

Standing Committee of Officials of the  
Ministerial Council on Energy

Electricity amendments and further amendments to the  
electricity and gas rule-change process

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## Glossary

### Abbreviations

ACCC	Australian Competition and Consumer Commission
ACT	Australian Competition Tribunal
AEMA	Australian Energy Market Agreement - the intergovernmental agreement between the Commonwealth and all of the States and Territories first made in 2004 and amended in 2006
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
MCE	Ministerial Council on Energy
NEL	National Electricity Law, Schedule to the <i>National Electricity (South Australia) Act 1996</i>
NEM	National Energy Market comprising the interconnected jurisdictions of NSW, ACT, Qld, Vic, Tas, SA and the Commonwealth offshore area.
NEMMCO	National Electricity Market Management Company
NER	National Electricity Rules – Statutory Rules made under Part 7 of the NEL
NGL	National Gas Law, Schedule to the proposed <i>National Gas (South Australia) Act 2007</i>
NGR	National Gas Rules – Statutory Rules proposed to be made under Chapter 7 of the NGL
SCO	Standing Committee of Officials reporting to MCE

## Relevant Publications

MCE Decision on Review of Decision-Making in the Gas and Electricity Regulatory Frameworks, June 2006

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=839F2DC1-AE13-142E-8425FEF5F2E8C822>

Final Report of the MCE Expert Panel on Energy Access Pricing, April 2006

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=B0F3AD4C-A1C6-28DB-CB9CC594D2B88090>

MCE Arrangements for Consumer Advocacy in the Energy Sector, December 2005

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=2CB6A5A9-EDA6-E716-FD118AA822DD7665>

Energy Market Reform Bulletin No 68 – Release of MCE Statement of Scope – A National Legislative Framework for Gas and Electricity

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=C1CF57E4-D8A3-3039-E47E5E40C3F58B8A>

2006 Comprehensive Legislative Package: Overview and Response to Expert Panel on Energy Access Pricing

<http://www.mce.gov.au/assets/documents/mceinternet/2006ComprehensiveLegislativePackage%5FOverviewandResponsetoExpertPanel20061107112522%2Epdf>

Regulatory Impact Statements on Form of Regulation, Pricing Principles, Information Disclosure and Regulatory Decision-Making, November 2006

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=BFE1687D-FD85-42F6-8BF0063BEEFE6846>

National Gas Law Exposure Draft, November 2006

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=BFD374E5-E6C0-4624-0BFCDC9856F0C65F>

## Part 1: Overview

### Introduction

This paper describes the main features of the exposure draft of the National Electricity Law (NEL) Amendment Bill.

The Ministerial Council on Energy (MCE) will consider submissions on the draft NEL before making a final decision on the legislation in the first half of 2007, and introducing the required legislation in the South Australian Parliament for commencement on 1 July 2007.

The structure of this paper is as follows:

- Part 2 explains the draft NEL amendments released with this paper;
- Part 3 explains proposed changes to the rule change process in the NEL and National Gas Law (NGL) to provide further streamlining and industry involvement;
- Part 4 notes the impact of the NEL changes on the Regulations; and
- Part 5 describes the high level approach to distribution revenue and pricing rules to assist the understanding of the NEL amendments.

Much of the core policy in this paper has been set out in the Standing Committee of Officials (SCO) document '2006 Comprehensive Legislative Package: Overview and Response to Expert Panel on Energy Access Pricing' released on 7 November 2006<sup>1</sup>. The relevant regulatory impact statements were released at the same time.<sup>2</sup>

#### *Relationship to the NGL and NGL Consultation*

This package introduces a number of amendments that are intended to legislatively align the gas and electricity regimes. The aim for an appropriate level of consistency in gas and electricity access regimes is recognised in the Australian Energy Market Agreement (AEMA).

A draft NGL was released for a public consultation period on 7 November, which closed on 19 December.

SCO has not had an opportunity to consider the submissions it received to incorporate suggestions into this draft of the NEL amendments. SCO notes that all submissions are currently available on the MCE website and raise a number of important issues for consideration in finalising both the NEL and NGL.<sup>3</sup> Those who are making submissions on both laws need not repeat issues already raised unless they want to highlight a particular impact on the electricity industry. SCO will consider NGL submissions on equivalent NEL provisions in the process of finalising the NEL.

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1 See

<http://www.mce.gov.au/assets/documents/mceinternet/2006ComprehensiveLegislativePackage%5FOverviewandResponsetoExpertPanel20061107112522%2Epdf>

2 See Regulatory Impact Statements on Form of Regulation, Pricing Principles, Information Disclosure and Regulatory Decision-Making, November 2006

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=BF1687D-FD85-42F6-8BF0063BEEFE6846>

3 The submissions are at

<http://www.mce.gov.au/index.cfm?event=object.showContent&objectID=98F3581D-05A4-2B77-7F2B616AAB1A98E9>

## The Legislative Structure

The National Electricity Market (NEM) is comprised of six state-based regions that trade electricity across borders: New South Wales (including the Australian Capital Territory), Queensland, Victoria, South Australia, Snowy region and Tasmania. A co-operative Commonwealth, State and Territory legislative framework is in place to govern the operations of the NEM. The governance framework of the NEM and oversight of the MCE are established by the AEMA.

The present framework works through "lead" legislation in South Australia (the *National Electricity (South Australia) Act 1996*). This lead legislation is then applied as the law in the other jurisdictions through 'Application Acts', which apply the Schedules to the respective South Australian Acts in their jurisdiction.

The electricity legislative framework is made up of a number of key pieces of legislation. These include the Schedule to the *National Electricity (South Australia) Act 1996*; the National Electricity Law (NEL); Regulations under that Act, the National Electricity Rules made under the NEL; Part IIIAA of the *Trade Practices Act 1974* (TPA) establishing the Australian Energy Regulator (AER); and the *Australian Energy Market Commission Establishment Act 2004* of South Australia.

### *National Electricity Law and Rules*

The NEL was re-enacted in 2005 to implement the governance arrangements in the AEMA. This legislative package will amend the NEL to implement:

- the changes resulting from the Expert Panel advice;
- the transfer of distribution economic regulation to the AER; and
- the MCE decision on merits review.

The National Electricity Rules (NER) are made under the NEL to provide detailed operational regulatory requirements for electricity transmission and distribution.

### *The Australian Energy Regulator and Australian Energy Market Commission*

The AER was established as a constituent part of the Australian Competition and Consumer Commission under the TPA. Among its powers and functions is the implementation and enforcement of the NEL and NER.

The AER is currently responsible for electricity transmission regulation. The amendments will confer functions on the AER under the NEL and NER relating to the economic regulation of distribution networks. All new distribution determinations commencing after 1 July 2007 will be made by the AER. The related amendments to the NER detailing the transfer of economic regulation of electricity distribution will be made by the South Australian Energy Minister on the recommendation of the MCE.

The Australian Energy Market Commission (AEMC) was established in 2004 under South Australian legislation as a separate statutory commission. The AEMC has responsibility for rule-making and market development in both electricity and gas.

### *Key amendments to the NEL*

The key amendments to the NEL are as follows:

- Transfer of economic regulation of distribution  
Following the NEL amendments, the AER will become responsible for the economic regulation of distribution from 1 July 2007. Consistent with the AEMA, the NEL will allow the MCE through the South Australian Minister to make new national rules for distribution revenue and price control.
- Expert Panel on Energy Access Pricing  
This package implements recommendations of the Expert Panel adopted by the MCE. In particular, it changes the national electricity market objective into the national electricity objective and s. 16(2) of the NEL will be remodelled so that the AER must take into account the pricing principles recommended by the Expert Panel when exercising discretion relating to a price/revenue determination and when making a binding arbitration decision. Decisions about the form of regulation will now be more directly guided by considerations of market power through the 'form of regulation factors'.

The NEL continues to allow a 'fit-for-purpose' model of regulatory decision making in the NER, as has already been applied by the AEMC in the new Chapter 6A of the NER for regulation of electricity transmission.

A framework for information disclosure and regulatory reporting to the AER is inserted into the NEL, to address the concerns expressed by the Expert Panel about the need for adequate information from both service providers and related parties.

- Merits review  
A limited form of merits review available for specified economic regulatory decisions is implemented in the NEL. Proceedings may be brought before the Australian Competition Tribunal in respect of the following decisions:
  - AER pricing and revenue determinations for transmission and distribution (including application of the regulatory test);
  - AER decisions not to exempt entities from ring fencing guidelines or impose additional ring fencing requirements; and
  - Other decisions prescribed by regulation to be reviewable.
- Access Dispute Framework  
The amendments provide for an enforceable access dispute framework in the NEL consistent with the approach in the NGL and TPA. This framework will initially apply only to access disputes relating to distribution networks.

## **Part 2: National Electricity Law (NEL)**

### ***Part 1: Preliminary***

This part contains formal provisions dealing with the citation and commencement of the Amendment Bill.

### ***Part 2: Amendment of National Electricity (South Australia) Act 1996***

#### **Preliminary: items 5 – 9B**

##### *Definitions*

Item 5 of the Bill amends the definition of 'Court' to make the NEL consistent with the NGL.

Item 6 of the Bill contains a series of new definitions, notably: access determination; access dispute; associate; distribution determination; and distribution regulatory obligation or instrument.

"access determination" and "access dispute" (see new s 2A inserted by item 7 of the Bill)

This Bill introduces an access dispute resolution process. If a user or prospective user and a network service provider cannot agree on conditions for access to the network either party may notify the AER that an access dispute exists. The AER may then resolve the dispute by making an access determination under s125 of the NEL. This framework is intended to initially apply only to distribution access disputes, whereas transmission disputes will remain subject to the process in Chapter 6A of the NER.<sup>4</sup>

"associate"

The *Corporations Act 2001* definition of 'associate' is replicated in the NEL. Its meaning may, however, be expanded by regulations. The concept of an 'associate' is used in the new NEL information gathering regime. The purpose of allowing regulations to expand the definition is to provide flexibility as the electricity industry continues to use and adapt 'related party arrangements' falling outside the *Corporations Act 2001* meaning of associate that may impede the effectiveness of aspects of the regulatory regime, including ring-fencing.

"distribution determination"

The AER has been given a new power to make revenue and pricing determinations for a distribution network which will include aspects of the distribution network service provider's (DNSP's) negotiation framework for negotiable services. These essentially mirror transmission determinations which have also been redefined.

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<sup>4</sup> See page 14 below.

"distribution regulatory obligation or instrument"

This definition is based on the definition of transmission regulatory obligation and the equivalent NGL drafting. The drafting reflects the policy that an order of compensation under an Act is not included as a regulatory obligation.

*Form of regulation factors, direct control network service and negotiated network service*

Item 7 of the Bill creates new ss 2B, 2C and 2E of the NEL establishing the concepts of direct controlled network services, negotiated network services and the 'form of regulation factors'.

A direct controlled network service is a service for which the price is fixed by the AER in a revenue or network pricing determination. In transmission these are the prescribed transmission services controlled by revenue cap in Chapter 6A of the NER. In distribution, the Rules will be able to specify particular services as controlled, or leave the decision up to the AER in a distribution determination, having regard to the form of regulation factors.

Negotiated network services are those transmission and distribution services regulated under a negotiate/arbitrate regime (such as that specified for negotiable transmission services in Chapter 6A of the NER). These services are not subject to upfront price control, but a binding arbitration mechanism is provided for the resolution of disputes about price and non-price aspects of access.

The form of regulation factors were recommended by the Expert Panel to be used as part of a 'market power test' when determining the form of regulation to apply to network services. They are equivalent to the form of regulation factors in s 13 of the NGL. These factors are relevant to the AER in determining if a network service is to be a negotiated or regulated network service. Consistent with the Expert Panel's recommendation, the 'form of regulation' factors for electricity are:

- a. the presence and extent of any barriers to entry in a market for electricity network services;
- b. the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by an electricity network service provider and any other electricity network service provided by the network service provider;
- c. the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by an electricity network service provider and any other service provided by the network service provider in any other market;
- d. the extent to which any market power possessed by an electricity network service provider is, or is likely to be mitigated by any countervailing market power possessed by a network service user or prospective network service user;
- e. the presence and extent of any substitute, and the elasticity of demand, in a market for an electricity network service in which an electricity network service provider provides that service;

- f. the presence and extent of any substitute for, and the elasticity of demand in a market for, electricity or gas (as the case may be);
- g. the extent to which a prospective network service user or network service user of an electricity network service has adequate information to enable them to negotiate on an informed basis with an electricity network service provider for the provision of an electricity network service to them by the network service provider.

The 'other factors' criteria that the Expert Panel recommended are not included in the enumeration of the form of regulation factors in s2C, but are separately included as considerations each time the form of regulation factors are referred to.

Officials note that the AEMC has already had regard to market power in determining the split between transmission prescribed and negotiable services. The insertion of these factors in the NEL is not intended to result in any inconsistency with the AEMC approach of defining those services in transmission.

#### *Ring-fencing requirement*

Item 7 of the Bill also introduces a definition of ring-fencing requirement into the NEL to enable the imposition of additional ring-fencing requirements or their waiver to be subject to merits review under the new Division 3A of Part 6.

#### *Participating Jurisdictions*

Item 8 of the Bill amends s 6 of the NEL to remove redundant provisions now Tasmania is a participating jurisdiction.

### **Regulatory Guidance: National Electricity Objective and Principles**

Item 9 of the Bill introduces a new 'national electricity objective' as s 7 of the NEL and a set of 'revenue and pricing principles' as a new s 7A. In line with the Expert Panel's recommendation to promote consistency between electricity and gas regulation these provisions mirror ss 20 and 21 of the NGL.

#### *National Electricity Objective*

The objective of this Law is to 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 primary focus of the NEL objective is economic efficiency. The ultimate purpose is expressed in terms of the long-term interests of consumers. The promotion of efficient investment and efficient operation will encourage productive efficiency, allocative efficiency and dynamic efficiency, and will maximise the long term interests of consumers.

The objective refers to “effective investment in, and efficient operation and use of, electricity services”. The objective emphasises that a long term perspective is to be taken with respect to consumer interests, and that a critical factor in such a long term

perspective is the impact of decisions on investment in electricity infrastructure and services.

The national electricity objective and the amended definition of electricity services (see item 6 (6) of the Bill) are also drafted to re-emphasise the broader issues of upstream and downstream supply which will become more relevant when the NEL is expanded to encompass non-economic distribution and retail functions.

The MCE sees alignment between the objectives of the electricity and gas regimes as being an important foundation for the regimes. The objects clause of the NEL is therefore drafted as an objective of the Law, rather than an objective of the market.

A common objective for both the NEL and NGL will provide a uniform guiding principle in relation to all aspects of the regime where discretions are required to be exercised or interpretations to be made. Administrative bodies (including Ministers) will have to ensure that their regulatory decisions are consistent with the objectives of the NEL and NGL, and the AEMC will have to test any future Rule changes against the objectives of the NEL or NGL (as applicable) when making Rules. Courts and other review bodies will also be guided in their application of both regimes by the common objective.

#### *Revenue and Pricing Principles*

Item 9 of the Bill also creates a new s 7A in the NEL that establishes the revenue and pricing principles. These principles guide the AER in its determinations of appropriate revenue and pricing outcomes when exercising an AER economic regulatory function or power. They have been developed from the Expert Panel's recommended principles and have been drafted with electricity-specific wording. The revenue and pricing principles are as follows:

- (2) A network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in—
  - (a) providing direct control network services; and
  - (b) complying with—
    - (i) a distribution regulatory obligation or instrument; or
    - (ii) a transmission regulatory obligation or instrument.
- (3) A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes—
  - (a) efficient investment in a distribution system or transmission system with which the operator provides direct control network services; and
  - (b) the efficient provision of network services; and
  - (c) the efficient use of the distribution system or transmission system with which the operator provides direct control network services.
- (4) Allowance should be made for the value of a distribution system or transmission system with which a regulated network service provider provides direct control network services.
- (5) Regard should be had to any valuation of a distribution system or transmission system set out in any—
  - (a) as the case requires, previous distribution determination or transmission determination; or;

- (b) determination or decision under the National Electricity Code or jurisdictional electricity legislation regulating the revenue earned, or prices charged, by a person providing services by means of that distribution system or transmission system.
- (6) Regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider in, as the case requires, a distribution system or transmission system with which the operator provides direct control network services.
- (7) Regard should be had to the economic costs and risks of the potential for under and over utilisation of a distribution system or transmission system with which a by a regulated network service provider provides direct control network services.

The drafting of the principles is also consistent with the National Access Regime pricing principles in s 44ZZCA of the *Trade Practices Act 1974* which start with the word 'should'. The principles are accordingly drafted to work consistently with the overriding national electricity objective to guide both the AEMC in amending the NEL and the AER in interpreting and applying the NEL and NER. Accordingly, the AER must take the revenue and pricing principles into account in the revised s 16 of the NEL.

*Fit for purpose decision making model*

The Expert Panel recommended that the NEL provide flexibility for the AEMC to provide detailed rules governing the nature of the discretion of the AER to accept or reject aspects of a service provider's proposal. The Expert Panel also expressed concern that a blanket propose-respond model, which had arisen in the Gas Code through legal interpretation, would not achieve MCE's policy objectives. To avoid legal interpretations of the NEL and NER creating similar difficulties in the future the Bill includes an equivalent of s 24 of the NGL in item 11. The intention is to ensure that 'propose-respond' rules, such as for capital and operating expenditure in transmission and distribution, are clearly specified as such. The new section 9A is not intended to direct the AEMC either towards or against adopting particular models for aspects of a proposal in the rules, just to ensure it clearly specifies when a service provider's proposal is to be given particular weight.

*Manner in which AER performs AER economic regulatory functions or powers*

Item 14 of the Bill replaces s16 of the NEL to implement the Expert Panel's recommendation that the AER be guided by the revenue and pricing principles in exercising relevant discretions under the NER. Accordingly, this section lists the factors that the AER must consider when performing or exercising an economic regulatory function or power. This section has been amended to require the AER to consider the national electricity objective rather than the national electricity market objective.

The new s 16 also requires the AER to have regard to the revenue and pricing principles when making network revenue or pricing determinations or when making access determinations that involve prices or charges for network services. The AER is also permitted to consider the revenue and pricing principles when performing any of its other functions if it considers it appropriate to do so.

Amendments to s 15 (see item 13 of the Bill) make clear the AER's roles in: monitoring compliance with both the legislative framework and determinations; initiating prosecutions; preparing and publishing performance reports. Performance

reporting is considered essential for the AER to subject regulated businesses to competition by comparison. A necessary and convenient power is included in s 15(2), as in s 44AL of the TPA.

### **Information Gathering Powers**

Item 17 of the Bill makes the NEL search warrant provisions consistent with current criminal law policy (and with the NGL) by strengthening the suitability criteria for authorised people under s 20 of the NEL and introducing identity cards for authorised people. Item 18 revises s 21 of the NEL by removing the concept of a 'possible breach' and replacing it with the need for a 'reasonable suspicion' of a breach. These should better protect individuals' rights in enforcement operations by the AER. Search warrants are a tool for breaches of the legislative regime rather than economic regulation.

This Bill also introduces substantial amendments to the AER's information gathering powers under the NEL. Item 19 of the Bill replaces s 28 of the NEL and introduces new Divisions 4 and 5 to Part 3 of the NEL. These powers mirror the information gathering powers given to the AER in Part 2.1 of the NGL to provide a consistent information gathering regime across electricity and gas, fully implementing the concerns of the Expert Panel about the necessity of information provision in gas and electricity regulation.

Division 3 of Part 3 (s 28) allows the AER to require the provision of information and documents where that information is, or those documents are, relevant to the performance of the AER's functions. Persons are not required to provide information where they have a "reasonable excuse" for not doing so (for example, the person is not capable of complying with a relevant request) or if the information is subject to legal professional privilege. This matches s 41 of the exposure draft of the NGL and the existing s 28 of the NEL. The only difference is that this drafting makes clear that, consistent with current case law, any duty of confidence is not a reasonable excuse.

Division 4 of Part 3 establishes the framework for the AER to obtain the information required for enforcement and general regulatory reporting. This Division creates the concepts of a 'general regulatory information order' and a 'regulatory information notice', and outlines the processes by which these instruments may be used by the AER.

The AER can only serve a regulatory information notice or make a general regulatory information order if it considers it reasonably necessary for the performance or exercise of its functions and these instruments can only be applied to service providers and their associates.

The AER must, before issuing a regulatory information notice, take into account the comments received, including the likely costs of compliance (s 28F(3) and (4)). Consultation is intended to ensure the AER does not exercise its powers without regard to why it requires the information and taking into account the regulatory burden that may be imposed.

Section 28H allows the AER, through a regulatory information instrument, to require information be kept and provided in a manner such that it can verify whether a service provider is complying with the ring-fencing provisions of the NEL and NER.

These instruments are intended to clearly set out the information requirements on service providers to report annually and at a revenue reset (access arrangement

approval). By creating clear obligations, regulators, users and service providers will be able to more clearly ascertain compliance with the law and the efficiency of prices for services. As well, the framework set out in the NEL should help to avoid information being collected in several different ways under different parts of the NER. Using the law to establish the AER's powers is considered preferable to the law mandating that the rules provide the same powers, which would only serve to complicate the rule making test based on the national electricity objective.

Section 28R provides that the AER may publish performance reports on the financial or operational performance of one or more network service providers. This is considered a key aspect of transparency for both distribution and transmission network service providers. SCO notes performance reporting is already a major part of the distribution regulatory regimes in SA and Victoria. However, the AER will not be able to issue regulatory information instruments solely for the purpose of collecting information for these reports (see s 28D(4)).

### *Protection and Disclosure of Confidential Information Held by the AER*

Item 15 of the Bill implements revised drafting to s 18 of the NEL for the application of the AER's confidentiality regime in s 44AAF of the TPA (see also item 20 for the AEMC's similar obligation). The substantive effect of the existing and revised s 18 remain the same, namely to ensure confidential information is protected but can be passed to other government institutions regulating the NEM including the ACCC, NEMMCO and AEMC. The section allows the NEL and NER to authorise disclosure in particular cases as described below.

Item 19 of the Bill also introduces a new Division 6 to Part 3 of the NEL that outlines various restrictions on the disclosure of confidential information by the AER. It outlines particular circumstances under which the AER can release confidential information (with or without omissions). These provisions mirror Division 1 of Part 8.2 of the NGL. It is considered important that, consistent with the approach in s 44AAF of the TPA, the confidentiality regime for the AER is contained in the Law rather than the NER. This avoids any inconsistency with the TPA and achieves consistency with the NGL.

### **Rule making powers**

Items 22 to 24 make a series of changes to the AEMC's rule making powers, including:

- The new s 34(2)(e) makes it clear that guidelines, etc, made under the NER may leave matters to be determined by the AER, AEMC, NEMMCO or jurisdictional regulator.
- The new s 34A prohibits the AEMC from making Rules that create civil or criminal penalties for breaches of the NER.

Notably, item 24 prevents the AEMC from making Rules so that there is no economic regulation of networks replicating the effect of the current s 36 of the NEL. It also prevents the AEMC from requiring the use of total factor productivity as a regulatory economic methodology unless the regulations to the *National Electricity (South Australia) Act 1996* allow the AEMC to require this methodology. This prohibition is designed to allow the AEMC the ability to review the use of TFP and present the outcome of that review to the MCE before Rule-change applications are progressed.

## Part 6: Proceedings and Merits Review

A new Division 2A is being inserted into Part 6 of the NEL, by item 34 of the Bill, to more clearly apply the procedural parts of State and Territory commercial arbitration Acts to disputes before the dispute resolution panel. Item 35 of the Bill clarifies the procedures for judicial review of decisions by the dispute resolution panel.

Item 36 of the Bill introduces new Divisions 3A and 3B into Part 6 of the NEL. The new Division 3A provides for Merits Review (see the commentary below). The new Division 3B introduces provisions to allow the parties to an access determination to enforce the determination in Court without relying on the regulator. Those provisions are modelled on s 152DU to 152DZ of the TPA (see also s 44ZZD of the TPA).

### *The new Division 3A: Merits Review*

The new Division 3A of Part 6 of the NEL provides a limited form of merits review for specified economic regulatory decisions.

Merits review proceedings may be brought before the Australian Competition Tribunal (ACT) by:

- a regulated network operator to whom the reviewable regulatory decision applies;
- a network service provider, user, prospective user or end user whose commercial interests are materially affected by the reviewable regulatory decision; or
- a user or consumer association.

The decisions subject to merits review will be:

- Transmission determinations under Chapter 6A of the NER and distribution determinations under Chapter 6 of the NER; and
- The imposition of additional ring-fencing requirements or waiver of requirements under the AER ring-fencing guidelines.

(Regulations under the South Australian may prescribe other decisions of the AER under the Rules to be decisions subject to merits review. No others decisions are currently intended to be included in the initial Regulations.)

These decisions have been identified by the MCE as being suitable for a form of merits review on the basis that (i) they may have a substantial impact on the economic viability of network and service providers and (ii) the decision-making power may involve the exercise of significant amounts of discretion.

The merits review will be on limited grounds, with restrictions placed on the evidence that may be brought to establish any ground of review. The grounds for review will be as follows (s71G):

- the original decision-maker made an error of fact in its findings of facts, and that error of fact was material to the making of the decision;
- the original decision-maker made more than one error of fact in its findings of facts, and that those errors of fact, in combination, were material to the making of the decision;
- the exercise of the original decision-maker's discretion was incorrect, having regard to all the circumstances;
- the original decision-maker's decision was unreasonable, having regard to all the circumstances.

These grounds will provide a limited merits review that enables correction of errors. An applicant for merits review will need to seek leave from the ACT to bring an action for review and, amongst other things, will need to meet a materiality threshold. The ACT must be satisfied that there is a serious question to be tried. In addition, for revenue-related errors, the amount at issue must exceed \$5m or 2% of average annual regulated revenue, or if quantification is not readily possible, the amount in issue must be material in terms of an entity's regulated revenue. In all other cases (ie non-revenue errors) the ACT will have to be satisfied that the error is a material one.

There will be a relatively wide scope for persons and groups to intervene in merits review proceedings, once commenced. Persons with a sufficient interest in the original decision are able to intervene, as well as jurisdictions, and user and consumer associations and interest groups with leave of the ACT.

The ACT will have wide powers. It will be able to affirm or vary the original decision, or set the decision aside and either substitute a new decision or remit the matter to the AER for reconsideration (s 71N). The ACT will not, however, be able to vary an network revenue or pricing determination or remit such a decision to the AER in a manner that would have the effect of backdating the decision (s 71O).

There will also be strict requirements as to the presumption that indemnity costs are to be awarded by the ACT unless exceptional circumstances exist (s 71S).

### **Amendments to Rule change process**

Part 3 of this paper discusses the MCE amendments to the Rule-change process flagged by the MCE Communiqué of 27 October 2006.

The Rule-change test is amended in item 42 of the Bill with a new s 88A to require the AEMC to have regard to the form of regulation factors in making Rules relevant to decisions about the form of regulation (ie whether a service is controlled, negotiated or unregulated). New s 88B requires the AEMC to take into account the revenue and pricing principles in making Rules relevant to a transmission or distribution determination.

Item 44 inserts a new s 90A into the NEL allowing the South Australian Minister to make a further set of Rules to implement the new distribution and consumer advocacy arrangements.

Item 45 clarifies the AEMC's ability to make rules that are necessary or consequential to those requested.

Item 55 clarifies the situations where the AEMC may decline to hold public hearings.

### **Access disputes**

Item 58 introduces a new Part 10 into the NEL to provide for the procedures and requirements for access disputes resulting from commercial negotiations between users and network owners/operators. Under the new Part 10, a dispute occurs when a user/prospective user is unable to agree with an electricity network owner/operator about one or more aspects of access to an electricity network service that are specified by the Rules to be an aspect about which there can be an access dispute (see the definition of access dispute in the new s 2A of the NEL [item 7 of the Bill]). The initial distribution rules will specify price and non-price aspects of access to a

distribution network as aspects about which there can be an access dispute. It is not proposed, however, to so specify aspects of access to transmission networks, and transmission access disputes will therefore continue to be subject to the dispute resolution framework in Chapter 6A of the NER.

The NEL provides for the AER to act as arbitrator over parties to an access dispute, which are defined as (s124, cf s 44U of the TPA):

- The person notifying the AER of an access dispute under section 123(1); and
- A person notified by the AER under section 123(3).

The amended NEL will establish the AER's powers and makes an access determination binding on the parties to an access dispute. It creates an access dispute framework that is consistent with the Competition Principles Agreement, Part IIIA and IXC of the TPA and the NGL. By using the regulator to determine access terms and conditions if there is a dispute:

- Consistency will be maximised in the application of the revenue and pricing principles to both controlled and negotiated services, thereby enhancing certainty and predictability in regulation and negotiations;
- Information gaming will be minimised;
- Power asymmetries, particularly those in distribution, will be counterbalanced;
- A unified appeal mechanism to the Federal Court will assist in providing accountability, legal precedent and further consistency; and
- Consistency will be enhanced for access to electricity and gas networks.

It is noted that the regulator's involvement in distribution access disputes is already enshrined in derogations 9.7.4, 9.15.2, 9.28.2 and 9.37.4 of the NER.

Sections 126 and 127 set out the AER's powers to terminate an access dispute. Section 126 is designed to ensure the access dispute framework is not gamed and good faith negotiations have been attempted. Additional termination circumstances can be added by the Rules (such as where an Ombudsman scheme covers the issue). Section 127 makes clear that the AER must terminate where the service is capable of being provided on a genuinely competitive basis consistent with the AEMC transmission rules (6A.30.5(e)).

Section 128 replicates the restrictions on connection negotiations in 5.2.2 of the NER. This should ensure existing contractual rights are protected.

The new Part 10 sets out the procedures covering the nature of the hearing, the party's right to representation and the role of the AER as arbitrator. For example, in the dispute hearing the AER is not bound by the technicalities, legal forms or rules of evidence (s134). Part 10 also sets out the AER's powers in a hearing and the disclosure of information requirements on a party to communicate information relevant to the hearing. The procedural rules are accompanied by criminal penalties and an enforceable framework that is not appropriate to be placed in Rules or other delegated legislation.

Part 10 also covers the costs associated with access disputes. It requires each party to bear its own costs, and provides the AER with the discretion to order a party to pay the costs of another party in the dispute hearing.

The NER will provide further detail relating to access disputes.

### **Other NEL amendments**

Item 20 implements a new drafting for the application of the AEMC's confidentiality obligations in s 24 of it's the AEMC Establishment Act. The substantive effect remains the same.

Item 25 allows the MCE to direct the AEMC to conduct reviews of the effectiveness of competition in retail energy markets in accordance with clause 14 of the AEMA.

Item 37 ensures that infringement notices are not issued more than 12 months after the AER forms a belief that there has been a breach.

Item 38 deletes s 84 as this has been moved to s 28ZA.

Item 58 inserts a new Part 11 (General) into the NEL. New section 146 makes clear that late decisions under the NEL or NER are still legally valid. Section 147 ensures that if the AER misses the deadlines for transmission or distribution determinations it must report to the MCE on its handling of the matter.

Item 59 amends Schedule 1 of the NEL to implement Expert Panel recommendations and the new rule heads of power for distribution.

Items 60 – 67 amend Schedule 2 of the NEL to make it consistent with the NGL. In particular, Part 6A deals with evidentiary certificates. Double jeopardy is also now protected between civil and criminal actions (item 66).

Item 69 amends Schedule 3 of the NEL to clarify the role of the AER in taking actions over previous breaches of the old NEL and Code.

## **Part 3: Additional amendments to the rule change process for the NEL and NGL**

SCO has also agreed to consult upon further amendments to the NEL rule change process to assist the AEMC manage its workload. There has not been time to include all of these in the draft, but stakeholder comments on the concepts are invited on this paper's explanation of them. It is intended that the additional changes will be included in the NEL and NGL amendments to be introduced into the South Australian Parliament in 2007 after full consideration has been given to your comments in this round of consultation.

### **Background**

The broad policy framework for Rule-making under the National Electricity Law (NEL) was designed in 2004 to make it relatively easy for a person to request a Rule-change and to ensure that the AEMC would deal with the applications efficiently. This system came into operation in July 2005. The key features of the framework are;

- any person may apply for Rule-changes;
- limited powers for the AEMC to initiate Rule-changes;
- limited gatekeeper role for the AEMC to reject applications without sufficient details or those that are misconceived or lacking in substance;
- timelines binding the AEMC to ensure that applications are dealt with in a timely fashion; and
- information sharing between the ACCC, AER and AEMC to assist the AEMC in considering Rule-change proposals.

The Rule-change process was developed from the original code-change process in chapter 8 of the National Electricity Code through MCE consultation in 2004.

### **What underpins the new Rule-change process?**

The policy underpinning the Rule change process was agreed to in the MCE Report to COAG in December 2003<sup>5</sup>. It was agreed that 'the AEMC will be bound to consider all developed proposals for rule changes that are submitted by market participants, user representatives, market operators and governments, and will have power to reject, amend or approve those proposals with written reasons'. The policy intent has now been reflected in clause 8.4 of the AEMA.

### **Progress on Rule-change proposals**

The AEMC has subsequently been progressing over 30 Rule-change applications, many of which have required extensions to the minimum time periods required by the NEL. SCO has consulted with the AEMC in developing this package of changes to make the rule change process more efficient and strengthen the original policy intent behind the legislation.

### ***Additional Minimum Content for Rule change requests***

Currently electricity regulations prescribe the following minimum content for rule change applications (and the gas regulations are intended to mirror these):

- (a) the name and address of the person making the request;

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5 See in particular 4.2.1(a) and (c), 4.2.3 and Appendix 2, Part 2.

- (b) a description of the Rule that the person proposes be made, including, if the request is for a derogation, a statement as to whether the derogation is a jurisdictional derogation or a participant derogation;
- (c) a statement of the issue concerning the existing Rules that is to be addressed by the proposed Rule and an explanation of how the proposed Rule would address the issue;
- (d) an explanation of how the proposed Rule would or would be likely to contribute to the achievement of the national electricity market objective

The AEMC can reject changes which do not meet these criteria. It is proposed that the existing criteria be strengthened to include the following requirements:

- An explanation of the expected benefits and costs of the proposed rule change and potential impacts of the change on those likely to be affected.
- In the case of a *participant derogation*, change proposed by NEMMCO or a change to the rules where the benefits will primarily fall on the proponent, detailed analysis of the impact of the change on those likely to be affected having regard to the objective.
- A clear statement of the nature and scope of the problem to be solved by the Rule change. (This is required to provide the AEMC guidance on evaluating or developing alternative solutions which may arise during the assessment process. Defining the boundaries is aimed at avoiding solutions which are outside the scope of the problem.)

These will assist the AEMC in rejecting rule change applications that simply assert that the object of the NEL has been met. Participants requesting derogations should also bear a greater responsibility of showing what their changes will mean.

#### ***Prior Consultation – fast-track process***

The Gas Market Leaders Group has proposed that the gas market operator should run consultation on rule changes and submit those for final approval to the AEMC. The idea that a market operator or other institution or group of participants is able to run open consultation sessions, rather than require the AEMC to do all the work, may save considerable resources and allow industry to come to a consensus view before starting a rule change process.

Accordingly the NEL/NGL will be amended to allow discretion for the AEMC to go straight to a draft determination (s 99) where the NEMMCO, gas market operator, Economic Regulation Authority (for gas) or AER has conducted separate consultation on a proposed change and;

- the consultation has been open to participation or comment from any person;
- proposes a solution based on that consultation;
- adequate records of consultation and submissions made during the consultation process are given to the AEMC; and
- the proposed change is accompanied by detailed analysis of how it satisfies the rule making test.

The above safeguards are designed to ensure the consultation process is robust, differing views have been considered and the proposal represents a view that is based upon the views of market participants. It would also be expected that the AEMC would be made aware of these processes, but it would have no formal role in pre-approving them.

This is not in the draft Bill.

***Power to determine order in which rule change applications proceed***

Section 95(1) currently requires the AEMC to publish rule change applications "as soon as practicable" and thus start consultation. This wording requires them to respond very quickly to all applications and does not allow them to consider resource issues or the importance of the applications. This section will be amended to give the AEMC greater discretion to determine the order in which it deals with rule change applications. This will not affect the time limits that apply to all AEMC decision making.

This is achieved by item 49 of the draft Bill.

***Higher gate-keeper role – information provision***

Section 94 will be amended to allow the AEMC to request further information from applicants. The AEMC's timeline for dealing with applications will not run while they are waiting for the information. If the AEMC has not received a response to their request within two months the timeline begins running again and the AEMC is required to deal with the application without the further information if they satisfy the current minimum requirements.

This is because under s 94 the AEMC is required to accept all applications that provide a specified minimum amount of information. The AEMC has found that they regularly require more information to make rule change determinations and have to expend substantial resources to obtain the information.

The proposed amendment is intended to improve the efficiency of the AEMC without unduly disadvantaging less resourced applicants who are unable to provide further information. This is achieved in item 48 of the draft Bill.

There will be an exception to the automatic start of the process after 2 months where:

- The rule change has been requested by or on behalf of a registered participant;
- The registered participant is capable of providing further information or analysis which would assist in the consideration of the rule change proposal; and
- The registered participant has not made a bona fide attempt to provide the AEMC with the information requested.

If this is the case, the AEMC will have the discretion not to proceed with the application. The effect of this is that registered participants could be requested to provide information and analysis to the AEMC at the start of the process above the minimum thresholds. This is intended to better inform consultation and reduce the industry's and the AEMC's costs in working out what was actually being sought. AEMC consultants would be given a simpler task of analyzing a well developed proposal.

This exception is not in the draft Bill.

**Higher gatekeeper role – no clear or material benefits**

If the AEMC considers that a rule change application does not indicate that clear or material benefits to the NER are likely, the AEMC may refuse to progress the rule change where it has:

- published its intent not to progress the rule change application; and
- considered any submissions made on whether the rule change should be progressed.

The discretions would be exercised by the AEMC having regard to the national electricity/gas objectives. It would be expected that if the AEMC received submissions asking for the rule change to be considered that were not trivial, it would then progress the rule change.

This is not in the draft Bill.

**Higher gatekeeper role – rejection where recently considered**

The AEMC will have discretion to decline to proceed with a rule change where the issues raised –

- are currently being considered; or
- were considered by the AEMC in a rule change process finalized within the last 12 months

and the AEMC has published its intent not to progress the rule change application and considered any submissions made on whether the rule change should be progressed.

This should stop gaming of the rule change process. This discretion would also be exercised having regard to the national electricity/gas objective.

This change will operate alongside the broader consolidation powers and the ability for the AEMC to implement other solutions to the problem posed by the rule change applicant that have been raised in consultation.

This is not in the draft Bill.

**Consolidation**

The NEL will be amended to give the AEMC greater discretion to consolidate rule change applications. A "stop the clock" provision will also be inserted to allow the AEMC to align the timelines of the consolidated applications.

Currently under s93 of the NEL the AEMC can only consolidate multiple rule change applications into one application if the proposed rule changes relate to "the same subject matter." This has reduced the AEMC's efficiency when there is a reason to deal with multiple applications together but the applications do not relate to the same subject matter.

This is achieved at item 43 of the draft Bill. The current draft requires all consolidated requests to be treated according to the time line of the last request. Consideration may be given to whether later rule change proponents should be able to consent to their requests being considered according to the timing of the first request (and thereby avoid restarting the process).

**Consolidation: greater discretion to make a rule change in response to consultation**

The current rule change process is essentially designed around a model where a proponent identifies a problem and proposes a solution and then the AEMC decides about whether or not that meets the objective. The NEL does, however, explicitly recognize some flexibility for the AEMC in drafting a particular rule. This is set out in s. 99(3) and 105(3) where the draft (or final rule) 'need not be the same as the draft' or proposed rule.

This still leaves the AEMC constrained in how far they are able to respond to new ways of solving a particular market problem raised in consultation.

To solve this problem the NEL will explicitly allow the AEMC to make a rule change which implements a solution to the problem posed by the rule change application best meeting the electricity/gas objective, which

- is of the nature of that proposed by the rule change applicant; or
  - is raised during the consultation process and has been open to comment by the public; and
- is focused on solving the problem raised by the rule change application.

The solution to the original problem posed would therefore need to be set out in a submission to consultation after a s 95 notice or a draft decision. If the solution was only made after the draft decision and the AEMC wanted to adopt it, the AEMC would need to re-open consultation on the particular solution as it has recently done with the 'reasonable estimates' advice.

The solution is still consistent with the MCE Report to COAG which stated that the AEMC 'will have power to reject, amend or approve those proposals with written reasons'. However, by requiring the issues to be brought up in consultation and for the solutions to come from consultation, this change is not another way for the AEMC to initiate its own rule changes as prohibited by the MCE report to COAG. To implement this effectively, it would be necessary to make the statement of the problem being addressed more clearly in each rule change proposal.

This is not in the draft Bill.

**Two weeks longer for draft and final decisions**

The AEMC's experience is that the 8 weeks it is currently given to prepare a draft rule determination and 4 weeks for a final determination are inadequate. Sections 99(1) and 102(1) will be amended to extend these periods to 10 and 6 weeks respectively. This change retains the discipline of a time limit for the AEMC but adjusts it to reflect the work required to prepare the determinations.

This is achieved in the draft Bill at items 52 and 54.

**Prospectively extending timelines for difficult matters**

Section 107 will be amended to allow the AEMC to publish a notice setting out extended timelines for complex matters at the time it opens consultation on the proposal. This makes explicit the AEMC's power to extend its timelines for complex matters prospectively rather than just at each stage. This amendment makes the rule change process more transparent because it allows the AEMC to give stakeholders an extended timeline for a complex application early in the rule change process.

This is achieved in the draft Bill at item 55.

**Four weeks additional consultation (rather than just 3).**

A new provision will be added to give the AEMC a four week "stop the clock" power during finalisation of a final decision if submissions raise new issues that require further public consultation with stakeholders.

This is achieved in the draft Bill at item 56.

It is also intended that the AEMC should be able to call interested parties in for a conference to discuss issues with the rule change.

**Minimal application fee**

It is proposed to introduce, for a proposed rule change, an application fee to be prescribed by regulation. The purpose of the fee would be to ensure proponents are committed to the changes they request.

This is proposed to be tiered as follows:

- Registered participants (generally) – \$10,000
- Corporation who is not a registered participant – \$10,000
- Natural persons - \$1000
- User or consumer associations or interest groups (as defined in NEL) - \$1000
- Persons seeking a participant derogation - \$20,000
- Non-controversial rule changes (as defined in NEL) - \$0
- MCE, Minister of a participating jurisdiction, NEMMCO, Gas Market Operator, AER or ERA – \$10,000
- NEMMCO, Gas Market Operator, AER or ERA where prior consultation has been carried out and meets criteria for streamlined process - \$0

The AEMC may waive a fee relating to a particular application where it considers it is in the public interest to do so.

Note that a fee for a participant derogation application can justifiably be higher because additional analysis is likely to be required for the AEMC to consider a particular participant's circumstances.

It is not intended that application fees become a mechanism for funding the AEMC. The AEMC's funding is governed by the AEMA and State and Territory arrangements.

This is not in the draft Bill.

## Part 4: Regulations for the NEL

The primary regulation of the NEM is through the legislative structure of the NEL and NER. This is not intended to change. There are, however, a number of matters of a transitional or whole of government nature that are appropriate to be placed in regulations under the South Australian application act. These are applied in each jurisdiction. Under the AEMA, all regulations need the unanimous support of MCE Ministers.

It is not intended that there will be substantial change to the existing Regulations under the NEL in light of the amendments. Accordingly, in the NEL, regulations will continue to govern:

- which provisions of the rules are civil penalties (given justice policy considerations in each jurisdiction);
- some detailed procedure of the rule change process (so that the AEMC does not amend its own process);
- transitional issues dealing with the legislative changes; and
- other minor or procedural matters arising out of the NEL.

There may be some need to update the regulations relating to the rule change process in light of the NEL amendments (see Part 3 above).

There will now be a regulation making power to expand the meaning of 'associates' for the purposes of the information gathering powers. This was considered appropriate because such a regulation would expand the reach of a power in the NEL itself. SCO notes that a number of submissions to the NGL have suggested other ways of achieving the same policy goal and will consider those submissions in finalising both the NEL and NGL.

A draft of the Regulations will be available for comment when the NEL goes into the South Australian Parliament.

## Part 5: National Electricity Rules

The following discussion sets out the framework upon which the distribution revenue rules are being developed. A more detailed explanation of and reasoning behind the distribution revenue rules and the draft rules will be released for consultation in the coming months. The main purpose of this Part is to provide a high level description of the rules to enable respondents to understand and more effectively comment on the NEL amendments. Substantive analysis of the issues raised by these rules will be undertaken in light of the comments on the exposure draft of the rules.

The revenue rules largely build on the AEMC's approach to electricity transmission to achieve MCE's consistency objective with appropriate differences reflecting the nature of distribution networks. Analysis has been undertaken of the appropriate differences between transmission and distribution. A summary table of the differences from the AEMC's approach regarding revenue and negotiable services is below.

There are also significant differences in the approach to distribution pricing as opposed to transmission pricing. The AEMC's approach to transmission is based around the small customer base of transmission network service providers and revenue cap regulation. The greater diversity of distribution customers and services mandates a more flexible approach to distribution pricing.

### Approach to distribution revenue rules

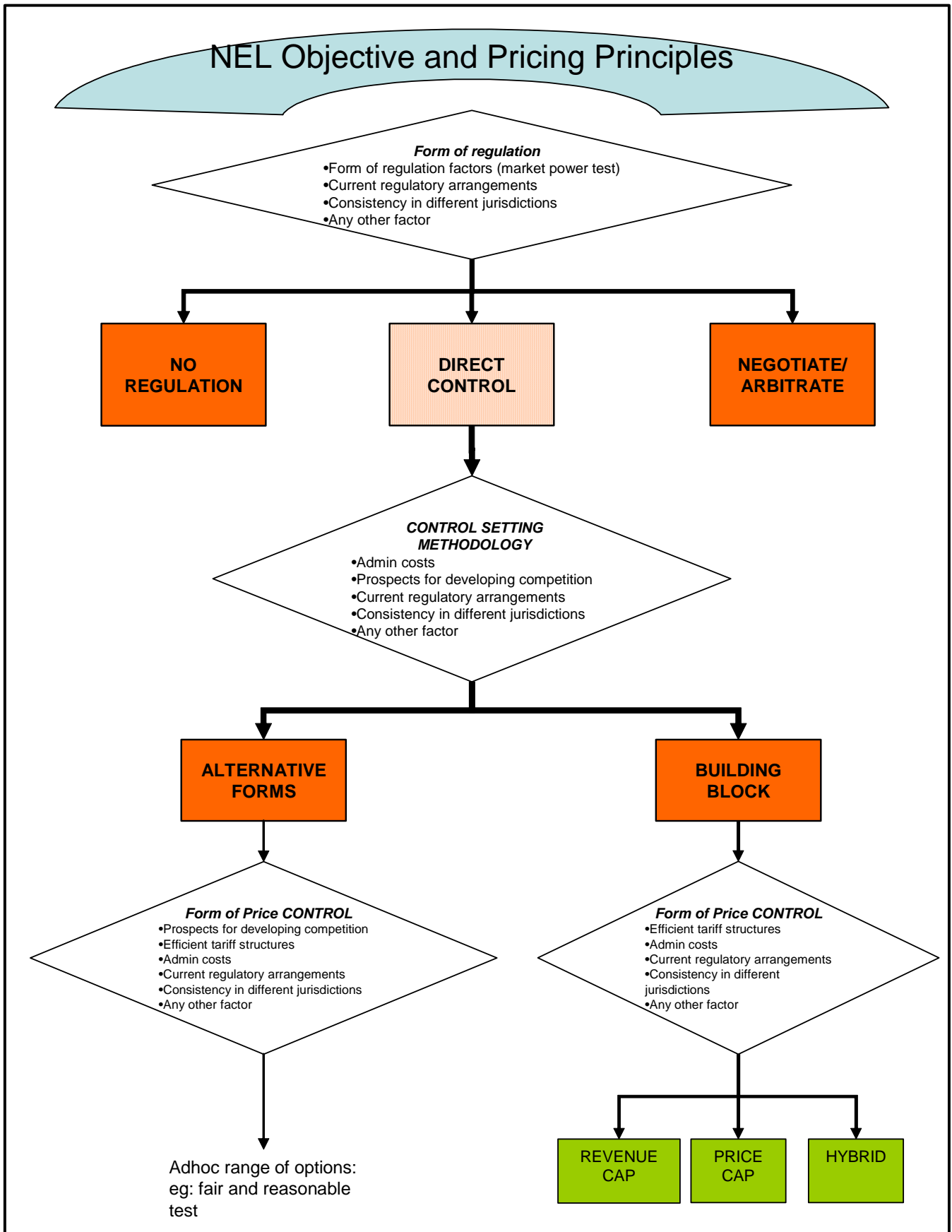
#### Form of Regulation

The initial distribution Rules will not distinguish between distribution services on the basis of being prescribed, negotiable or excluded services such as occurs in the current Rules. Rather, the initial distribution Rules will distinguish between services on the basis of the form of regulation that will apply to those services, which may be:

- Direct Control (of revenue, or price, or a combination of both);
- Negotiate / Arbitrate; or
- Unregulated.

The initial distribution Rules will not prescribe the form of regulation to be applied to individual distribution services. The application of the form of regulation factors in the NEL, by either the AEMC when making Rules or the AER when exercising discretion, will be the process by which the form of regulation for particular distribution services will be determined.

A diagram summarising the form of regulation and the flow on effects with the control setting methodology and form of price control decisions is below.



### **Direct Control Form of Regulation**

The initial distribution Rules will allow the use of two control setting methodologies, building block and alternative. A distinct form of price control decision is associated with each control setting method.

### **Control Setting Methodology**

Where the AEMC makes a Rule, or the AER makes a determination (as the case may be), to regulate a service through a direct control form of regulation, the Rules will require the AEMC or the AER to consider:

- (a) administrative costs of all parties;
- (b) prospects of competition (i.e. the potential for development of competition for the service in the relevant market);
- (c) the aim for consistency in the application of the form of regulation and methodology for similar services in different jurisdictions;
- (d) the current regulatory arrangements applying to the service; and
- (e) any other factor considered relevant

to make a Rule or determination on the control setting method to be applied to regulate the service between:

- (a) a building block method; or
- (b) an alternative method.

An alternative control setting method is intended to be used when a light-handed direct control form of regulation is appropriate.

At this stage, the initial distribution Rules will not allow a Total Factor Productivity (TFP) based control setting method to be used as an alternative to the building block method. The initial Rules for distribution will permit the AER to use TFP as a regulatory tool to assist the building block method. The Rules will allow the AER to collect information from distributors and from Jurisdictional Regulators, from international sources, and from other sources that the AER considers appropriate, in order to build a database for the application of TFP.

The MCE will direct the AEMC to undertake a review of TFP.

### **Form of Price Control under Building Block Methodology**

Where the AEMC makes a Rule, or the AER makes a determination (as the case may be), to regulate a service through a building block control setting method, the Rules will require the AEMC or the AER to consider:

- (a) administrative costs of all parties;
- (b) efficient tariff structures;
- (c) the aim for consistency in the application of the form of regulation and methodology for similar services in different jurisdictions;
- (d) the current regulatory arrangements applying to the service; and
- (e) any other factor considered relevant

when making a Rule or determination whether to apply:

- (a) a revenue cap;
- (b) a price cap; or
- (c) a combination of both.

The combination of revenue cap and price cap could include a 'tariff basket' approach currently adopted by particular jurisdictional regulators. A price cap approach may include a 'revenue yield' approach currently adopted by particular jurisdictional regulators.

In contrast, the transmission Rules only allow a revenue cap as the form of price control under the building block method.

### **Form of Price Control under Alternative Methodology**

Where the AEMC makes a Rule, or the AER makes a determination (as the case may be), to regulate a service through an alternative control setting method, the Rules will require the AEMC or the AER to consider:

- (a) administrative costs of all parties;
- (b) prospects of competition (i.e. the potential for development of competition for the service in the relevant market);
- (c) efficient tariff structures;
- (d) the current regulatory arrangements applying to the service;
- (e) the aim for consistency in the application of the form of regulation and methodology for similar services in different jurisdictions; and
- (f) any other factor considered relevant

when making a Rule or determination on the form of price control to apply under the alternative control setting method (e.g. fair and reasonable test, service specific revenue / price cap).

### **Form of Regulation, Control Setting Methodology and Form of Price Control Guidelines**

To assist network service providers in making applications and give greater certainty to all interested parties, the AER will be obliged to make (non-binding) guidelines relating to its application of the various tests regarding the form of regulation, control setting method and form of price control. These will need to be made and amended according to consultation procedures in the Rules. The rules will also empower interim guidelines for the purposes of the NSW and ACT determinations. Nonetheless, in a determination the AER's responsibility will be to apply the tests in the Rules (having regard to their guidelines) and not just the applying guidelines themselves.

### **Negotiate / Arbitrate Form of Regulation**

The initial distribution Rules will set out general pricing principles for negotiated services that will be based upon to the principles in the transmission Rules (6A.9.1). There will be a requirement for a distribution network service provider to prepare a negotiating framework.

The AER will be the binding arbitrator for access disputes but small customer dispute resolution schemes (like Ombudsman) will retain their current jurisdiction.

Commercial arbitration will be available to the parties but will not be specifically provided for in the rules. The initial distribution Rules will not constrain the distribution network service provider or the seekers of a service from attempting to resolve disputes through private dispute resolution. Nor will the Rules bind a person acting as a private dispute resolution body in the process to be followed, the information sought from the parties or the criteria for resolving the dispute. These are all matters to be agreed between the parties.

The initial distribution Rules will allow those customers who are already eligible to access the alternative dispute resolution mechanism<sup>6</sup> to bring complaints and disputes regarding the provision of distribution services to the body responsible for alternative dispute resolution (an energy Ombudsman in most States and Territories). Where the customer is defined by State-based legislation to have mandated access to an alternative dispute resolution scheme, the decision of the body responsible for alternative dispute resolution is binding.

Where the AER acts as arbitrator, the NEL (s 16(2)(a)(ii)) will bind the AER to apply the same revenue and pricing principles as would apply under a control form of regulation. The rules will also set out negotiated distribution pricing criteria matching those in rule 6A.9.1 for electricity transmission. The Rules will also specify the dispute resolution procedure to be followed by the AER. Accordingly, an access dispute may be a dispute with respect to:

- (a) the price which a DNSP proposes to charge a service applicant for a negotiated transmission service, or the amount of any access charge;
- (b) the proposed access arrangements or connection agreements of the service applicant;
- (c) any question as to the fairness and reasonableness of an offer to connect in relation to a distribution network that arises under rule 5.3.6(c);
- (d) access to, connection to, modification of a connection to, or the augmentation of, the provision of network services or distribution use of system services, or the modification of the provision of network services or distribution use of system services, in respect of any distribution network; or
- (e) any combination of the above.

The AER, acting as arbitrator, will be able to require the service provider to provide any service to the applicant. An arbitrator must terminate proceedings if there is effective competition in the provision of the disputed service (s 127).

### **Unregulated Distribution Services**

Control or Negotiate / Arbitrate are not applicable forms of regulation for a distribution service provided in an effectively competitive market. The seekers of the service have alternative service providers with whom to negotiate provision of the service. Therefore there will be provision for unregulated distribution services in the Rules. For clarity, a service may be unregulated in terms of price, but may be regulated in

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<sup>6</sup> Eligibility to access the alternative dispute resolution mechanisms are defined under State and Territory-based legislation and will remain so under Item 17 of Annexure 2 of the amended AEMA.

other aspects (e.g. if the service co-utilises assets which are also utilised to provide regulated services).

### **Building Block Control Setting Method**

#### **Opening Asset Values**

The Rules for distribution will use the values determined in the most recent regulatory determination for each distribution network service provider by the relevant Jurisdictional Regulator as the opening value of the regulatory asset base. This is the same basis as the opening asset values of transmission network service providers in the transmission revenue Rules.

#### **Roll-Forward of Regulatory Asset Base**

The roll-forward model for a distribution regulatory asset base is:

The opening value of the regulatory asset base at the commencement of the previous regulatory control period

*plus*

actual capital expenditure in the previous regulatory control period

*less*

actual depreciation in the previous regulatory control period and disposals in the previous regulatory period

*equals*

opening value of the regulatory asset base at the commencement of the current regulatory control period.

In rolling-forward capital expenditure into the next regulatory control period, there is no opportunity for the AER to make an ex-post assessment of prudence and efficiency of the expenditure. The actual capital expenditure during the previous regulatory control period is automatically rolled into the regulatory asset base. However, the regulatory asset base is reduced by the actual depreciation during the previous regulatory control period.

A prudence and efficiency test will be included in the initial distribution Rules to apply only to new DNSPs who are not already regulated.

#### **Asset Revaluation**

The initial distribution Rules will not make provision for asset revaluation.

#### **Adjustment to the Regulatory Asset Base**

The initial distribution Rules will allow the AER the discretion to adjust the regulatory asset base:

- (a) to include assets when services become subject to a direct control form of regulation; or
- (b) to exclude assets when services that were previously subject to a direct control form of regulation are no longer subject to a direct control form of regulation.

The Rules will include a principle to guide the AER in exercising its discretion. The Rules will require the AER to use deprival value<sup>7</sup> when valuing the assets to be added to or removed from the regulatory asset base. Including such a principle in the Rules will create greater certainty on how the adjustment will be made and ensure a consistent approach is adopted over time.

### **Depreciation**

The initial distribution Rules will provide that the annual building block revenue requirement must include a depreciation component. Depreciation is calculated on the value of each asset or category of assets included in the regulatory asset base over the economic life of that asset or category of assets. The Rules will not prescribe a depreciation method.

### **Operating Expenditure and Capital Expenditure**

The AEMC approach to operating and capital expenditure in transmission will be adopted for distribution. The initial distribution Rules will require the distribution network service provider to include in its revenue proposal, a forecast of operating expenditure and capital expenditure that it considers is required in order to achieve each of the following (the 'expenditure objectives'):

1. meet the expected demand for direct controlled distribution services;
2. comply with all applicable regulatory obligations associated with the provision of direct controlled distribution services
3. maintain the quality, reliability and security of supply of direct controlled distribution services ; and
4. maintain the reliability, safety and security of the distribution system through the supply of direct controlled distribution services.

The AER must accept the forecast of required expenditure of a distribution network service provider that is included in a revenue proposal if the AER is satisfied that the total of the forecast expenditure for the regulatory control period reasonably reflects ('the expenditure criteria'):

1. the efficient costs of achieving the expenditure objectives;
2. the costs that a prudent operator in the circumstances of the relevant distribution network service provider would require to achieve the expenditure objectives; and
3. a realistic expectation of the demand forecast and cost inputs required to achieve the expenditure objectives.

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<sup>7</sup> Clause 6.10.3(e)(5)(iii)(A) of the current Rules states the principle that deprival value should be the preferred approach to valuing network assets. Deprival value is defined in the Rules as a value ascribed to assets which is the lower of economic value or optimised depreciated replacement value.

If the AER is not satisfied as referred to above, it must not accept the forecast of required expenditure of a distribution network service provider that is included in a revenue proposal.

In deciding whether or not the AER is satisfied as referred to above, the AER must have regard to the following ('the expenditure factors'):

- (i) the information included in or accompanying the submission of the Revenue Proposal;
- (ii) submissions received in the course of consulting on the Revenue Proposal;
- (iii) such analysis as is undertaken by or for the AER and is published prior to or as part of the draft decision of the AER on the Revenue Proposal or the final decision of the AER on the Revenue Proposal (as the case may be);
- (iv) benchmark expenditure that would be incurred by an efficient Distribution Network Service Provider over the regulatory control period
- (v) the actual and expected capital expenditure and operating expenditure of the Distribution Network Service Provider during any preceding regulatory control periods;
- (vi) the relative prices of operating and capital inputs;
- (vii) the substitution possibilities between operating and capital expenditure;
- (viii) whether the total labour costs included in the capital and operating expenditure forecasts for the regulatory control period are consistent with the incentives provided by the applicable service target performance incentive scheme in respect of the regulatory control period; and
- (ix) the extent to which the forecast of required expenditure of the distribution network service provider is referable to arrangements with a person other than the provider, that, in the opinion of the AER, do not reflect arm's length terms.

### **Corporate Income Tax**

The initial distribution Rules will provide that the annual building block revenue requirement must include a component for the estimated cost of corporate income tax.

This approach reflects a post-tax weighted average cost of capital model, as is currently used in transmission regulation and in some jurisdictions for distribution regulation. Under this WACC model, corporate income tax is treated as a cash flow item rather than being a variable in the cost of capital.

### **Weighted Average Cost of Capital**

The initial distribution Rules will provide for a nominal post-tax weighted average cost of capital.

The initial distribution Rules will leave the value of WACC parameters to the discretion of the AER, in contrast to the transmission Rules which specify the value of each WACC parameter. This reflects the past divergence of WACC in electricity distribution as opposed to a consistent approach by the ACCC in electricity transmission.

The initial distribution Rules will require the AER to undertake a review of WACC parameters every 5 years. These periodic reviews will coincide with those conducted for transmission (with the first due by 1 July 2009). The reviews may allow a single set of parameters for transmission and distribution to develop and be fixed over time.

The initial distribution Rules will include a principle that the values of the parameters used in the WACC model must be commensurate with the prevailing conditions in the market for funds and the risks involved in delivering the services subject to a control form of regulation, by reference to the financial structure for a service provider that reflects standard industry structure for a going concern and best practice.

### **Cost Pass-Throughs**

The initial distribution Rules will provide for the following pass-through events:

- a regulatory change event;
- a service standard event;
- a tax change event; and
- a terrorism event.

Additional pass-through events defined by the AER in a regulatory determination will qualify for a pass-through of costs during a regulatory control period. In contrast, the transmission Rules define all pass-through events in the Rules.

### **Contingent Capital Expenditure Projects**

The initial distribution Rules will not make provision for contingent projects. Uncertain distribution capital expenditure projects can be accommodated as cost pass-through events.

### **Re-Opening a Regulatory Determination**

The initial distribution Rules will allow the AER to revoke and substitute a regulatory determination on certain grounds including where the regulatory decision was made on the basis of false or materially misleading information provided to the AER and where there was a material error made in setting the regulatory cap.

There will be no re-opening for force majeure unless it is defined as a pass-through event in a regulatory determination.

## **Incentive Schemes for Distribution Network Service Providers**

The initial distribution Rules will provide incentives for:

- (a) efficiency benefit sharing;
- (b) capital expenditure efficiency; and
- (c) distribution network service performance efficiency.

### **Efficiency Benefit Sharing**

The initial distribution Rules will require the AER to develop and publish an incentive scheme that provides for a fair sharing between distribution network service providers and distribution network users of:

- (i) efficiency gains (derived from actual operating expenditure being less than the forecast operating expenditure in a distribution determination); and
- (ii) efficiency losses (derived from actual operating expenditure being more than the forecast operating expenditure in a distribution determination).

The initial distribution Rules will differ from the transmission Rules in that the distribution Rules will not require the AER to publish efficiency benefit sharing scheme parameters and their values.

The AER will have discretion on whether or not to carry-forward efficiency gains or losses into a subsequent regulatory control period.

### **Capital Expenditure Efficiency**

The initial distribution Rules will allow a distribution network service provider to earn and retain in the current year and subsequent years of a regulatory control period the return on capital on the difference between the forecast capital expenditure in a distribution determination and the actual capital expenditure, when the actual capital expenditure is less than the forecast capital expenditure in the current year in a distribution determination.

The initial distribution Rules will not allow a distribution network service provider to earn and retain in the current year and subsequent years of a regulatory control period, the return on capital on the difference between the actual capital expenditure and the forecast capital expenditure in a distribution determination, when the actual capital expenditure is greater than the forecast capital expenditure in the current year in a distribution determination.

The Rules will allow a distribution network service provider to earn and retain in the current year and subsequent years of a regulatory control period the regulatory depreciation on the forecast capital expenditure in a distribution determination, whether actual capital expenditure is above or below the forecast capital expenditure.

The AER will have discretion to use carry-forward incentives where appropriate.

### **Service Performance Incentive**

The initial distribution Rules will provide the AER with discretion to set a distribution network service provider's revenue at risk under the network service performance incentive scheme.

The initial distribution Rules will contain high level principles to be considered by the AER in developing and publishing a service performance incentive scheme. The service standards incentive framework should:

- (a) provide incentives for the distribution network service provider to improve or maintain existing performance;
- (b) provide incentives for the distribution network service provider to improve service performance . These incentives are based on service standards set by the jurisdiction in accordance with the amended AEMA, any customer service performance standards developed as part of the 2007 legislative package, and the actual performance of the distribution network service provider;
- (c) take into account the related implementation costs and administrative burden associated with each of the approaches;
- (d) be at least sufficient to offset any financial incentive for a distribution network service provider to reduce costs at the expense of service levels;
- (e) improve incentives in relation to any performance measure that exceed the cost of improving the performance but are less than the customers' willingness to pay for that improvement; and
- (f) take into account the cost to the distribution network service provider of complying with the performance targets specified in the incentive framework average and minimum service targets when determining the form of price control, including the cost of expected recognition payments for failure to meet 'minimum performance targets'.

In addition, the initial distribution Rules will also contain a requirement that the service target performance incentive scheme to be developed and published by the AER for distribution network service providers must take into account:

- the standards set by the participating jurisdiction (through jurisdictional electricity laws or other instruments) and standards in the NEL and NER; and
- the regulatory obligations with which the distribution network service provider must comply (as defined in the NEL).<sup>8</sup>

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<sup>8</sup> The two additional matters that the AER must take into account when developing a service performance incentive scheme is intended to clarify that the scheme will be based on service standards set by the jurisdiction (in accordance with items 2 and 19 of Annexure 2 of the AEMA), and the regulatory obligations placed upon the DNSP, including the obligation to make guaranteed service level payments to customers. The scheme and its parameters may also take into account the DNSP's actual past performance against those standards and accordingly provide ongoing incentives to improve performance.

Item (f) above reinforces that the AER must take into account guaranteed service level payments when developing the scheme.

Performance measures included in an incentive scheme should:

- (a) be unique and not a derivation of other measures included in the service incentive scheme;
- (b) reflect those areas of performance that are most valued by distribution network users;
- (c) be specified in a meaningful manner;
- (d) to the greatest extent possible, reflect those aspects of performance that can be influenced by the distribution network service provider;
- (e) be based on data that is reliable, easily verifiable and not excessively costly to obtain.

For the purposes of the service standards incentive scheme, the Rules will require the AER to consult with the jurisdiction regarding the (average) network performance service standard set by the jurisdiction and the current performance of the network service provider. This is to ensure that the design and parameters of the service standards incentive scheme adhere to the principle that the DNSP is only rewarded for improvements in network service performance.

In terms of process, the AEMC's process for the development of a transmission service standards framework is largely applicable for distribution and therefore should be adopted.

It should be noted that jurisdictions will retain the ability to determine whether there is a recognition payment payable to the customer if the network's performance is below the guaranteed service level. Jurisdictions will also retain the ability to set the amount of the guaranteed service level payment. Customer performance standards will further be looked at in the 2007 package.

### **Regulatory Procedure**

#### **Procedure**

The initial distribution Rules will provide that a distribution network service provider must include the following in its application for a regulatory determination:

- (a) actual capital expenditure over the preceding regulatory control period;
- (b) forecast capital expenditure in each regulatory year over the next regulatory control period;
- (c) depreciation schedules for each regulatory year over the next regulatory control period;
- (d) forecast operating expenditure for each regulatory year over the next regulatory control period; and
- (e) estimated cost of corporate income tax for each regulatory year over the next regulatory control period.

The Rules will provide the AER with the ability to issue distribution guidelines outlining the information requirements that the AER needs to conduct its functions, including assessing a distribution network service provider's application. The

information guidelines could specify in detail the type and form of information that the AER requires for regulatory reporting and for regulatory determinations.

The initial distribution Rules will require a distribution network service provider to lodge its application for a regulatory determination to the AER 18 months prior to the next regulatory reset period.

### **Information Disclosure**

The NEL will adopt the principle that when a distribution network service provider or a third party has failed to provide the AER with information:

- (a) requested by the AER; and
- (b) necessary for the AER to make a regulatory determination

within a reasonable time, the AER will be allowed to make its own assessment of the information sought and use that assessment for the purposes of a regulatory determination (s 28M).

The confidential information provisions will be elevated to the National Electricity Law, consistent with the approach taken in the National Gas Law. The NEL (s 28V) will require the AER to consider, when it does not have the consent of the information provider to publish the information, whether to publish confidential information in an aggregated form, or publish the information when the AER is of the view that:

- (i) the disclosure of the information would not cause detriment to the provider; or
- (ii) although the disclosure of the information would cause detriment to the provider that provided it, the public benefit in disclosing it outweighs that detriment.

## **Approach to Distribution Pricing Rules**

### **Aggregate Annual Revenue Requirement**

The initial distribution pricing Rules will require that the aggregate annual revenue requirement of the distribution network service provider is to be determined in accordance with the initial distribution revenue Rules.

In defining aggregate annual revenue requirement, the initial distribution pricing Rules will allow adjustments to maximum allowable revenue for over and under-recovery of revenue if the revenue cap form of price control is used. Over and under-recovery is not required if the price cap form of price control is used.

### **Principles for determining tariff classes**

The initial distribution pricing Rules will require that the distribution network service provider, when creating a tariff class, must:

- (i) identify the distribution service(s) to which the tariff class applies;
- (ii) identify which customers or class of customers the tariff class contains, or identify the customers or class of customers who are eligible to be provided a distribution service;
- (iii) identify the charging parameters that apply to the tariff class.

When creating a tariff class, the DNSP must have regard to:

- (1) economically efficient grouping of customers, and
- (2) the transaction costs of further differentiation.

There must be transparency between previous and proposed new tariff classes. If the tariff class is a new tariff class, the DNSP must identify the parent or origin tariff class from which the new tariff class is derived. If the new tariff class is to replace an obsolete or redundant tariff class, the DNSP must identify the previous tariff class which the new tariff class replaces. A DNSP must provide a justification of the allocation parent or origin tariffs and quantity estimates associated with those tariffs.

A DNSP may transfer a customer or group of customers to a new tariff class upon written notice to the customer/s.

Where a particular customer has a choice as to which existing current tariff class they fall within, and where the customer or the customer's retailer nominates to the DNSP which tariff class they choose to fall within, the DNSP must apply that tariff class to that customer.

### **Principles for allocating revenue to prices**

The pricing principles in the initial distribution pricing Rules will apply to all direct control distribution services (ie building block revenue capped, price capped or hybrid and the alternative control setting method)<sup>9</sup>.

The Rules will contain the following pricing principles:

1. For each tariff class established by a distribution network service provider, the revenue expected to be recovered from the tariff class should lie between an upper bound determined by the stand alone cost of serving the customers to whom the tariff class applies, and the lower bound determined by the avoidable cost of not serving the customers to whom the tariff class applies.
2. The distribution network service provider must select one or more charging parameters and set the associated tariff level for each charging parameter taking into account the long run marginal cost for each relevant dimension of service, and having regard to:
  - i. the transaction costs associated with each charging parameter;
  - ii. the scope of customers to alter their consumption of each relevant dimension of service by reference to the corresponding charging parameter.
3. The distribution network service provider must adjust the tariff levels for each charging parameter so as to ensure that the revenue expected to be recovered from the tariff class under (1) is recovered, while seeking to minimise the extent of distortion to the pattern of usage implied by the tariff levels set in accordance to (2).

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<sup>9</sup> NERA also notes that the pricing principles are applicable for TFP and for negotiated distribution services.

## **Side Constraints**

The initial distribution pricing Rules will include a provision that a distribution network service provider must not increase the weighted average revenue amount for each tariff class in any year by more than (whichever is the greater):

- (i)  $(1 + \text{CPI}) (1 + 2\%)$ ; or
- (ii)  $(1 + \text{CPI}) (1 - X) (1 + 2\%)$ .

The Rules will also include a provision that a distribution network service provider must not increase any charging parameter in any tariff class in any year by more than (whichever is the greater):

- (i)  $(1 + \text{CPI}) (1 + 3.5\%)$ ; or
- (ii)  $(1 + \text{CPI}) (1 - X) (1 + 3.5\%)$ .

Where a new tariff class has been introduced, the side constraint rule will apply between the parent or origin tariff class from which the new tariff class was derived, or which the new tariff class replaces, and the new tariff class.

## **AER Guidelines**

The initial distribution pricing Rules will require the AER to develop and publish guidelines, in accordance with the Distribution Consultation Procedures, dealing with the calculation by a DNSP of stand-alone, avoidable and long-run marginal costs so as to demonstrate compliance with the principles for allocating revenue to prices.

## **Procedure and Compliance**

### **Pricing Proposal**

The initial distribution pricing Rules will require a DNSP to submit a Pricing Proposal to the AER at the same time as it submits its Revenue Proposal. The Pricing Proposal must:

- (i) set out the DNSP's proposed tariff classes;
- (ii) set out the DNSP's proposed charging parameters for each proposed tariff class; and
- (iii) demonstrate the DNSP's compliance with these rules.

A Pricing Proposal must be based on audited historic charging parameter quantities.

### **Annual Tariff Report**

The DNSP must, by 30 April each year, submit an Annual Tariff Report to the AER which sets out the proposed tariffs for each tariff class for the coming financial year (from 1 July) and which demonstrates that any proposed annual increase in prices are within the side constraints set by the rules.

Except where a service is regulated by a price cap, the Annual Tariff Report should also demonstrate the DNSP's forecast as to whether the actual revenue to be recovered by the DNSP in the current financial year will not exceed the aggregate annual revenue requirement for that year. If actual revenue recovered is likely to exceed the aggregate annual revenue requirement for that year, the DNSP must

adjust the aggregate annual revenue requirement for the subsequent year downward by the difference. Similarly, if actual revenue is likely to under-recovered the aggregate annual revenue requirement for that year, the DNSP must adjust the aggregate annual revenue requirement for the subsequent year upward by the difference.

The AER must, by written notice to the DNSP, require the DNSP to re-submit the Annual Tariff Report where the AER is not satisfied that the DNSP's proposed tariffs for the forthcoming financial year comply with the rules.

The rules would require the DNSP to publish by 31 May in each year its prices for the forthcoming year commencing 1 July, unless the AER has issued a notice to the DNSP requiring a resubmission. A DNSP may not increase the its prices where the AER has issued it with a notice requiring a resubmission.

### **New tariffs or tariff classes within a regulatory period**

A rule is required which allows a DNSP to amend / create new:

- charging parameters within a tariff class; and/or
- tariff classes

within a regulatory period where approved by the AER. The DNSP must submit a written proposal to the AER setting out the proposed amendments / new tariffs or tariff classes and demonstrating the proposal's compliance with the rules.

### **Billing and Settlement**

The initial distribution Rules will replicate Clause 6.8 (previously clause 6. 16) of the Current Rules.

### **Prudential requirements for distribution**

New rules are required which replicate clause 6.7 (previously clause 6.15) of the current rules.

### **Data Requirements**

The initial distribution Rules will replicate clause 6.10 (previously clause 6.18) of the current Rules.

### **Tariff Equalisation Schemes**

The effect of the tariff equalisation schemes in South Australia, Tasmania and Queensland will be maintained in the pricing rules through derogations.

**Table 1: Fundamental differences between distribution and transmission networks**

Issue	Transmission	Distribution	Implications
Key role in market	<p>Reliability and security of supply. Increased competition and supply/demand balancing between regions</p> <p>TUOS represents about 8% of average end-user price</p>	<p>Reliability and security for individual consumers and subregions</p> <p>DUOS represents between 40-50% of average end-user price</p>	<p>Transmission can have significant impact on market outcomes. Distribution has little impact on wholesale market.</p> <p>Increased distribution pricing has much higher impact on consumers.</p>
Impacts of under investment	<p>Less reliable supply and system security. Price separation between regions, distorted economic dispatch within regions and redirected generation investment – efficiency risk</p>	<p>Blackouts in service areas and poor quality of supply – security risk</p>	<p>Different stakeholders and political risks for underdevelopment</p>
Key customers	<p>Large generators and distribution networks. Generally registered market participants.</p>	<p>Households, small businesses, industrial and commercial customers, local government for streetlights, embedded generators. Generally not registered market participants.</p>	<p>In negotiation, information and commercial power asymmetry tends to be much higher in distribution. Registered market participants can be influenced by provisions elsewhere in the Rules.</p>
"Lumpiness" of capital assets and investment	<p>Small number of large assets. Investments also governed by Chapter 5 of the NER (including the Regulatory Test).</p>	<p>Large number of smaller assets. Regular investments to facilitate new connections, system augmentation and asset replacement. Chapter 5 provisions (including regulatory test) also apply to investments.</p>	

**Table 2: Differences between transmission (AMEC) and distribution economic regulation rules (revenue and negotiable services)**

1	<p>Scope of services falling within each form of regulation</p>	<p>Direct Control Negotiate/Arbitrate Unregulated</p> <p>Services falling within scope of each form of regulation explicitly defined (by reference to services provided).</p> <p>AEMC had regard to the same factors as in the market power test in NEL in formulating service definitions</p>	<p>Direct Control Negotiate/Arbitrate Unregulated</p> <p>Services falling within scope of each form of regulation not defined Services falling within scope of each form of regulation determined by AER applying market power test in NEL.</p>	<p>Control, negotiate/arbitrate and unregulated options are available in both Rules.</p> <p><b>Differences:</b></p> <p>(1) Services will not be defined into particular categories in the initial distribution rules.</p> <p>(2) The AER will determine the scope of services falling under each form of regulation for distribution.</p> <p>(3) Services can move between different forms of regulation for distribution without the need for a Rule change.</p> <p>Distribution services are generally greater in number and more diverse than transmission services (regulators have identified at least forty distinct distribution services). Establishing clear service definitions that can be consistently applied across businesses is likely to be difficult, at least initially.</p> <p>The market power associated with the same service differs between distribution businesses, as a result of different market circumstances, eg. different degrees of established competition.</p> <p>Greater scope for future changes in circumstance to warrant movement of distribution services between forms of regulation.</p> <p>Significant variation in current approach between businesses. Providing AER with discretion allows flexibility during transition to greater consistency.</p> <p>Summary: Benefits of allowing for greater flexibility in distribution. Not relevant to the same degree for transmission.</p> <p>Both approaches consistent with Expert Panel</p>
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2	Control setting methodology	<p>Building block approach mandated in the Rules for all services subject to direct control (cl 6A.5.4) No other methodology available.</p> <p>TFP may be used to support/inform the building block method (6A.6.6, 6A.6.7).</p>	<p>Building block approach mandated in the Rules for DUOS services.</p> <p>Alternative (ad hoc) approaches also available such as 'fair and reasonable' test for other services subject to direct control. Approach to be determined by the AER.</p> <p>TFP may be used to support/inform the building block method.</p>	<p>recommendation.</p> <p><b>Difference:</b> Building block approach is the only method of direct control available for transmission; other control setting methodologies are permitted for distribution The range and variation between different distribution services included within the scope of direct control can be expected to be wider for distribution than transmission, as a result of: (i) the range of services offered by a DNSP being more varied than TNSP services (ii) market circumstances differing more widely across DNSPs. These differences mean that alternative forms of control are likely to be relevant in the case of distribution. (iii) customers for many services being smaller and more diverse, resulting in fewer services being subject to negotiate/arbitrate and more remaining within scope of direct control The greater flexibility in the distribution rules will also assist with transition from the current arrangements, which differ widely between jurisdictions.</p>
3	Form of Price Control	Revenue control required in the Rules	Rules allow AER to determine the appropriate form of price control: Revenue control, price control or combination	<p><b>Difference:</b> Distribution rules allow the AER to determine the form of price control, which need not be a revenue control The distribution rules allow for more than one control setting method. Different forms of price control may be appropriate under different control methods. Therefore it is appropriate for the rules to contain this flexibility for distribution.</p>
4	Adjustment to regulatory asset	Rules allow for removal of assets	No provisions for asset stranding	<b>Differences:</b>

	base (RAB)	<p>subject to commercial stranding, under limited circumstances (cl S6A.2.3). Once assets have entered the RAB for prescribed services they cannot be allocated to negotiated services (6A.19.2(7)) Assets may be allocated from negotiated services to the RAB for prescribed services (6A.19.2(8))</p>	<p>Adjustments made to RAB when services move in/out of control form of regulation. Prescribe adjustments based on deprival value.</p>	<p>(1) No asset stranding provision in distribution rules. (2) Distribution rules allow for assets to be removed from the RAB and allocated to negotiated services. Fewer distribution assets are likely to be of a substantial size, dedicated to one user, resulting in a lower risk of commercial stranding. As there are no specific rules relating to prudent discounts, providing incentives for service providers to use these provisions would not be relevant for distribution (as it is for transmission). A difference in the distribution rules from the approach for transmission can be justified on the basis of the above. Both rules allow for assets to be allocated from negotiated services to the RAB. The distribution Rules prescribe a valuation basis for making the adjustment, (ODV) which provides transparency and certainty in the regulatory process. Inclusion of distribution rules to allow assets to be reallocated from the RAB to negotiated services is consistent with the ability for services to move between forms of regulation in the rules.</p>
5	Depreciation	<p>Straight line depreciation prescribed for assets used by single user (or group of users) with indexed value &gt;\$20m (cl 6A.6.3(c)).</p>	<p>No equivalent provision in distribution rules</p>	<p><b>Difference:</b> Distribution rules do not contain a provision requiring assets used by a single user and valued at &gt;\$20m to be depreciated on a straight line basis. This provision has been adopted in the transmission rules to support the provision in the rules to allow for the removal from the RAB of assets subject to commercial stranding. If there is no equivalent provision in relation to commercial stranding in the distribution rules, the provision in relation to straight line depreciation</p>

				is also not required.
6	WACC parameters	Single values set in Rules and reviewed by AER every five years. (cl 6A.6.2 and 6A.6.4))	Initially set at discretion of AER for each DNSP (reflecting an efficient service provider operating in the same environment as the regulated business)	<b>Difference:</b> For transmission WACC parameters are set in the rules; for distribution AER has discretion to determine WACC parameters. To date, there has been consistency in WACC parameter values in regulatory decisions for TNSPs but not for DNSPs across jurisdictions.  The AER review of transmission parameters will also look at distribution parameters to see if a single set of values can be locked in for distribution.
7	Cost pass-through	Cost pass-through allowed in defined circumstances: Network support pass-through (cl 6A.7.2) and defined events (cl 6A.7.3) Process for cost pass-through defined in Rules.	Events can be defined in determinations or otherwise at discretion of AER subject to principles in the Rules.  Some key pass through events defined in the Rules.  Process for cost pass-through defined in Rules.	<b>Difference:</b> For transmission, eligible cost pass-through events are defined in the Rules. For distribution they are to be determined by the AER, subject to principles in the Rules and some key events.  There is no justification in terms of differences in the underlying characteristics of distribution for the rules to differ from those for transmission. However, there has not been a consistent approach by jurisdictional regulators to defining pass-through events for distribution. In transmission there has been consistency, which allows for codification. The distribution rule allows consistency to evolve through AER determinations, which ultimately may be codified in Rules.
8	Contingent projects	Amend determination when contingent projects are triggered	No equivalent provision in distribution Rules.	<b>Difference:</b> No contingent project regime in distribution

		(cl 6A.8.2). Available for investment projects for which timing of expenditure is uncertain at the time of the determination (identified by TNSP at time of determination and determined by the AER).		rules. Transmission capex can be lumpy and strongly influenced by individual projects, which may suffer a range of external impacts on timing and scope. Distribution capex is more predictable through demand trends. Uncertain distribution projects may be accommodated by pass-through.
9	Re-opening of determination	Revoke and substitute a determination where capital expenditure incurred to overcome an unforeseen event. (cl 6A.7.1)	No equivalent provision in distribution Rules.	<b>Difference:</b> No re-opening regime for unexpected capex in distribution rules. Distribution capex is less likely than transmission capex to be lumpy and strongly influenced by individual events.
10	Service performance incentives	AER to develop transmission service performance standards scheme, subject to principles in the Rules. (cl 6A.7.4(a)) Scheme focused on reliability and spot price outcomes). (cl 6A.7.4(b)(1)) Revenue at risk set at 5% of maximum allowable revenue. (cl 6A.7.4(b)(3))	AER to develop distribution service performance standards scheme, subject to principles in the Rules. Scheme focused on: network service performance standards; and network customer service performance standards AER to set revenue at risk.	<b>Differences:</b> (1) Focus of each service scheme is on different elements. (2) AER to determine revenue at risk for distribution, rather than this being set in the Rules. Network customer service performance standards for distribution form part of the customer protection regime for end-use customers and reflect a difference in operating environment between transmission and distribution. This is reflected in the role of States and Territories in setting service reliability standards under the AEMA. Distributors businesses vary in terms of cost of meeting service standards vs revenue/cost of incentives and willingness to pay of customers. Policy outcome is best achieved by leaving discretion with AER, rather than prescribing revenue at risk in distribution Rules.

				Outages in distribution do not generally impact on wholesale price in the way that transmission outages can.
11	Arbitrator under negotiate/arbitrate	Commercial arbitrator appointed by AER, from nominations by TNSP and applicant. (cl 6A.30)	Commercial arbitration available. Ombudsman or AER as binding arbitrator.	<b>Difference:</b> The arbitrator for disputes is a commercial arbitrator for transmission but the AER or ombudsman for distribution. Many distribution customers likely to be of a smaller scale, making the cost and process of commercial arbitration prohibitive.
12	Regulatory procedure	Lodge revenue proposal with AER <b>13</b> months prior to next reset period. (cl 6A.10.1(a)(1)).	Lodge revenue proposal with AER <b>18</b> months prior to next reset period.	<b>Difference:</b> Time frame allowed for distribution is 18 months; for transmission is it 13 months. Transitional issues to be addressed in regulation those distribution services outside of the main building block control may make a longer timeframe appropriate for distribution. Consistency in the timeframes between distribution and transmission is not of prime importance.