unnecessary to provide an additional mechanism to obtain this information by requiring numeric values of allocators to be included in the cost allocation method.

The Commission views the lack of specific cost information in the cost allocation method as appropriate and consistent with the role of the cost allocation method being a principles-based document which does not require frequent revision. The exclusion of certain numeric values of allocators (or other such cost-related information) from the cost allocation method does not impede effective negotiation. This is because other, more purpose-specific mechanisms exist in the rules which enable negotiating parties to access relevant information. If a provider fails to provide information for the purposes of clause 6.7.3(c), the dispute resolution process is available.

6.3.2 Assessment considerations

Transparency

The proponent considers that the proposed rule will increase the transparency of the provision of negotiated services through inclusion of numeric values of allocators in the cost allocation method which is required to be published on DNSPs' websites. However, the Commission considers wide publication of numeric values of allocators is unlikely to yield material benefits since customers can request cost information related to the service as part of a negotiation.

Moreover, the numeric values of allocators alone are insufficient to gauge whether a service offer is appropriate because the cost allocation method is between service classes (eg direct control, negotiated and unregulated). Therefore the transparency of numeric values of allocators will only identify the split of indirect costs and so further information would be required for the cost of a specific negotiated service.

Stakeholder engagement

It is not clear whether the proposed rule will impact stakeholder engagement. In combination with the additional consultation it is likely that it may encourage parties who may benefit from any changes to the cost allocation method to engage. Increasing the level of information can be generally positive for stakeholder engagement, however the costs of providing such information are material and negotiating parties are already able to access such information.

Regulatory process

The costs to DNSPs of including the numeric value of allocators is material. This is because the numeric values are likely to change frequently, as noted in submissions.⁴⁸ If the AER is required to approve the publishing of allocators, it increases the AER's costs, especially if changes are subject to public consultation.

We note that the principles in the rules state that numeric allocators be included in a cost allocation method if they are used. The AER's guidelines formulate this principle as a requirement to include stable allocators, as they will remain valid throughout the operation of the cost allocation method. We view this distinction between stable allocators and those that change as appropriate as the cost allocation would not require updating should it include stable allocators, however to include numeric values of allocators that change, the cost allocation method will require updating at the same rate.

The AER proposes an alternative approach in its submission to the Consultation Paper.⁴⁹ It suggests that a separate schedule would be a more workable approach to annual updating of cost allocation methods. The rule proponent submits that such an approach has merit which is potentially lower cost.⁵⁰ Such a schedule could potentially avoid approval, and any consultation requirements that pertain to the cost allocation method. Although this approach has regard for the costs of the AER, it does not address those of the DNSP. A schedule would still require the DNSP to prepare, publish and update the schedule. The publication of a separate schedule may also add to confusion regarding the role of the schedule in relation to the cost allocation method. A schedule also does not address whether or not there would be any benefits of publishing the numeric values of allocators since customers can seek such information directly from DNSPs during the negotiation process.

6.4 Final determination

Overall, the Commission does not consider that the publication of the numeric value of allocators will lead to more efficient prices. This is because the parties that may benefit from such information already have access to relevant cost information through the negotiation framework. The rules for the negotiation framework require the provider to demonstrate, inform and provide arrangements to review the basis of its charges. In addition, the publication of the numeric value of allocators on their own is unlikely or at most minimally beneficial to inform customers of the costs of service. The costs to DNSPs to prepare and publish, and the AER of approving revised cost allocation methods, are therefore likely to outweigh such potential benefits.

⁴⁸ See for example, SA Power Networks, Consultation Paper submission, 15 March 2013, p. 6; CitiPower & Powercor, Consultation Paper submission, 14 March 2013, p. 4; Networks NSW, Consultation Paper submission, 15 March 2013, p. 9.

⁴⁹ AER, Consultation Paper submission, 21 March 2013, p. 2.

⁵⁰ Trans Tasman Energy Group, Draft Determination submission, 5 July 2013, p. 3.

7 Amendment of negotiated distribution service pricing principles

In this chapter the Commission considers the proposals set out in the rule change request for amending the negotiated distribution service pricing principles. Specifically, the rule change request seeks to amend the word "should" to "must" in the pricing principle which relates the price of a negotiated service and its relationship to cost (ie that the price must be based on the cost of service).

7.1 Rule proponent's view

The rule proponent states that requiring prices to be based on the cost incurred provides a "default" position on how prices must be established. The rule proponent also states that by having such a default position included in the rules, it provides clarity to the AER in solving any dispute.⁵¹

It also states that although it recognises that parties may in theory agree to any method of establishing prices, the minimum requirement is appropriate because a significant imbalance of market power exists between customers and the DNSPs.⁵² However, in response to the draft determination, the rule proponent states that its "inclusion of 'significant imbalance of market power' in relation to this proposed change is misplaced".⁵³

In response to the draft determination, the rule proponent submits that including "must" (instead of "should"):⁵⁴

- establishes a clear "starting point" for establishing DNSP prices, because as the AER pointed out "prices are only based on costs";
- removes the continued requirement for consumers to "influence the AER's decision making" as part of each determination process; and
- still retains a "degree of discretion" for the AER as prices must be "based on" the DNSP's cost."

7.2 Stakeholder views

The Western Sydney Regional Organisation of Councils supports the proposed rule change and view particular benefits from the change for negotiated distribution

51 Trans Tasman Energy Group, Rule change request, 7 December 2013, p. 4.

52 Trans Tasman Energy Group, Rule change request, 7 December 2013, p. 4.

53 Trans Tasman Energy Group, Draft Determination submission, 5 July 2013, p. 5.

54 Trans Tasman Energy Group, Draft Determination submission, 5 July 2013, p. 6.

services.⁵⁵ The South Australian Government and Local Government Association of South Australia also support the proposed change.⁵⁶

The AER submits that the rules currently require DNSPs to inform service applicants of the reasonable costs of supplying negotiated services, and also to demonstrate how prices reflect costs. It further submits that the proposed change does not seem to establish a new requirement or restriction but reflects an existing requirement.

In response to the Consultation Paper the AER submitted that while a marginal change, it supports it because to the extent that the use of "should" is ambiguous, the proposed substitution of "must" would reduce such uncertainty.⁵⁷ However in response to the draft determination, the AER submits that "nominal support for that element was based on it clarifying the provisions' intent".⁵⁸ It states that it appreciates the AEMC's rationale for not approving this element that it would reduce the AER's flexibility.⁵⁹

DNSPs state the proposed change would result in more intervention than currently required and is inconsistent with the negotiated framework as a "light-handed" approach.⁶⁰ SA Power Networks stated that a high degree of price setting direction would require cost allocation guidelines to be very prescriptive in all aspects of costs and that imposing a pricing requirement will effectively limit the negotiation process.⁶¹

In response to the draft determination, APA Group, NSW DNSPs, Energex and SP AusNet submit support for the Commission's draft proposal.⁶²

7.3 Draft determination and analysis

The following subsections provide the Commission's draft determination and analysis in respect of each of the key assessment factors set out in chapter 3.

⁵⁵ Western Sydney Regional Organisation of Councils, Consultation Paper submission, 27 March 2013, pp. 1-2.

⁵⁶ Government of South Australia, Consultation Paper submission, 14 March 2013, p. 1; Local Government Association of South Australia, Consultation Paper submission, 4 April 2013, p. 1.

⁵⁷ AER, Consultation Paper submission, 21 March 2013, p. 4.

⁵⁸ AER, Draft Determination submission, 7 June 2013, p. 2.

⁵⁹ AER, Draft Determination submission, 7 June 2013, p. 2.

⁶⁰ See for example, Ergon Energy, Consultation Paper submission, 14 March 2013, p. 1; CitiPower & Powercor, Consultation Paper submission, 14 March 2013, p. 4; Jemena, Consultation Paper submission, 14 March 2013, p. 7; Networks NSW, Consultation Paper submission, 15 March 2013, p. 10.

⁶¹ SA Power Networks, Consultation Paper submission, 15 March 2013, pp. 6-7.

⁶² APA Group, Draft Determination submission, 2 July 2013; NSW DNSPs, Draft Determination submission, 28 June 2013; Energex, Draft Determination submission, 4 July 2013; SP AusNet, Draft Determination submission, 4 July 2013.

7.3.1 Response to the issues raised by the rule proponent

The rule proponent has stated that the negotiated distribution principles should be amended to provide guidance in the event of an access dispute. The basis for the AER's decision making in arbitration is the negotiated service criteria, which must be consistent with the principles. The negotiated service criteria are determined as part of the revenue determination and so are part of the broader consultation process. It is therefore possible to influence the AER's decision making as part of this process.

The rule proponent has stated that by adopting the proposed rule it will remove the continued requirement for consumers to "influence the AER's decision making" as part of each determination process. We recognise that participation is not costless, however, limiting stakeholder input appears inconsistent with other aspects of the rule change request. Regardless, the AER's submission suggests that there is not a material difference in the manner in which it would interpret the principle whether the wording is "should" or "must". Specifically, the AER stated that the proposal "initially appears to further constrain DNSPs in their negotiations with service applicants. However, the requirement relates only to prices being based on, or having some relationship to, supply costs. The proposed change seems not to establish a new requirement or restriction, but to reflect an existing requirement."⁶³

In the draft determination the Commission also raised some concern with the proposed drafting of the rule from a legal perspective. Specifically, that all but one of the principles use the word 'should' which is constructed in a way to signal that there is a degree of discretion (on the part of the AER) because the contents are not absolute across each DNSP. That is, the principles contain parameters which will differ when applied to each DNSP. As a "variable" which will differ among DNSPs, it cannot be defined absolutely. The one principle which uses "must" is one that can be applied universally – that the same discounts be offered to all customers. Adopting the word "must" would therefore have the effect of altering this legal framework in the rules.

The rule proponent has responded that this aspect could potentially be mitigated by changing all the principles to "must". The Commission does not consider there is sufficient evidence to adopt such an approach. Moreover, amending the wording of all of the principles is outside the scope of the rule change request.

The Commission has also considered the rule proponent's view that the amendment establishes a clear "starting point" for establishing prices. However, as the rule proponent has recognised, "based on" retains a degree of discretion and so little difference should be actualised in "starting points" for prices whether the principle states "should" or "must". Further, the relevant framework for "starting points" are the criteria, which in practice do contain the word "must".

The Commission maintains its view that there is insufficient evidence to justify changing the principle and notes the AER's submission which states:⁶⁴

⁶³ AER, Consultation Paper submission, 21 March 2013, p. 4.

⁶⁴ AER, Draft Determination submission, 7 June 2013, pp. 1-2.

“The rule change proponent appears to seek a more deterministic outcome for negotiated services than the negotiated service classification is intended to provide. Again as the AEMC's draft determination indicates, were negotiated service applicants to seek such an interventionist approach to price setting, it would appear to be evidence that the negotiated service classification may not be appropriate for the service in question.”

7.3.2 Assessment considerations

Transparency

The proposed rule is unlikely to have a material effect on the transparency of the principles. The AER's submission suggests that there may be no difference in outcomes.⁶⁵

Stakeholder engagement

The Commission stated in the draft determination that the proposed rule is unlikely to have an effect on stakeholder engagement. However, the rule proponent responded that changing the principle to "must" avoids the continued requirement to influence the AER's decision making. However, since the principles inform the AER's decision of the criteria during a regulatory determination process, it is unlikely that a party will have a material decrement in its engagement requirements by doing so as any engagement is likely to be much broader during such a process. Regardless, the Commission does not consider any potential changes in engagement as sufficient evidence to change the principle based on the reasons set out above.

Regulatory process

The proposed rule change does not materially affect the process, but does potentially limit the AER's discretion in determining the negotiated service criteria. It may also detract from the current clarity of the Rules.

7.4 Final determination

Overall, the Commission considers that changing the word "should" to "must" in the rules is unlikely to lead to a material change in efficiency and thus will not contribute to the NEO. Adopting the proposed drafting would also alter the legal framework which currently exists in the rules and could have unintended impacts on the interpretation of other pricing principles.

⁶⁵ AER, Consultation Paper submission, 21 March 2013, p. 5.

Abbreviations

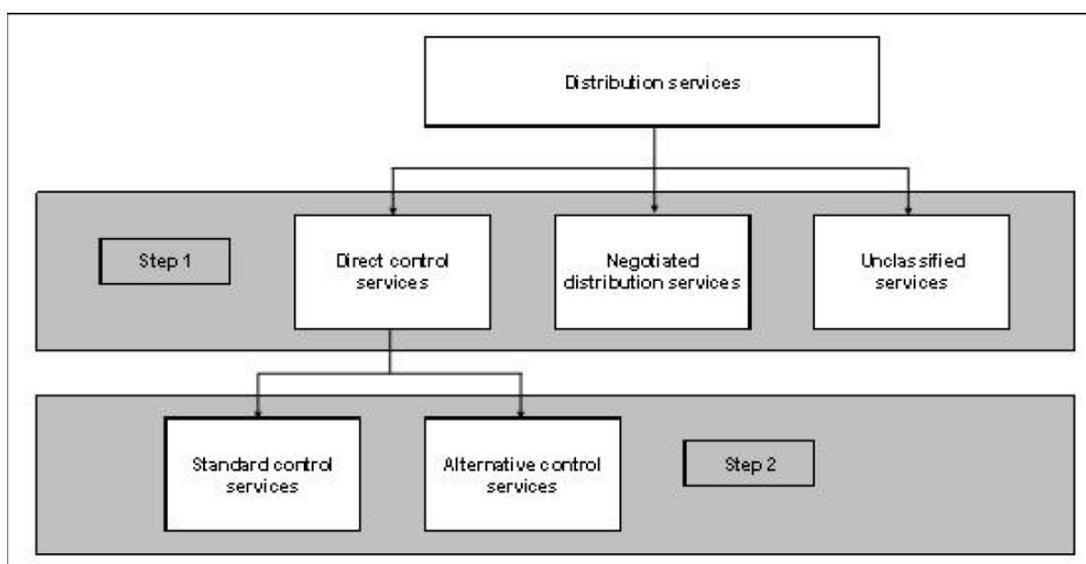
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
Commission	See AEMC
DNSP	distribution network service provider
draft determination	draft rule determination in relation to the rule change request
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER	National Electricity Rules
rule change request	rule change request to the Commission seeking to make changes to the cost allocation method and its role in the negotiating framework
rule proponent	Trans Tasman Energy Group

A Regulatory framework for cost allocation method and negotiated services

A.1 Negotiated services

Negotiated distribution services are a category of services for which the parties can negotiate the terms and conditions for services, including price. This is in contrast to direct control services for which the Australian Energy Regulator (AER) determines the maximum price that a DNSP can charge for a particular service.⁶⁶ Services that are not classified by the AER are not regulated under the rules. Direct control services must be further classified as either standard control or alternative control. This process is illustrated in Figure A.1 below.

Figure A.1 Distribution service classification process



In making its decision on service classification, the AER is to have regard to the form of regulation factors,⁶⁷ which include:

- the extent to which any market power possessed by a network service provider is, or is likely to be, mitigated by any countervailing market power;
- the presence and extent of any substitute, and the elasticity of demand; and
- the extent to which there is information available to a prospective user, and whether that information is adequate, to enable the user to negotiate on an informed basis with a network service provider.

⁶⁶ Note in practice the AER may approve a maximum price change for a basket of services or the total revenue that a DNSP may recover from certain activities. For ease of reference, we refer to the AER's role in standard and alternative control as price setting, given the level of regulatory oversight.

⁶⁷ NEL, clause 2F.

Once the AER classifies a service, there is no scope under the rules for the AER to change its classification of services or to classify new services within a regulatory control period.⁶⁸

The number of negotiated services remains small. There are currently no negotiated services in NSW⁶⁹ and Queensland.⁷⁰ In Victoria⁷¹ and Tasmania⁷² some public lighting services are classified as negotiated services. The most significant number of negotiated services are in South Australia, for example, public lighting, new and upgraded connections, non-standard metering services, large customer metering services, embedded generation services.⁷³

Direct control services are characteristically services where it is considered necessary to regulate the revenue earned by DNSPs through the AER making a distribution determination. Direct control services have price setting requirements for the AER under the rules. Pricing for negotiated services is determined by the negotiating parties; however, the process is bound by the requirements in the rules. This includes:

- the DNSP's negotiating framework; and
- the DNSP's negotiated distribution service criteria.

The negotiating framework forms part of a distribution determination. Therefore it is approved by the AER. It sets out the requirements that a DNSP is to comply with in respect of the preparation, replacement, application or operation of its negotiating framework. There are minimum requirements for the framework set out in the rules, including the kind of information the DNSP is required to provide to an applicant.

The negotiating framework forms part of a distribution determination. Therefore it is approved by the AER. It sets out the requirements that a DNSP is to comply with in respect of the preparation, replacement, application or operation of its negotiating framework. There are minimum requirements for the framework set out in the rules, including the kind of information the DNSP is required to provide to an applicant.

The negotiated distribution service criteria must give effect to and be consistent with the negotiated distribution principles. These principles are set out at clause 6.7.1 of the NER and generally relate to the relationship between the cost and price of a negotiated service. For example, the price for a negotiated distribution service should be based on the costs incurred in providing that service. We understand that to date, there have not

⁶⁸ NER, clause 6.2.3.

⁶⁹ AER, *Final decision: New South Wales distribution determination 2009-10 to 2013-14*, 28 April 2009, p. 28.

⁷⁰ AER, *Final decision: Queensland distribution determination 2010-11 to 2014-15*, May 2010, Appendix A.

⁷¹ AER, *Final decision: Victorian electricity distribution network service providers Distribution determination 2011-2015*, 29 October 2010, Appendix B.

⁷² AER, *Final Distribution Determination Aurora Energy Pty Ltd 2012-13 to 2016-17*, April 2012, Attachment 1. Note reference to draft determination for decision - Attachment 1, p. 50.

⁷³ AER, *Final decision: South Australia distribution determination 2010-1 to 2014-15*, May 2010, pp. 280-285.

been any disputes lodged under the rules in relation to negotiated distribution services.

A.2 Cost allocation method

The cost allocation method is a document published by a DNSP which sets out how it will allocate costs between the different classes of services that it provides. Essentially it is a set of instructions to convert the statutory accounts (corporate reporting) into the regulatory accounts (for compliance with the economic regulatory framework). DNSPs are required to publish cost allocation methods under the rules. Its principal aim is to ensure that an appropriate amount of costs are allocated to the activities that drive the relevant costs, and in particular between regulated and unregulated services. This is so customers of the relevant category of services are paying prices that reflect the cost of delivering those services. If a higher proportion of costs were allocated to one service (for example, standard control) relative to the costs of providing it, customers of that service would end up cross-subsidising other customers.

An important consideration for any cost allocation method is the distinction between direct and indirect costs. Direct costs are those that are incurred as a result of carrying out a specific activity and so can be easily attributed to it. For example, the labour and vehicle costs to fix a fault in the distribution network are directly related to providing standard control (or regulated) services. In contrast, indirect costs are those that relate to a broader range of activities and cannot be easily attributed to one category of service and so are usually referred to as "shared costs". For example, overhead costs, such as the Chief Executive Officer's salary and the costs of the head office's premise, relate to providing all the services that the distribution business provides, including those that are unregulated.

Under the rules, the AER is required to develop cost allocation guidelines. DNSPs' cost allocation methods are to be developed in accordance with the AER's guidelines. The guidelines are required to give effect to the cost allocation principles in the rules. There are seven cost allocation principles, which are:

- “1. the detailed principles and policies used by a *Distribution Network Service Provider* to allocate costs between different categories of distribution services must be described in sufficient detail to enable the AER to replicate reported outcomes through the application of those principles and policies;
2. the allocation of costs must be determined according to the substance of a transaction or event rather than its legal form;
3. only the following costs may be allocated to a particular category of *distribution services*:
 - (a) costs which are directly attributable to the provision of those services;

- (b) costs which are not directly attributable to the provision of those services but which are incurred in providing those services, in which case such costs must be allocated to the provision of those services using an appropriate allocator which should:
 - (i) except to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be causation based; and
 - (ii) to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be an allocator that accords with a well accepted cost allocation method;
- 4. any cost allocation method which is used, the reasons for using that method and the numeric quantity (if any) of the chosen allocator must be clearly described;
- 5. the same costs must not be allocated more than once;
- 6. the principles, policies and approach used to allocate costs must be consistent with the *Distribution Ring-Fencing Guidelines*;
- 7. costs which have been allocated to a particular service cannot be reallocated to another service during the course of a *regulatory control period*.⁷⁴

The regulatory determination process is highly dependent on the cost allocation method. This is because the revenues for direct control services are related to the costs that are attributed to providing those services. For this reason, it is important for the cost allocation method to remain as stable as possible. Substantial changes in approaches even between periods will affect the comparability of costs between past and future periods.

The AER has approved three amendments to cost allocation methods since the introduction of Chapter 6 of the NER.⁷⁵ DNSPs are also required to amend their cost allocation methods if required by the AER to take into account any change to the AER's cost allocation guidelines.⁷⁶ The AER published its cost allocation guidelines in June 2008.⁷⁷ It was also required to publish a separate set of guidelines to apply to the Victorian DNSPs.⁷⁸ This set of guidelines was to be consistent with the Essential

⁷⁴ NER, clause 6.15.2

⁷⁵ See the AER website, Determinations & Access Arrangements, Cost allocation method.

⁷⁶ NER, clause 6.15.4(g).

⁷⁷ AER, Electricity distribution network service providers, Cost allocation guidelines, June 2008.

⁷⁸ These are included as Appendix A to the guidelines noted above.

Services Commission's approach to enable consistency between future regulatory periods and historic periods.⁷⁹

⁷⁹ NER, clause 11.17.4.

B Summary of issues raised in submissions - first round

Stakeholder	Issue	AEMC Response
Assessment framework		
Energex (p. 3)	Framework could be strengthened with the addition of the criterion "improved information for decision making".	Noted. The Commission has revised the assessment framework. See chapter 3.
Jemena (p. 4)	Rather than simply whether rule change will lead to more efficient prices for negotiated services, should also consider whether the proposed change would lead to more efficient provision of network services.	As above.
CitiPower & Powercor (p. 2); SA Power Networks (p. 4)	The assessment framework is appropriate.	As above.
Consultation on changes to the cost allocation method		
Networks NSW (p. 9); Energex (p. 4); SP AusNet (p.2); AER (p. 3)	Stakeholders already able to provide input into cost allocation method at guideline stage. This is optimal as guidelines determine how each DNSP is required to develop its cost allocation method.	Agree. See section 5.3.1.
Energex (pp. 5-6)	Distribution consultation procedures refer to AER documents rather than DNSP documents. Consultation would increase time, would need to extend deadline to approve amendment.	Agree. The Commission has considered the additional regulatory burden. See section 5.3.2.
CitiPower & Powercor (pp. 2-3)	Current process provides sufficient flexibility for constructive dialogue between the AER and DNSP. Introduction of a formal consultation will impose costs and it is questionable whether the benefits outweigh the costs. Stakeholders will not have the same access to the DNSP as the AER and unlikely to understand the subtleties of the cost accounting system and service provider model. A formal process will constrain the AER's flexibility to reach an optimal outcome.	As above.

Stakeholder	Issue	AEMC Response
Ergon Energy (pp. 2-3)	Regulatory Information Notice issued by the AER includes an audit to ensure compliance with the cost allocation method. To date, the AER has approved cost allocation methods well within the time frame. Applying the formal consultation procedures would increase the time to gain approval.	Agree. The Commission has considered the existing governance frame work and additional regulatory burden in assessing the rule change request. See section 5.3.2.
AER (p. 3)	The AER approval of the cost allocation method is relatively mechanistic. The potential benefits to customers from consultation on the cost allocation method approval are not clear.	As above.
Jemena (p. 6)	Does not believe that additional consultation is required but does not oppose it as long as it does not slow down or delay the cost allocation method approval process.	The Commission has considered the comment that additional consultation is not required and the additional regulatory burden of imposing a requirement. See section 5.3.2.
SA Power Networks (p. 5)	Costs of additional consultation will be significant and far outweigh any benefits.	Agree. See section 5.4.
Western Sydney Organisation of Regional Councils (p. 1)	Welcomes the proposed rule change as it provides greater transparency and consultation through the negotiation process.	Noted. The Commission recognises that transparency and consultation are integral to the regulatory process, however the costs of regulatory burden need to be weighed against the potential benefits gained from additional consultation. The Commission considers that the current arrangement appropriately balances opportunity for effective stakeholder engagement and regulatory costs. See section 5.3.1.
<i>Inclusion of numeric values of allocators</i>		
AER (p. 3); Ergon Energy	Cost allocation method is high level principles and does not contain information	Agree. The Commission recognises that

Stakeholder	Issue	AEMC Response
(p. 2); Jemena (p. 6); SA Power Networks (pp 4-6); CitiPower & Powercor (p. 3)	necessary to understand specific cost information.	the role of the current cost allocation method is high level and other provisions provide more appropriate information for access seekers. See section 6.3.1.
AER (p. 2); SA Power Networks (p. 1); Networks NSW (p. 2)	Existing negotiated service provisions provide a more direct way of accessing relevant information.	Agree. Comment as above.
AER (p. 3)	Separate schedule more workable to amending cost allocation method but would still add to burden and costs.	Noted. The Commission has considered this alternative and concludes that whilst the costs are less than the rule change proposal there are still costs without identifiable benefits. See section 6.3.2.
CitiPower & Powercor (p. 4)	Do not see benefit in updating the cost allocation method annually but if deemed necessary should not trigger a formal consultation process.	Noted. The Commission has considered the regulatory burden of updating. See section 6.3.2.
SP AusNet (p. 3)	Concern is not well-founded. An independent auditor is specifically required to assess whether information for the Regulatory Information Notice is prepared in accordance with the cost allocation method. Unclear how the quantification of allocated values would allow a negotiated service customer to establish whether an offer was compliant with the NER. Unclear on how an individual negotiated services customer would use this information to meaningfully assess the price offered by a NSP.	Agreed. The Commission considers that the current governance framework is appropriate. See section 6.3.1.
Energex (p. 6); SA Power Networks (p. 6)	Publishing values may jeopardise the commercial viability of non-regulated services.	Noted. The Commission does not consider that the potential benefits of publishing numeric allocators outweigh the regulatory costs of doing so. See section 6.4.
SA Power Networks (pp.	Comparability is being addressed separately by AER in expenditure forecast	Noted. The Commission considers that

Stakeholder	Issue	AEMC Response
4-6)	assessment guidelines. It endorses ENA view that interfering with the cost allocation method is not a proportional regulatory response to perceived problems in comparability. There is disparity in classification of like services, and changes for negotiation will affect all DNSPs and some don't have any negotiated services. Major concern of proponent appears to be verifying compliance whereas the Regulatory Information Notice template is devoted to this and independent auditors verify. Does not believe value of allocators will provide any assistance in verifying compliance with the approved cost allocation method.	the current governance framework is appropriate. See section 6.3.1.
Jemena (p. 6); SA Power Networks (p. 6); Energex (pp. 5-6); Networks NSW (p. 9); CitiPower & Powercor (pp. 3-4); Ergon Energy (pp. 2-3); AER (p. 3)	Inclusion of numeric values of allocators will require more frequent updating which will add regulatory burden.	Agree. The Commission has explicitly considered the additional regulatory costs in assessing the rule change request. See section 6.3.2.
WSROC (pp. 1-2)	The allocated value for an activity may vary between distributors but activities are similar. Propose a standardised list of activities be included in a pro forma cost allocation method, issued via the AER and applied to all distributors. Without clearly identified activities and costs establishing the distributor's compliance with 6.7.1 it becomes problematic for the customers, as well as compliance with 6.7.5(c)(3) to demonstrate cost reflectivity.	The AER is currently considering the comparability of distributors' costs in its Expenditure Forecast Assessment Guideline (see http://www.aer.gov.au/Better-regulation-reform-program). We note that although activities by distributors may be considered similar, accounting systems vary in how costs are defined. This affects the costs of activities. The proposal to standardise activities is outside the scope of this rule change and would have significant implementation costs. The Commission considers that the current governance arrangements provide confidence that compliance is maintained. Furthermore, there are appropriate provisions in the rules for

Stakeholder	Issue	AEMC Response
		customers to request relevant information to a service negotiation. This is discussed in section 6.3.1.
<i>Negotiated service prices</i>		
AER (p. 4)	The rules currently require DNSPs to inform service applicants of the reasonable costs of supplying negotiated services, also demonstrate how prices reflect costs. The proposed change does not seem to establish a new requirement or restriction but to reflect an existing requirement. To the extent that the use of "should" is ambiguous, the proposed substitution of "must" would reduce such uncertainty. While a marginal change, the AER supports.	Noted. The Commission considers that a case has not been made to amend the principles. See section 7.3.1.
Ergon Energy (p. 1); CitiPower & Powercor (p. 4); Jemena (p. 7); Networks NSW (p. 10)	The proposed rule is inconsistent with the intent of the distinction between service classifications.	Agree. See section 7.3.1.
SP AusNet (pp. 3-4)	AER has determined for that principle for SP AusNet it default to a binding obligation - view any justifiable departure from a cost based pricing approach should be at the discretion of the AER and there is no valid reason to not leave open this discretion for the regulator.	As above.
SA Power Networks (p. 7)	Imposing requirement for negotiated services based on cost effectively limits the negotiation process - no further amendment necessary. High degree of price setting direction would require cost allocation guidelines to be very prescriptive in all aspects of costs. Do not believe practical or desirable for negotiated prices and likely to reduce AER's flexibility in the interpretation or application of framework.	As above.
WSROC (p. 2)	Support the proposed rule change to clause 6.7.1.	Noted. The Commission encourages the stakeholder to provide further evidence of a problem and how the proposed amendment will address the problem.

Stakeholder	Issue	AEMC Response
		See section 7.3.1.
<i>Transitional arrangements</i>		
Energex (pp. 6-7)	Any changes to principles will require change to guidelines. Any new guidelines would not take effect until the next regulatory period and so no transitional arrangements required. If required to take effect immediately will impact revenue and uncertainty would not be in the best interest of customers.	Noted. No rule has been made so transitional arrangements are not required.
SA Power Networks (p. 7)	Would only be practical to apply rule change as a part of the regulatory reset process and consultation would need to be finalised before submission of the regulatory proposal. Any changes during a regulatory period would be challenging and potentially inequitable.	As above.
Networks NSW (p. 10)	Do not consider transitional requirements are necessary in the event that cost allocation principles are amended.	As above.
<i>Other issues</i>		
Government of South Australia (p. 1); Local Government Association of South Australia (p. 1)	Supports appropriate rule changes that provide for increased transparency of the DNSP's costs and cost allocation between and within classifications. Rule changes should provide uniformity in the provision of DNSP's costs to the AER, prevent costs being applied twice, provide insight into how specific tariff costs are established, enable effective comparison between DNSP's costs, enable increased stakeholder engagement, and establish more efficient prices.	Noted. The transparency of DNSP costs are provided under the assessment framework. The cost allocation between and within classifications is addressed by the AER as part of the Regulatory Information Notice. The current arrangements appropriately balance regulatory oversight, DNSP ownership and stakeholder transparency and engagement. See section 4.
Networks NSW (p. 9)	Consider issue more relevant to transmission networks as provide more negotiated services.	Noted.

Stakeholder	Issue	AEMC Response
Grid Australia (p. 1)	The transmission cost allocation methodology framework is appropriate. A lengthy public consultation was conducted on the guidelines. The AER has the necessary discretion to ensure that the cost allocation methodology meets the principles.	Noted. The Commission considers that the governance framework for cost allocation methodology in transmission is similar to that in distribution. The Commission has determined that the current arrangements in distribution are appropriate. See section 5.3.1.

C Summary of issues raised in submissions - second round

Stakeholder	Issue	AEMC Response
<i>General</i>		
AER (pp. 1-2)	Supports the AEMC's draft determination. Reiterates that the proposed rule change would do little to improve outcomes for negotiated service applicants but would increase administrative costs for regulated businesses and the AER.	Agree. The AEMC has not changed its position from the draft determination.
APA Group (p. 1)	Supports the AEMC's draft determination. States that additional consultation on an individual cost allocation method would add unnecessary administrative costs. Also states that existing rules provide relevant information on the costs of a service more directed at the applicant's needs and lower administrative costs relative to a requirement to have numeric allocators published.	As above.
Ausgrid, Endeavour Energy and Essential Energy (p. 1)	Supports the AEMC's draft determination. It states that there is insufficient evidence that there is a problem with the existing provisions that hinders the ability of parties to negotiate. It also notes that adopting the proposed rule would introduce extra costs and disproportionate regulatory burden.	As above.
Energex (p. 1)	Supports the AEMC's draft determination. Notes that there is no demonstrated benefit of additional public consultation on the cost allocation method as it is already subject to the guidelines which are developed with public consultation. Also notes that publishing cost allocators may jeopardise the	As above.

Stakeholder	Issue	AEMC Response
	commercial viability of non-regulated services as well as introducing regulatory burden which would outweigh the benefits.	
SP AusNet (p. 1)	Supports the AEMC's draft determination. Notes that deficiencies perceived by proponent in the cost allocation method are addressed by other mechanisms to provide customers with information enabling effective negotiation and ensure allocation of costs is efficient. It also notes that opportunities for stakeholder engagement are at the guideline stage.	As above.
Specific issues		
Trans Tasman Energy Group (p.1)	Questioned the comment in the draft determination that numeric allocators were available outside of the cost allocation method.	The AEMC clarifies that the comment made in the summary of the draft determination, as quoted, was referring to access to such information under the negotiation framework requirements (specifically clauses 6.7.5(c)(3)). This is discussed in further detail in chapter 6.
Trans Tasman Energy Group (p. 2)	Submits that the publication of numeric values of allocators would benefit all consumers, not just those of negotiated services.	The rule proponent's stated purpose for the publication of numeric values of allocators is to aid in the negotiation of prices for negotiated distribution services. The prices for direct control services are determined by the AER and so the publication of numeric values of allocators would be of little benefit to customers of those services as a large quantity of cost information is already included in the service provider's regulatory proposal.
Trans Tasman Energy Group (pp. 2-3)	Questioned the basis of the conclusion in the draft determination that the costs of including numeric values of allocators would outweigh	The AEMC did not quantify the potential costs or benefits of the proposed rule change. However, the AEMC considered that since the costs of the proposed rule

Stakeholder	Issue	AEMC Response
	the benefits.	change could be identified and the benefits were unclear, it concluded that the costs would be likely to outweigh the potential benefits. Further discussion of the consideration of this aspect of the rule change request is contained in section 6.3.
Trans Tasman Energy Group (p. 5)	States that its rule change request is seeking increased flexibility to establish services and prices rather than greater regulatory control. To do so it seeks greater transparency in provider's costs, including the numeric values of allocators and a clear methodology and basis for costs via the change to the negotiated pricing principle.	The AEMC refers to its comments in section 4.1 which address the regulatory approach of negotiated services. Negotiated services currently do provide flexibility in how services and prices are established. A clear methodology and basis for costs would be inconsistent with the rule proponent's request, as well as the nature of and the intention of negotiated services. Transparency of provider's costs is currently accessible to the negotiating party through existing provisions in the rules, as discussed in section 6.3.1.