

Australian Energy Market Commission

RULE DETERMINATION

**National Electricity Amendment (Participant
derogation - NSW DNSPs revenue smoothing)
Rule 2017**

Rule Proponents

Ausgrid
Endeavour Energy
Essential Energy

1 August 2017

**RULE
CHANGE**

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About the AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

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Summary

The Australian Energy Market Commission (Commission) has made a final rule in response to a joint request for a participant derogation from Ausgrid, Endeavour Energy and Essential Energy (NSW DNSPs). The rule change request has sought to minimise price volatility for NSW DNSP customers that may occur as a result of the outcome of the judicial review proceedings in relation to the NSW DNSPs' 2014-19 distribution determinations.¹

The final rule, which is a more preferable rule, provides a process that allows for any increased or decreased revenue as a result of the remaking of the distribution determinations for the current regulatory control period to be recovered over the current regulatory control period² and the subsequent regulatory control period³ or just the subsequent regulatory control period (as the case may be). The process provides a mechanism that:

- minimises price volatility for consumers that may occur as a result of the remaking of the distribution determinations for the current regulatory control period
- allows the proponents to recover the revenue that they are entitled to for the current regulatory control period in the subsequent regulatory control period should circumstance prevent them from doing so in the current regulatory period.

Overview of the final rule

The final rule incorporates elements of the proposed rule, and is designed to achieve the same outcome of minimising price volatility for NSW DNSP customers. The key features of the final rule are:

- The final rule allows the proponents to recover any increased or decreased revenue as a result of the remaking of the distribution determinations for the current regulatory control period over the current regulatory control period and/or the subsequent regulatory control period. The final rule is designed to allow each proponent to recover only the revenue that it is entitled to recover. Compared to the draft rule, the final rule incorporates a revenue recovery principle to clarify that the revenue adjustment determination made by the

¹ The NSW DNSPs applied to the Australian Competition Tribunal (Tribunal) for merits review of the 2014-19 distribution determinations under s.71B of the NEL. On 26 February 2016, the Tribunal set aside the determinations and remitted them to the AER. The Federal Court handed down its decision on 24 May 2017 and made orders on 4 July 2017. See section 1.2.2 for further details regarding the judicial review proceedings.

² This is the period between 1 July 2014 to 30 June 2019

³ This period will start on 1 July 2019. The length of the regulatory control period will be determined as part of the AER's distribution determination. The AER is currently consulting on the framework and approach for this distribution determination

Australian Energy Regulator (AER) should provide the proponents with the ability to recover the same revenue (in net present value equivalent⁴ terms), but no more than as they would have, had the remade 2015 determination been in place from the commencement of the current regulatory period, and had all the control mechanisms specified in the remade 2015 determination been implemented in each relevant regulatory year.

- The final rule provides the AER with the discretion to determine whether any revenue adjustments should be made in order to smooth revenue across the current regulatory control period and the subsequent regulatory control period, including the allocation of amounts between the two periods.
- The AER is required to make a decision in relation to revenue adjustments and revenue smoothing that is separate from any distribution determination. The decision will be given effect through the pricing proposal and distribution determination processes. The AER's determination on revenue smoothing will not affect the remaking of the 2015 distribution determination, or the terms of the subsequent distribution determination (other than to include the variation amounts).

The main differences between the proponents' proposed rule and the final rule are as follows:

- The final rule gives the AER greater discretion to decide how any revenue adjustments are made.
- The final rule distinguishes more clearly between the processes that need to apply based on the timeframe for the remaking of the distribution determinations for the current regulatory control period.

The final rule also sets out a process to be followed if the AER is required to reopen the distribution determination for the subsequent regulatory control period. This would be required if the outcome of the judicial review proceedings is not known in time to be incorporated when the distribution determination for the subsequent regulatory control period is issued.

⁴ The 'net present value equivalent' concept in the revenue recovery principle is used to compare the present value of two cash flow scenarios as the relevant DNSP will be recovering the revenue it is entitled to in a timeframe that is different to that where the remade determination had been in place from the commencement of the current regulatory control period. The use of the term "net present value" is consistent with its use elsewhere in Chapter 6 of the NER. For example, clause 6.5.9(b)(3) applies the same concept in relation to the determination of the X factor.

Reasons for the Commission's final determination

The Commission considers that the final rule is in the long term interest of consumers, because it provides stable prices for consumers, outlines a mechanism that best minimises price volatility and enables NSW DNSPs to recover the efficient costs of providing network services.

Providing stable prices

The need for this rule is brought about by a set of circumstances that the National Electricity Rules do not contemplate. Significant price volatility in a short period of time has the potential to distort consumers' budgetary decisions on energy spending, as well as investment decisions on energy usage. This distortion could lead to long term inefficient outcomes for consumers.

A process that smooths any revenue increase or decrease as a result of the outcome of the judicial review proceedings is likely to lead to more stable prices, which would allow consumers to make better informed decisions. The Commission considers that this is in the long term interests of consumers.

Outlining a mechanism that best minimises price volatility

The Commission considers that the final rule is better able to minimise price volatility than the proposed rule. The final rule avoids prescribing an adjustment process that may not be flexible enough in responding to uncertain outcomes from the judicial review proceedings.

The Commission considers that the AER, in consultation with the proponents and other relevant stakeholders, is in the best position to make informed decisions as to how to smooth revenue across two regulatory control periods to minimise price volatility. The final rule provides the AER with the discretion to make these decisions in accordance with a set of requirements on net present value neutrality and consultation with the proponents and stakeholders the AER considers relevant.

Enabling NSW DNSPs to recover the efficient costs of providing network services

As the processes for remaking the distribution determinations for the current regulatory control period may not be finalised until after the current regulatory control period ends, a NSW DNSP may not have the opportunity to recover the revenue it is entitled to in the current regulatory period.

The final rule provides a mechanism that allows the AER to include revenue adjustments in the subsequent regulatory control period so that a NSW DNSP is provided with a reasonable opportunity to recover the efficient costs of providing network services during the current regulatory control period and subsequent regulatory control period.

The need to provide an opportunity to the NSW DNSPs to recover their efficient costs is further clarified by the inclusion of the revenue recovery principle in the final rule. The revenue recovery principle states:

“... that the NSW DNSP must be given the ability to recover the same, but no more, revenue (in net present value equivalent terms) as it would have recovered if:

- (a) the remade 2015 determination had been in force from the commencement of the current regulatory control period; and
- (b) the formulae giving effect to the control mechanisms specified in the remade 2015 determination had been applied in each regulatory year of the current regulatory period.”

Related rule change

ActewAGL, the distribution network service provider for the Australian Capital Territory, submitted a rule change request seeking a participant derogation to provide a mechanism to similarly minimise price volatility for customers in the Australian Capital Territory. The final determination in relation to ActewAGL’s rule change request was published on the same date as this determination, and is available on the Commission’s website⁵.

⁵ www.aemc.gov.au/Rule-changes/Participant-derogation-ACT-DNSP-Revenue-Smoothing

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1 Rule change request and rule making process

1.1 The rule change request

On 18 July 2016, the New South Wales distribution network service providers Ausgrid, Endeavour Energy and Essential Energy (NSW DNSPs) submitted a joint rule change request to the Australian Energy Market Commission (Commission) seeking a participant derogation to amend the National Electricity Rules (NER)⁶. The rule change request has sought to provide a mechanism to minimise price volatility for NSW DNSP customers that may occur at the conclusion of the judicial review proceedings in relation to the NSW DNSPs 2014-19 distribution determinations.⁷ The rule change request proposes to allow any required adjustments to the NSW DNSPs' revenues for the 2014-19 regulatory control period to be recovered over two regulatory control periods.

ActewAGL, the distribution network service provider for the Australian Capital Territory, submitted a rule change request seeking a participant derogation to provide a mechanism to similarly minimise price volatility for customers in the Australian Capital Territory on 23 September 2016. The final determination in relation to ActewAGL's rule change request was published on the same date as this final determination and is available on the Commission's website.⁸

1.2 Current arrangements and relevant background

1.2.1 Regulation of distribution network service provider revenue

As monopoly service providers, the revenue of distribution network service providers, such as the NSW DNSPs, is regulated by the Australian Energy Regulator (AER). The AER regulates the distribution network service provider's revenue through the making of distribution determinations.⁹ A distribution determination covers a regulatory control period, which is usually a five year period.

⁶ A participant derogation is a rule made at the request of a person who is conferred a right, or is subject to an obligation, under the NER that exempts that person or a class of person of which that person is a member, from complying with a provision of the NER; or modifies or varies the application of a provision of the NER to that person or that class of person. Refer to section 91(5) of the NEL.

⁷ The NSW DNSPs applied to the Australian Competition Tribunal (Tribunal) for merits review of the 2014-19 distribution determinations under s.71B of the NEL. On 26 February 2016, the Tribunal set aside the determinations and remitted them to the AER. The AER subsequently sought judicial review in the Full Federal Court of the Tribunal's decision.

⁸ www.aemc.gov.au/Rule-changes/Participant-derogation-ACT-DNSP-Revenue-Smoothing.

⁹ The AER's duty to make distribution determinations is set out in clause 6.2.4 of the NER.

A distribution determination is a 'reviewable regulatory decision' under the National Electricity Law (NEL).¹⁰ Parties that are affected¹¹ by the AER's distribution determination can apply to the Australian Competition Tribunal (Tribunal) for a review of the decision under the limited merits review framework in Division 3A of the NEL. In general terms, the applicant must demonstrate an error of fact, incorrect exercise of discretion, or unreasonableness by the AER in respect of the distribution determination.¹² In addition, the applicant must demonstrate why the Tribunal varying or setting aside that decision on the basis of one or more of those grounds would, or is likely to, result in a decision that is materially preferable to the existing decision in terms of making a contribution to the achievement of the national electricity objective (NEO). If the affected party or the AER¹³ is not satisfied with the decision of the Tribunal, it may apply to the Federal Court of Australia for judicial review of the Tribunal's decision.

1.2.2 Distribution determinations and undertakings relevant to this rule change request

Status of determinations and reviews

The AER made the final distribution determinations relevant to the rule change request in April 2015. These distribution determinations are referred to as the 2015 determinations by the NSW DNSPs in their rule change request and they cover the period from 1 July 2015 to 30 June 2019.¹⁴

¹⁰ Refer to section 71A of the NEL.

¹¹ Section 71A of the NEL provides the definition of 'affected or interested person or body' for the purposes of a reviewable regulatory decision. The definition includes: the network service provider to which the decision applies; a network service provider, network service user, prospective network service user or end user whose commercial interest are materially affected by the decision; a user or consumer association; and a reviewable regulatory decision process participant (e.g. stakeholders who have provided submission to the determination process).

¹² The grounds for review available under the limited merits review framework are: (a) the AER made an error (or more than one error) of fact in its findings and that error of fact (or, if more than one error, those errors in combination) was material to the making of the decision; (b) the exercise of the AER's discretion was incorrect, having regard to all the circumstances; (c) the AER's decision was unreasonable, having regard to all the circumstances. Refer to s. 71C of the NEL.

¹³ Or a person who is aggrieved by the decision.

¹⁴ There are two distribution determinations covering the 2014-19 period. The first covers the 'transitional regulatory control period' of 2014-15 and the second covers the 'subsequent regulatory control period' (being the 2015-19 period, as defined under rule 11.55) and was required to be made in certain respects as if the 'subsequent regulatory control period' included the transitional regulatory control period as the first regulatory year of that 'subsequent regulatory control period' - see clause 11.56.4(c). The requirement to have two distribution determinations for the 2014-19 period is set out in Part ZW, Division 2 of Chapter 11. This is to allow the AER and DNSPs to transition to changes made to Chapter 6 of the NER under the Commission's 2012 rule change on the economic regulation of network service providers. The 2015 distribution determinations as referred to by the proponents are the distribution determinations covering the 2014-19 period. Refer to s. 71A of the NEL.

The NSW DNSPs applied for merits review of the AER's final determinations in May 2015. The Australian Competition Tribunal (Tribunal) made its decision on 26 February 2016 to set aside the AER's decisions.¹⁵ The Tribunal's decision required the AER to remake its final determination in accordance with the Tribunal's directions. Subsequent to the Tribunal's decision, the AER applied to the Federal Court for judicial review of the Tribunal's decision.

On 24 May 2017, the Federal Court handed down its decision on the AER's application for judicial review of the Tribunal's decisions for Ausgrid, Endeavour Energy, Essential Energy and ActewAGL. The Federal Court dismissed the AER's application on most points including operating expenditure and return on debt, but upheld their application on the value of imputation credits (gamma).¹⁶ The consequence of the Federal Court orders made on 4 July 2017 is that the AER will be required to remake the 2015 determinations.

Undertakings provided to the AER by the NSW DNSPs

In May 2016, the NSW DNSPs gave undertakings¹⁷ to the AER under section 59A of the NEL that set out how network prices will be determined in 2016/17. The NSW DNSPs have now provided undertakings to the AER for 2017/18 network prices.

The undertakings mean that the revenues recovered by the proponents during 2016/17 and 2017/18 are likely to be different from the amounts that they are entitled to recover once the processes of remaking the distribution determinations for the current regulatory control period are completed.

¹⁵ The application for review made by the NSW DNSPs and ActewAGL were heard together by the Tribunal.

¹⁶ Refer to [2017] FCAFC 79; [2017] FCAFC 80.

¹⁷ The Ausgrid and Endeavour Energy undertakings provide for the 2016/17 NUOS charges to be set as 2015/16 approved prices adjusted to include changes in consumer price index in 2015/16. Essential Energy undertook to comply with the 2015 distribution determination when setting prices for 2016/17.

1.3 Issues the rule change request seeks to address

1.3.1 Potential for significant price volatility in the absence of a rule change

The NSW DNSPs submit that when the processes of remaking distribution determinations for the current regulatory control period are completed, NSW DNSP customers may experience a price shock in the final year of the current regulatory control period¹⁸ in the absence of a rule change.

The reasons for this potential price shock are explained below. In summary, the NSW DNSPs consider that under current NER provisions, it is likely that the remaking of distribution determinations for the current regulatory control period will result in customers facing either one of the following:

- large price increase in 2018/19, followed by a large price decrease in 2019/20; or
- large price decrease in 2018/19, followed by a large price increase in 2019/20.

The NSW DNSPs consider that either of these outcomes is not in the long term interests of consumers. The NSW DNSPs consider that it is preferable to instead smooth out any price increase or decrease over a longer period.

The rule change request further explains this issue under two possible outcomes of the judicial review proceedings – the AER is required to remake the 2015 determinations or the AER is not required to remake the 2015 determinations.¹⁹ As the judicial review proceedings were concluded before the final rule determination publication, this section will only discuss the outcome where the AER is required to remake the 2015 determinations.

Under the current rules, any adjustment to total revenue requirements as a result of the AER's remaking of the 2015 distribution determination must be recovered within the regulatory control period.²⁰ As it is unlikely that the remade 2015 distribution determinations will be in place prior to the fifth year of the current regulatory control period,²¹ any adjustment to total revenue requirements would need to be fully recovered in the 2018/19 regulatory year. This is likely to lead to significant network

¹⁸ The rule change request defines the current regulatory control period as the period between 1 July 2014 and 30 June 2019. Refer to Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p.36.

¹⁹ Refer to Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p. 5.

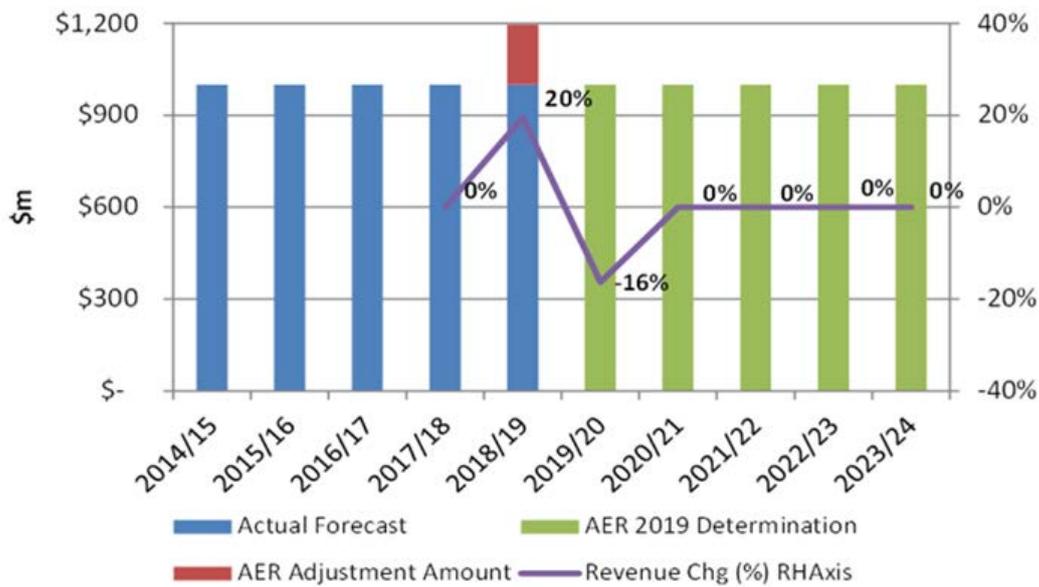
²⁰ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p. 2.

²¹ The fifth year is the final year of the 2014-19 regulatory control period.

price volatility. The NSW DNSPs submit that in the absence of a rule change, it is unclear whether the significant price volatility that results from the change in the revenue requirement can be managed by spreading the revenue impact over a longer period.²²

Figure 1.1 illustrates the potential for a price shock in the absence of a rule change. In this figure, the NSW DNSPs indicate the potential revenue change that would have a direct flow on effect to 2018/19 prices.

Figure 1.1 Potential for price shock without a rule change



Source: Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p.6

1.3.2 NER does not address the issue

The rule change request states that the NER does not contemplate the implications of extended judicial review proceedings on the recovery of revenue within and between regulatory control periods.²³ Two clauses were identified as limiting the NSW DNSPs' ability to reduce price volatility by allowing adjustments to revenue to be recovered over two regulatory control periods. These clauses are:

²² Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p. 2

²³ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p. 25

- **Clause 6.5.9 - The X factor.** The X factor is set by the AER for each regulatory year to determine a smooth price path over a regulatory control period. Clause 6.5.9 requires X factors to be set so that the total revenue requirement for a distribution network service provider for a regulatory control period is recovered within that regulatory control period. The NSW DNSPs contend that under the scenarios discussed in section 1.3.1 above, the AER would be required to set the X factor for the final year of the current regulatory control period such that the total revenue requirement for the DNSPs falls under their respective revenue caps and this would cause significant price volatility.²⁴
- **Clause 6.4.3 - Building block approach.** While this clause allows revenue increments and decrements from the previous regulatory control period to be included in the revenue building blocks of a subsequent regulatory control period, the NSW DNSPs contend that such inclusion is limited to amounts arising from the operation of a control mechanism in the previous regulatory control period. The proponents also consider that it is not clear whether this clause applies to the recovery of revenue adjustments that result from judicial review proceedings.²⁵

1.4 Solution proposed in the rule change request

The NSW DNSPs have sought to resolve the issues discussed above by proposing a rule that allows them to recover any increase in their annual revenue requirements for the current regulatory control period over two regulatory control periods.²⁶

The proponents consider that the proposed rule would:

- allow the proponents to recover the revenue that they are entitled to recover, by providing a reasonable opportunity to recover at least their efficient costs (as determined by the AER)
- avoid price shocks for consumers
- increase regulatory certainty
- enable efficient investment in and efficient use of electricity services.

The proponents outlined the following process for revenue recovery in the rule change request, under the assumption that the AER will remake the distribution

²⁴ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p. 5

²⁵ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p. 2, pp. 24-25.

²⁶ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, pp. 26-30

determinations for the current regulatory control period as a result of the judicial review proceedings:²⁷

- determine the “adjustment amount”, which the proponents defined as the change in the sum of the annual revenue requirements approved by the AER in the remade 2015 distribution determinations compared to the sum of the annual revenue requirements approved by the AER in the original 2015 distribution determination for the current regulatory control period²⁸
- determine the adjustment allocation between regulatory control periods based on recovering a default 20 per cent of the adjustment in the final year of the current regulatory control period (2018/19) and the remaining 80 per cent to be smoothed over the subsequent regulatory control period
- make any required adjustments in the current regulatory control period through the annual pricing proposal process for 2018/19
- make any required adjustments in the subsequent regulatory control period through the building block process
- apply a specified formula to make the adjustment equivalent in net present value terms²⁹
- make a separate “adjustment amount allocation determination” at the time of remaking the 2015 distribution determination that sets out the various decisions that the AER needs to make to implement the above approach.

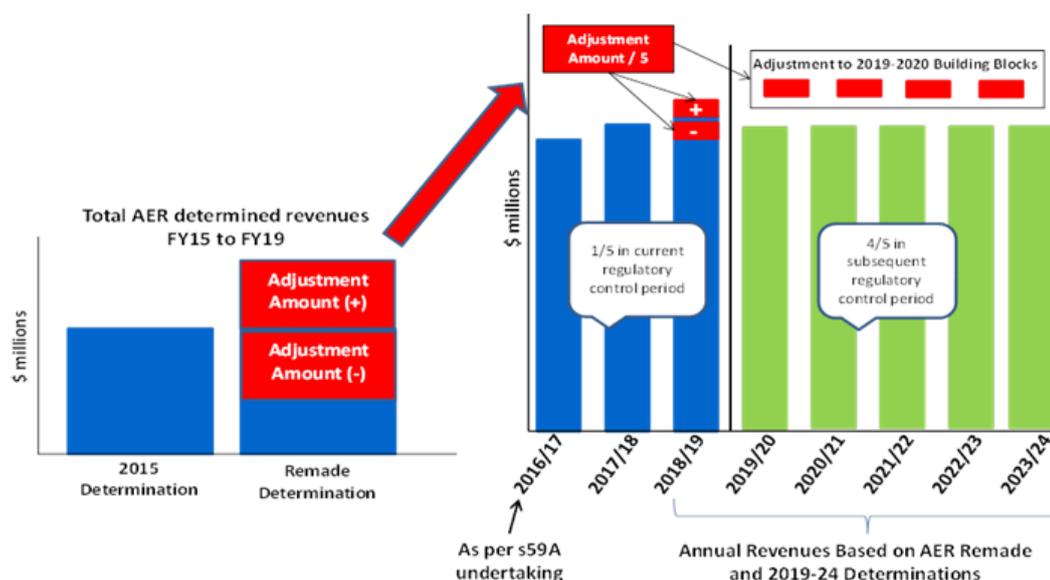
The below figure illustrates the mechanism that was proposed by the NSW DNSPs in the rule change request.

²⁷ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, pp. 8-18

²⁸ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, Figure 4

²⁹ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, pp. 12-13

Figure 1.2 NSW DNSPs Calculation of Adjustment Amount



Source: Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, Figure 5

The proponents considered that the proposed participant derogation would be included in Chapter 8A of the NER.

1.5 Draft rule determination

The Commission's draft rule determination was to make a more preferable draft rule, under which the AER may determine that the revenue that a NSW DNSP is entitled to recover in the current regulatory control period as a result of the judicial review proceedings be recovered over the current regulatory control period and/or the subsequent regulatory control period.

The draft rule provided the AER with the discretion to determine whether any revenue adjustments should be made in order to smooth revenue across the current regulatory control period and the subsequent regulatory control period, including the allocation of amounts between the two periods. The draft rule required the AER to prepare and issue an adjustment determination that is separate to the remade 2015 determination. The adjustment determination would then be given effect through the pricing proposal and/or distribution determination processes.

1.6 The rule making process

On 17 November 2016, the Commission published a notice advising of its commencement of the rule making process and consultation in respect of the rule change request.³⁰ The Commission also published a consultation paper (first round consultation) that identified specific issues for consultation. Submissions on the consultation paper closed on 15 December 2016. The Commission received seven submissions as part of the first round of consultation.

On 9 February 2017, the Commission extended the deadline for the draft determination to 27 April 2017.

The Commission published a draft rule determination on 26 April 2017. The draft rule determination considered all the issues that were raised by stakeholders in submissions during the first round of consultation. Submissions on the draft rule determination (second round consultation) closed on 20 June 2017. The Commission received nine submissions as part of the second round of consultation.

On 1 August 2017, the Commission published this final rule determination. The final rule determination has considered all the issues that have been raised by stakeholders in submissions during the first and second rounds of consultation.

³⁰ This notice was published under section 95 of the NEL.

2 Final rule determination

2.1 The Commission's final rule determination

The Commission's final rule determination is to make a more preferable final rule (final rule), under which the AER:

- may, in certain circumstances, determine that the revenue that a NSW DNSP is entitled to recover in the current regulatory control period as a result of the remaking³¹ of its distribution determination for the current regulatory control period, be able to be recovered over the current regulatory control period and the subsequent regulatory control period in a way that minimises price volatility for consumers³²
- must, in certain circumstances, determine that the revenue that a NSW DNSP is entitled to recover for the current regulatory control period as a result of the remaking of its distribution determination for the current regulatory control period, but which it has not been able to recover during that period, be able to be recovered in the subsequent regulatory control period.³³

In all circumstances, the AER is required to publish a determination (referred to in this determination and the final rule as the adjustment determination) outlining its decision. The adjustment determination is a separate decision to, but published at the same time as, a NSW DNSP's remade 2015 distribution determination.

The final rule will commence operation on 15 August 2017.

The Commission's reasons for making this final determination are set out in Chapter 3.

This chapter outlines:

- the rule making test for changes to the NER and Commission's consideration of the final rule against the national electricity objective (NEO)
- the assessment framework used by the Commission when considering the rule change request
- the Commission's consideration of the final rule against its strategic priorities.

³¹ The requirement for the AER to remake the distribution determinations for NSW DNSPs is as a result of the conclusion of the judicial review proceedings. See section 1.2.2 for further explanation of the judicial review proceedings and brief summary of the outcome.

³² Section 4.4 of this final determination provides further details on the circumstances under which the AER may determine the allocation of revenue across the two regulatory control periods.

³³ Sections 4.5 and 4.6 of this final determination provide further details on the circumstances in which a revenue increment or decrement is made in respect of the subsequent regulatory control period.

2.2 Rule making test

2.2.1 The national electricity objective (NEO)

Under the NEL, the Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO.³⁴ This is the decision making framework that the Commission must apply.

The NEO is:³⁵

“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 Commission considers that the most relevant aspects of the NEO are the efficient operation and use of electricity services with respect to the price of electricity.

2.2.2 Revenue and pricing principles

In addition to having regard to the NEO, the Commission must take into account the revenue and pricing principles in making a rule with respect to (among other things) the regulation of revenue earned, or that may be earned, by DNSPs from provision of services that are the subject of a distribution determination.³⁶

2.3 Assessment framework

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

- **Is reducing price volatility in the long term interests of consumers?**

A significant revenue adjustment could result from the remaking of the proponents’ distribution determinations for the current regulatory control period. This may lead to consumers experiencing a large network price increase or decrease between 2018/19 and 2019/20.³⁷ This price volatility may lead some consumers to make inefficient budgetary decisions on energy spending, or

³⁴ Refer to section 88 of the NEL.

³⁵ Refer to section 7 of the NEL.

³⁶ Refer to section 88B and Items 25-26J of Schedule 1 of the NEL. The revenue and pricing principles are set out in section 7A of the NEL.

inefficient investment decisions on the use of electricity services. The Commission has considered whether minimising price volatility would be in the long term interests of consumers in this case.

- **If so, what is the best method to minimise price volatility?**

If minimising price volatility is in the long term interests of consumers, the Commission has assessed the best method to achieve minimisation of price volatility.

- **Is enabling the proponents to recover the revenue that they are entitled to recover aligned with the revenue and pricing principles?**

The Commission has considered, in particular, whether the final rule is consistent with the following revenue and pricing principles³⁸:

- A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs of providing direct control service.
- A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to its direct control services.
- A price or charge for the provision of a direct control service should allow for a return commensurate with the regulatory and commercial risks involved in providing the service to which that price or charge relates.

2.4 Summary of reasons for making a more preferable final rule

2.4.1 Key features of the final rule

Having considered the rule change request against the assessment framework set out in section 2.3 and having considered the NEO and revenue and pricing principles, the Commission decided to make a final rule. The Commission has also made changes between the draft and final rules after considering submissions from stakeholders on the draft rule. The final rule is published with this final determination.

The key features of the final rule are:

- The final rule allows the proponents to recover any increased or decreased revenue for the current regulatory control period as a result of the remaking of the distribution determination. The final rule incorporates a revenue recovery principle to make clear that:

³⁷ 2018/19 is the final year in the current regulatory control period and 2019/20 is the first year of the next regulatory control period.

³⁸ Refer to section 7A of the NEL

“...the NSW DNSP must be given the ability to recover the same, but no more, revenue (in net present value equivalent terms³⁹) as it would have recovered if:

- (a) the remade 2015 determination had been in force from the commencement of the current regulatory control period; and
- (b) the formulae giving effect to the control mechanisms specified in the remade 2015 determination had been applied in each regulatory year of the current regulatory period.”⁴⁰

- The final rule provides the AER with the discretion to determine whether any revenue adjustments should be made in the current regulatory control period in order to smooth revenue across the current regulatory control period and the subsequent regulatory control period⁴¹, including the allocation of amounts between those two periods.
- The final rule requires the AER to make certain revenue adjustments to a proponent’s distribution determination for the subsequent regulatory control period in circumstances where that DNSP has been unable to recover the revenue they are entitled to recover under the remade 2015 distribution determination during the current regulatory control period.⁴²
- The AER’s adjustment determination of revenue adjustments under the final rule occurs separately from the making of a proponent’s distribution determination. The AER’s adjustment determination is given effect through the pricing proposal and/or distribution determination processes and will not affect the remaking of the 2015 distribution determination.

The Commission is satisfied that the final rule will, or is likely to, contribute to the achievement of the NEO. The Commission’s reasons for making this rule are briefly discussed in section 2.4.4 below. Chapter 3 of this determination provides a more in depth discussion of the Commission’s reasons.

³⁹ The ‘net present value equivalent’ concept in the revenue recovery principle is used to compare the present value of two cash flow scenarios as the relevant DNSP will be recovering the revenue it is entitled to in a timeframe that is different to that where the remade determination had been in place from the commencement of the current regulatory control period. The use of the term “net present value” is consistent with its use elsewhere in Chapter 6 of the NER. For example, clause 6.5.9(b)(3) applies the same concept in relation to the determination of the X factor.

⁴⁰ Refer to clause 8A.14.1 of the final rule.

⁴¹ This is applicable where the timeframe for remaking the distribution determination for the current regulatory control period provides the opportunity for revenue adjustment to be smoothed across two regulatory control periods. See clause 8A.14.4 of the final rule.

⁴² This is applicable where the timeframe for remaking the distribution determination for the current regulatory control period does not provide the opportunity for revenue adjustments to be smoothed across two regulatory control periods. See clause 8A.14.5 and 8A.14.6 of the final rule.

2.4.2 How the final rule compares with the proposed rule

Under section 91A of the NEL, the Commission may make a rule that is different (including materially different) from a proposed rule if it is satisfied that, having regard to the issues raised by the rule change request, the more preferable rule will, or is likely to, better contribute to the achievement of the NEO than the proposed rule.

The Commission is satisfied that the final rule, which is a more preferable rule, will, or is likely to, better contribute to the achievement of the NEO than the proposed rule for the following reasons:

- The final rule incorporates elements of the NSW DNSPs' proposed rule and is designed to achieve the same outcome of minimising price volatility for consumers. The main difference between the proposed rule and the final rule is that the final rule gives the AER greater discretion to decide whether smoothing should occur between the current regulatory control period and the subsequent regulatory control period. If a NSW DNSP's 2015 determination is remade prior to 1 March 2018 and the AER decides to smooth revenue across regulatory control periods, the final rule provides the AER with a level of discretion in determining the amount of revenue to allocate across the two periods. The final rule also sets out a process to be followed if the AER is required to reopen the subsequent distribution determination to incorporate adjustment to revenue for that period.⁴³
- The final rule also more clearly distinguishes between the different revenue adjustment processes that need to apply depending on when the distribution determinations for the current regulatory control period are remade.

2.4.3 How the final rule compares with the draft rule

The draft rule provided for the possibility of the Tribunal affirming or varying the AER's distribution determinations for the current regulatory control period. These provisions regarding the potential affirming or variation by the Tribunal are now no longer required as a result of the decision of the Full Federal Court of Australia in respect of the judicial review of the Tribunal's decision.⁴⁴ The deadline for filing an application with the High Court had now passed and no party to the proceedings has sought leave to the High Court to appeal the Federal Court's orders. Therefore, the provisions relating to the Tribunal affirming or varying the AER's 2015 determination have been removed in the final rule.⁴⁵

⁴³ This is the distribution determination of the subsequent regulatory control period.

⁴⁴ In matters NSD415/2016 (regarding Ausgrid), NSD 416/2016 (regarding Essential Energy) and NSD 418/2016 (regarding Endeavour Energy). Orders were made by the Federal Court in respect of these proceedings on 4 July 2017.

⁴⁵ In the AER's submission to the draft determination, the AER stated that as a result of the Full Federal Court's decision, the issue of whether the AER is required to remake the 2015 determinations is no longer a matter of speculation and that the AER will remake the 2015 determination. See page 5 of attachment C of the AER's submission to the draft determination.

The Commission has considered the proponents' and other stakeholders' submission to the draft rule. The final rule includes changes as a result of some of the issues raised in the submissions. The main differences between the two are as follows:

- **The final rule incorporates a revenue recovery principle** as discussed in section 2.4.1. The Commission has included the principle to make it clear that the AER has the ability under the final rule to make any necessary variations to the calculation of revenue adjustments under the final rule to allow the relevant NSW DNSP to recover the revenue it would have been entitled to recover during the current regulatory control period under the remade determination.
- **The final rule includes new provisions for the recovery of transmission revenue adjustments in the subsequent regulatory control period for the relevant NSW DNSP with transmission⁴⁶ assets (Ausgrid).** These provisions apply if the remade distribution determinations for the current regulatory control period are made after the pricing proposals for the final year of the current regulatory control period (specifically, made on or after 1 March 2018). The rule treats these revenue adjustments separately from adjustments to revenue for distribution standard control services.
- **The final rule incorporates certain revised definitions and terms** to address stakeholders' concerns about ambiguities in relation to some terminology.
- **The final rule incorporates revised timeframes** in line with the AER's submission on the timing of the remaking of the 2015 determinations and the timing on the AER's determination on the subsequent regulatory control period following the outcome of the judicial review proceedings.
- **The final rule updates the provisions that operate to exclude the application of certain provisions in Chapter 6 of the NER** to allow such exclusions to operate in respect of both the current and subsequent regulatory control period, where necessary.⁴⁷

⁴⁶ See clauses 8A.14.5 and 8A.14.6 of the final rule.

⁴⁷ See clause 8A.14.8 of the final rule.

2.4.4 Key reasons for this decision

This section outlines the reasons for the Commission's decision.

Reducing price volatility

The Commission considers that the smoothing of any increase or decrease in revenue across two regulatory control periods will minimise price volatility in certain circumstances. The Commission also considers that the minimisation of price volatility is in the long term interest of consumers.

In the absence of a rule change, prices could:

- rise significantly in the final year of the current regulatory control period followed by a sharp decrease in the first year of the subsequent regulatory control period; or
- fall significantly in the final year of the current regulatory control period followed by a sharp increase in the first year of the subsequent regulatory control period.⁴⁸

Under these circumstances, consumers may incorrectly make the assumption that the price increase/decrease in the final year of the current regulatory control period will continue and act accordingly. The assumption may lead consumers to inefficient long term outcomes:

- consumers may spend more or less money on electricity with inefficient long term budgetary outcomes; and/or
- make/refrain from making investments in alternative energy sources or technologies based on a temporary price rise/drop.

The Commission considers that stable prices allow consumers to make informed decisions as to their energy spending and usage. If revenue recovery occurs over a longer period and the adjusted revenue is smoothed over two regulatory control periods, prices would be more stable. The Commission considers that, in this case, the benefits of smoothing revenue across two regulatory control periods outweigh any costs of revenue recovery over a longer period.

⁴⁸ Price trajectory would depend on the remade distribution determination for the current regulatory control period, and the distribution determination for the subsequent regulatory control period.

Method of minimisation

The Commission considers that the final rule is better able to minimise price volatility than the proposed rule for the following reasons:

- The proponents set out a detailed revenue smoothing mechanism in their rule change request. However, as the timeframe for the remaking of distribution determinations for the current regulatory control period is uncertain, a variety of potential scenarios could eventuate. Therefore, the Commission considers that the use of a prescriptive mechanism (which provides for certain default allocations in smoothing revenue), as outlined in the proposed rule, is unlikely to provide sufficient flexibility to provide an efficient outcome for consumers.
- The Commission considers that the AER, in consultation with the proponents and other relevant stakeholders, is in the best position to make informed decisions as to whether and how to smooth revenue across regulatory control periods to minimise price volatility. The final rule provides the AER with the discretion to make these decisions in accordance with the requirements of the final rule:
 - The AER's determination of whether, and how, to smooth (referred to under the final rule as the 'adjustment determination') needs to take into account the revenue recovery principle so that the relevant DNSP has the ability to recover the same revenue (in net present value equivalent terms), but no more, than it would have had if the remade 2015 determination had been in place from the commencement of the current regulatory period, and had all control mechanisms specified in the remade 2015 determination been implemented in each relevant regulatory year.
 - The AER's determination on the discount rate used when calculating net present value. This discretion is consistent with the approach in other parts of chapter 6 (such as clause 6.5.9(b)(3) – X factor).⁴⁹
 - The AER may only decide to smooth revenue across two regulatory control periods if the remade 2015 determination is made prior to 1 March 2018 and the AER is satisfied that doing so is reasonably likely to minimise the variance in NUOS charges⁵⁰ between regulatory years and regulatory control periods.

⁴⁹ The AER's submission to the consultation paper states that "The discount rate for the NPV calculation will be the relevant weighted average cost of capital in the remade 2015 determination, noting this will vary year-by-year because of annual updates to the cost of debt" – see page 17 of the AER's submission.

⁵⁰ The term 'NUOS charges' is not defined in the NER. For the purpose of this final rule, the term NUOS charges is defined to include the relevant DNSP's prices for distribution standard control services, designated pricing proposal charges and jurisdictional scheme amounts. The intention of this rule is to provide a mechanism to minimise the variation in the network component of the final consumers' prices.

- The AER must set out in its adjustment determination the amounts that are to operate as a revenue increase or decrease (as the case may be) in the two regulatory control periods.
- The impact of the AER’s adjustment determination under the final rule must be neutral in terms of net present value.
- The AER must consult with the NSW DNSPs and any stakeholders that it considers appropriate, as part of its decision making process.

Enabling NSW DNSPs to recover the efficient costs of providing network services

In circumstances where the remaking of the 2015 determinations is not finalised until after the current regulatory control period ends, the proponents will not have the opportunity to recover the revenue they are entitled under the remade determinations in the current regulatory control period. The final rule provides the proponents the ability to recover the efficient costs of providing network services during the current regulatory control period by requiring the AER to make certain revenue adjustments to the distribution determinations for the subsequent regulatory control period. Such revenue adjustments are subject to the AER being satisfied that the amount achieves the revenue recovery principle.

Alignment with revenue and pricing principles

The Commission considers that the final rule is consistent with the application of the revenue and pricing principles. The Commission considers the following revenue and pricing principles most relevant to the final rule:

- A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs of providing direct control services.
- A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to its direct control services.
- A price or charge for the provision of a direct control service should allow for a return commensurate with the regulatory and commercial risks involved in providing the service to which that price or charge relates.

The Commission considers that allowing the AER discretion to determine any revenue adjustment across two regulatory control periods (if the AER determines to smooth revenue) and requiring the AER to adjust revenue in the subsequent distribution determination (where the remade determination is made after 1 March 2018) in accordance with the requirements set out in the final rule would:

- provide the proponents with a reasonable opportunity to recover their efficient costs, as well as
- achieve the most efficient outcomes for consumers.

2.5 Consistency with strategic priority

This rule change request is relevant to the Commission's strategic priority relating to market and network arrangements that encourage efficient investment and flexibility. The final rule would allow the proponents to recover their efficient costs, which consequently encourages efficient investment. In addition, allowing revenue to be recovered over two regulatory control periods will mitigate against price volatility for consumers. The final rule would also provide an appropriate level of flexibility to operate under changing circumstances.

3 Reasons for making more preferable final rule

This chapter outlines the rationale for the Commission's more preferable final rule to allow the proponents to recover their adjusted revenue across the current regulatory control period and the subsequent regulatory control period. The chapter is structured to discuss the Commission's reasoning on the following key issues:

- reducing price volatility
- method of minimisation of price volatility
- enabling the NSW DNSPs to recover their efficient costs of providing network services
- alignment with revenue and pricing principles.

3.1 First round comments: consultation paper

3.1.1 Reducing price volatility

Proponents' views on the consultation paper

As discussed in section 1.3, the proponents submit that the remaking of the distribution determinations for the current regulatory control period could lead to significant adjustment to the revenue that they are entitled to recover. The proponents also submit that under the current rules, any revenue adjustment can only be recovered in the current regulatory control period. In the absence of a rule change, NSW DNSP customers could experience a significant price shock.

The proponents sought to resolve this issue by proposing a mechanism that allows the recovery of revenue across the current regulatory control period and the subsequent regulatory control period. The proposed mechanism is described in section 1.4.

The proponents consider that the proposed rule promotes the NEO and is consistent with the revenue and pricing principles as it:

- allows the proponents to recover the revenue that they are entitled to, thus providing a reasonable opportunity to recover at least their efficient costs (as determined by the AER)
- avoids price shocks for consumers
- increases regulatory certainty
- enables efficient investment in, and efficient use of, electricity services.

The proponents have also considered the impact of setting revenues above or below efficient costs. Boxes 3.1 and 3.2 set out these considerations. The proponents submit that the proposed rule achieves a balance between the objectives of minimising pricing volatility and the setting of efficient prices to encourage efficient spending and usage.⁵¹

Box 3.1 Impacts of revenue set above efficient level

The proponents consider that the main impacts arising from revenues that are set above efficient levels for a short period include lower usage and network under-utilisation. This could lead to:

- increased uptake by consumers of other energy sources, such as gas or renewable energy, based on comparisons of network charges that are above efficient levels in the short term
- purchase of equipment by consumers, such as battery storage / load control, based on inefficient short term pricing arrangements that could lead to consumers not receiving the expected payback on their investment
- future network price increases to meet the requirements of the AER's revenue cap form of price control if the networks are under-utilised.

Source: Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, pp. 28-29.

Box 3.2 Impacts of revenue set below efficient level

The proponents consider that the main impacts arising from revenues that are set below efficient levels for a short period include higher usage and network over-utilisation. This could lead to:

- reduced uptake by consumers of other energy sources that may be efficient in the long term, based on inefficient short term price comparisons
- lack of investment by consumers in equipment, such as battery storage/load control, that could otherwise lead to efficient avoidance of future network charges
- increased capital investment to meet increased demand growth and corresponding future network price increases for customers.

Source: Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, pp. 28-29.

⁵¹ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p. 29.

Stakeholder views on the consultation paper

Ausgrid and Energy Networks Australia supported the rule change request. Energy Networks Australia considered that the rule change would increase regulatory certainty and promote efficient investment decisions by decreasing price volatility.⁵² Ausgrid considered that minimising price volatility between regulatory years and regulatory control periods aligns with the intent of the regulatory framework.⁵³

Red and Lumo Energy agreed with the importance of reducing price volatility, but considered that the Commission should wait for the judicial review outcome before making a rule change.⁵⁴

Energy Consumers Australia agreed with the proponents' intent to reduce price volatility, and considered that electricity consumers look for predictability in order to manage their budgets. Energy Consumers Australia also stated that price volatility would cause consumers to further lose confidence in the electricity market.⁵⁵

The Ethnic Communities Council of NSW (ECCNSW) commented that it is not clear what the result of significant price volatility would be on consumer behaviour. ECCNSW also noted the lack of significant research⁵⁶ to establish what consumer attitudes and behaviour might be around rapid and significant price variation.⁵⁷

The AER recognised the potential for price shocks if a rule was not made. The AER also agreed with the proponents that price shocks would lead consumers to make inefficient decisions. The AER further elaborated that the minimisation of price shocks was a key driver of the regulatory framework, as evident in:⁵⁸

- requirement for tariffs to move towards efficient structures
- application of side constraints
- revenue smoothing through the X factor.

⁵² Energy Networks Australia, Response to Consultation Paper – NSW and ACT DNSPs revenue smoothing, 15 December 2016.

⁵³ Ausgrid, Re: ERC0210 – Participant derogation – NSW DNSPs revenue smoothing, 12 December 2016, p.1.

⁵⁴ Red and Lumo Energy, Re: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2016 (ERC0201), 15 December 2016.

⁵⁵ Energy Consumers Australia, Submission to NSW and ACT Distribution Network Service Providers' (DNSP) revenue smoothing participant derogations (ERC0210), 23 December 2016.

⁵⁶ Ethnic Communities' Council of NSW clarified this statement with Commission staff during informal consultation after submission to the consultation paper closed. This statement is intended to say that no such research has been conducted by industry participants.

⁵⁷ Ethnic Communities' Council of NSW, Submission on The National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2016, 15 December 2016, p. 4.

⁵⁸ AER, NSW and ACT revenue smoothing rule change: AER submission to Australian Energy Market Commission consultation paper, December 2016, p.16.

3.1.2 Method of minimisation of price volatility

Proponents' views on the consultation paper

The rule change request proposed a detailed mechanism that allows the recovery of revenue across the current regulatory control period and the subsequent regulatory control period. The proposed mechanism is summarised in section 1.4.

Stakeholder views on the consultation paper

The AER provided a detailed submission on the operation of the proponents' suggested smoothing mechanism. The AER outlined a set of issues for the Commission to consider in making the draft rule:⁵⁹

- **Allowing the proponents or the AER to vary the revenue smoothing through the pricing proposals would increase uncertainty.** The NER requires the AER to approve and publish a pricing proposal within 30 business days of receipt. The AER considers that this timeframe would not allow for stakeholder consultation on departures from the default allocation in the AER determination on adjustment amount allocation under the participant derogation. This timeframe also does not allow the AER to assess and make a decision on such a departure from the default allocation.
- **Proposed derogations create unnecessary duplication of the regulatory process.** The proposed rule splits the decision making process on the smoothing of revenue across two separate processes: determination of revenue adjustment and allocation across regulatory control periods. This would increase the administrative burden for the AER and the proponents. The AER considers that it is preferable to finalise the allocation of revenue adjustments across regulatory control periods within the AER determination on revenue smoothing.
- **Allocation of the revenue adjustment having regard to high level principles rather than a prescribed calculation.** The AER considers that it may or may not need to remake the 2015 determinations. Moreover, the proponents may be under recovering or over recovering revenues in the current regulatory control period.⁶⁰

⁵⁹ AER, NSW and ACT revenue smoothing rule change: AER submission to Australian Energy Market Commission consultation paper, December 2016, pp. 4-5.

⁶⁰ In the AER's submission to the draft determination, the AER stated that as a result of the Full Federal Court's decision, the issue of whether the AER is required to remake the 2015 determinations is no longer a matter of speculation and that the AER will remake the 2015 determination. See page 5 of attachment C of the AER's submission to the draft determination.

3.1.3 Revenue and pricing principles

As discussed in the consultation paper, the Commission is required to consider whether the proposed rule is consistent with the revenue and pricing principles set out in section 7A of the NEL. The following revenue and pricing principles are most relevant in the context of this rule change request:

- a network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services and complying with regulatory obligations
- a network service provider should be provided with effective incentives to promote economic efficiency with respect to direct control network services
- price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.

Proponents' views on the consultation paper

The NSW DNSPs consider that the proposed rule is consistent with the revenue and pricing principles, as it:⁶¹

- minimises price volatility for consumers, in the case where price volatility is not be a result of cost volatility
- provides the NSW DNSPs with a reasonable opportunity to recover at least their efficient costs of providing the direct control services, as determined by the AER
- enhances certainty of revenue and price outcomes, which results in more efficient investment and consumption decisions
- minimises administrative costs for the AER and NSW DNSPs.

Stakeholder views on the consultation paper

Red and Lumo Energy considered that the rule change could breach the first and third revenue and pricing principles referred to in section 3.3.1 above.⁶² They consider that a one-off full adjustment to network charges would be more consistent with these principles. Red and Lumo Energy considered that a one-off adjustment would:

⁶¹ Ausgrid, Endeavour Energy and Essential Energy, Request for a rule change relating to derogation for the current regulatory control period and subsequent regulatory control period to minimise pricing volatility following the Australian Competition Tribunal's decision, p.2 and pp.26-30.

⁶² Red and Lumo Energy, Re: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2016 (ERC0201), 15 December 2016.

- allow the proponents to recover their efficient costs immediately, if the outcome of the judicial review proceedings leads to an increase in revenue requirement; or conversely
- allow network charges to readjust to their efficient levels, if the outcome of the judicial review leads to a decrease in revenue requirements.

Public Interest Advocacy Centre considered that the Commission should:⁶³

- consider the adequacy of the suite of existing side constraints
- assess whether the main effect of the derogation would be to increase potential network revenues from a positive adjustment amount
- undertake further consideration of the interaction between the network pricing objective and the pricing principles
- consider adopting temporary rules that prescribe variances to the method for revenue smoothing normally adopted by the AER.

3.2 Second round comments: draft determination

3.2.1 Reducing price volatility

Proponents' views on the draft rule and draft determination

The proponents submit that they support the intent of the draft rule,⁶⁴ in that it proposes a mechanism that allows the recovery of revenue across the current regulatory control period and the subsequent regulatory control period in order to reduce potential price shocks for consumers. However, the proponents also emphasise the importance of their ability to recover the revenue that they are entitled to under the remade 2015 determinations.

⁶³ Public Interest Advocacy Centre, Submission in response to the AEMC consultation paper on the DNSP proposed revenue smoothing derogation, 15 December 2016; Public Interest Advocacy Centre, Submission in response to the AEMC consultation paper on the DNSP proposed revenue smoothing derogation, 15 December 2016.

⁶⁴ Ausgrid, Ausgrid's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017; Endeavour Energy, Endeavour Energy's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017; Essential Energy, Essential Energy submission on AEMC's draft rule determination (Participant Derogation - NSW DNSPs Revenue Smoothing) ERC0210, 22 June 2017.

Stakeholder views on the draft rule and draft determination

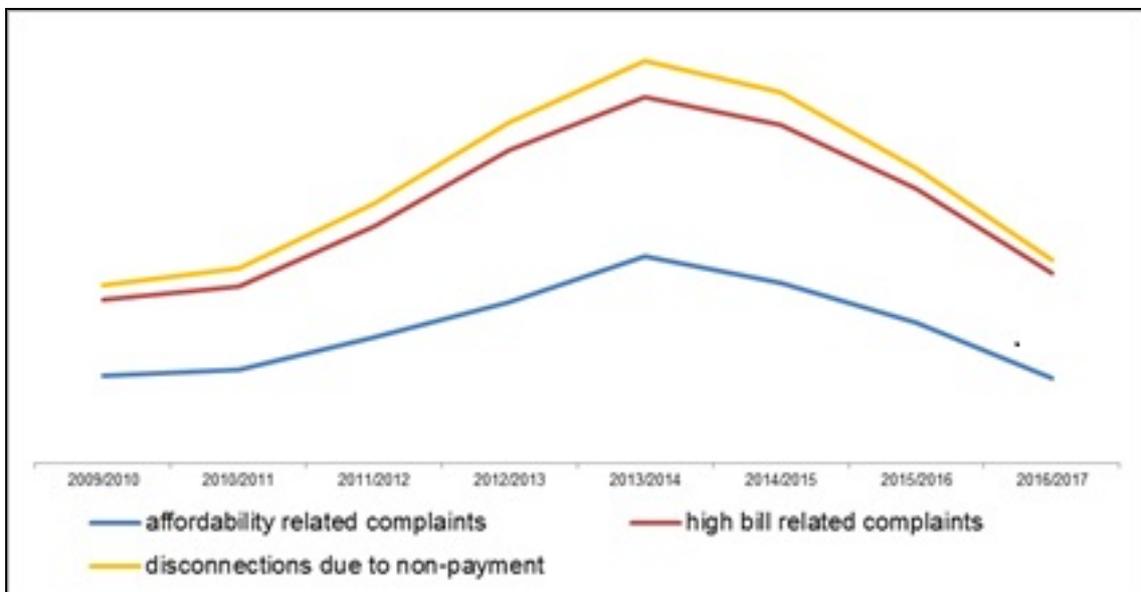
Energy Networks Australia (ENA) agrees with the proponents' views. ENA supports an outcome that achieves a price path that best serves the interests of customers, while ensuring that businesses can recover the efficient costs.⁶⁵

The Energy and Water Ombudsman New South Wales (EWON) has highlighted the impact of price spikes on consumers. EWON provided data to illustrate the following:

- price spikes have led to an increase in complaints to EWON regarding affordability and higher bills
- the last price spike also resulted in an increase in the number of residential disconnections
- sharp price rises have an adverse impact on the consumers who are already struggling with energy costs.

Figure 3.1 summarises the key data that EWON has provided. EWON considers that this trend may re-appear if customers experience another sudden price increase. Therefore, EWON supports the intent of the draft rule to reduce price volatility for consumers.⁶⁶

Figure 3.1 Impact of price shocks on complaints and disconnections



Source: AEMC analysis of data in EWON submission.

⁶⁵ Energy Network Australia, Submission to NSW and ACT DNSPs revenue smoothing, 20 June 2017.

⁶⁶ Energy and Water Ombudsman NSW, Submission to Participant derogation – NSW DNSPs revenue smoothing Draft Rule Determination, 20 June 2017.

NSW Farmers, NSW Irrigators Council and Cotton Australia largely support the draft rule for reducing price volatility. However, they raised a number of concerns regarding the impact on consumers of the limited merits review and judicial review processes, highlighting that the outcomes consumers are now faced with are undesirable.⁶⁷

The AER also agrees with the objective of the draft rule: to reduce price volatility that may arise from the outcome of the appeal process concerning the NSW/ACT distributors' 2015 determinations and to smooth any revenue adjustments over two regulatory control periods.⁶⁸ Similar to the proponents' submissions, the AER also emphasised the importance of providing the proponents the ability to recover the revenue they are entitled to under the remade 2015 determinations.

3.2.2 Method of minimisation of price volatility

Proponents' views on the draft rule and draft determination

The proponents consider that the draft rule requires additional clarity on a number of aspects relating to the operation of the draft rule. Specific concerns raised by the proponents include:

- **Incorporation of a principle when determining the adjustment amount.** The proponents consider that for the rule to be effective and achieve its over-arching objective, the inclusion of a principle in the rule is required. The proponents propose the following drafting for such a principle:

*"When determining an adjustment amount the AER must be satisfied that the adjustment determination will result in the relevant NSW DNSP's allowed revenue being the same (in net present value terms) as it would have been if the remade 2015 determination had been in place from the commencement of the current regulatory period and the control mechanism and control mechanism formulae specified in the remade 2015 determination had applied in each relevant regulatory year."*⁶⁹

- **One step process for determining both the adjustment amount and smoothing mechanism.** The proponents consider that under this approach, the steps that the AER will follow to arrive at the adjustment amount are not transparent⁷⁰
- **Reference to control mechanism in the adjustment amount and variation amount definitions.** The proponents consider that definition of the term "adjustment amount" and references to "control mechanisms" in the draft rule

⁶⁷ NSW Farmers, NSW Irrigators Council, Cotton Australia, Submission to Draft Rule Determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017, 19 June 2017.

⁶⁸ AER, submission to Participant derogation - revenue smoothing rule change, 23 June 2017.

⁶⁹ Ausgrid, Ausgrid's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017, p. 16, 20, 22.

⁷⁰ Ausgrid, Ausgrid's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017, p.5

may not necessarily permit the correct recovery of the revenue that they are entitled to under the remade determinations.⁷¹

- **Definition of adjustment and variation amount with reference to the final year of the current regulatory period.** The proponents consider that the definition should refer to each regulatory year of the current regulatory control period⁷²
- **Reference to undertakings in the definition of variation amount.** The proponents consider that the definition of the variation amount should refer to actual and allowed revenue
- **Need for an additional provision to allow for the exclusion of the revenue adjustments from the calculation of schemes⁷³ amounts that are based on annual revenue requirements.** The proponents consider that an additional provision be included in the final rule to prevent revenue adjustment from being considered by the AER when determining whether any amount is payable or recoverable under any schemes that applies to the NSW DNSPs subsequent regulatory control period.⁷⁴ This is to ensure the financial outcomes of applying incentives schemes in the subsequent regulatory control period are based on the revenue for that period only and not include revenue adjustments from the current regulatory control period.,⁷⁵

Stakeholder views on the draft rule and draft determination

ENA supports the proponents' view regarding transparency of the draft rule. ENA considers that the final rule, when made, should be capable of being implemented without any ambiguity.⁷⁶

The Energy and Water Ombudsman NSW (EWON)⁷⁷, the Public Interest Advocacy Centre (PIAC)⁷⁸ and Origin Energy⁷⁹ consider that the level of AER discretion in the draft rule is appropriate.

⁷¹ Ausgrid, Ausgrid's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017, p.4

⁷² Ausgrid, Ausgrid's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017, p.4

⁷³ Examples of such schemes include efficiency benefit sharing scheme, capital expenditure sharing scheme, service target performance incentive scheme, demand management incentive scheme, demand management innovation allowance mechanism, and small-scale incentive scheme.

⁷⁴ This was raised during consultation meetings between the Commission's staff, the proponents and the AER. The proponents have included a suggested clause in their second round submission. See p.24 of Ausgrid's submission to the draft determination.

⁷⁵ Ausgrid, Ausgrid's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017, p. 31.

⁷⁶ Energy Network Australia, Submission to NSW and ACT DNSPs revenue smoothing, 20 June 2017.

⁷⁷ Energy and Water Ombudsman NSW, Submission to Participant derogation - NSW DNSPs revenue smoothing Draft Rule Determination, 20 June 2017.

⁷⁸ PIAC, Submission to Draft determination on the NSW DNSPs Revenue Smoothing participant derogation, 23 June 2017.

PIAC also considers that when applying NPV neutrality to the calculation of the adjustment amount, the AER should use a discount factor that reflects the value of inflation rather than the Weighted Average Cost of Capital (WACC).

The AER provided a detailed submission on the operation of the draft rule. The submission outlined a set of issues for the Commission to consider in making the final rule:

- **The AER considers that a less prescriptive and more principle based rule would be more suitable.** The AER considers that the draft rule is preferable to that of the proponents. However, the AER considers that the draft rule remains more detailed and complex than necessary. The AER raised concerns that the level of prescription in the draft rule increases the probability that some part of the rule has not been drafted correctly despite the Commission's best intention and this would lead to unintended consequences.
- **The AER proposes that the inclusion of a revenue recovery principle would allow the rule to achieve its intent.** The AER suggests the inclusion of a revenue recovery principle alongside the definitions of adjustment amount and variation amount. The AER considers a revenue recovery principle would guide the revenue adjustment process and make clear that the proponents can only recover the revenues they are entitled to.

The AER proposes the following drafting for the revenue recovery principle:

“The AER... must be satisfied that the adjustment determination will result in the relevant NSW DNSP recovering the same revenue (in net present value equivalent terms) as it would have had if the remade 2015 determination had been in place from the commencement of the current regulatory period, and any control mechanisms specified in the remade 2015 determination had been implemented in each relevant regulatory year.”

- **The current definition of adjustment amount and variation amount may not allow the AER to consider all revenue adjustments required to ensure that the NSW DNSPs recover the revenue that they are entitled to.** The AER considers that there may be a number of additional adjustments that may be required in order to put the DNSPs back in the position in which they would have been had the remade 2015 determination been in place from the commencement of the current regulatory period. These adjustments not only include the changes to allowed revenue directly flowing from the remaking of the distribution determinations, but also include revenue adjustments that would have ordinarily flowed into prices for the current regulatory control period.

79 Origin, Submission to Draft rule determination – NSW DNSPs Revenue Smoothing, 20 June 2017.

- **Cut-off date of 1 February 2019 for the draft rule's scenario 2⁸⁰ (in which adjustment is recovered in the subsequent period without reopening that determination) is no longer appropriate.** The AER submits that in light of the recent decision by the Full Federal Court, the 1 February 2019 timeframe for scenario 2 would not permit the AER to conduct the remaking of the determinations and adjustment determination concurrently as required by the draft rule. The AER considers that this date should be changed to 1 May 2019. This would better align the rule's timeframe with the NER timeframe for the subsequent distribution determination.⁸¹

3.2.3 Revenue and pricing principles: submissions on draft determination

Proponents' views on the draft rule and draft determination

The proponents suggest the inclusion of a guiding principle in the final rule would allow it to operate as intended in a transparent and balanced manner without any ambiguity. The fundamental principle they propose is:

“the NSW DNSPs are not entitled to recover any more revenue than they are entitled to as determined by the AER under the remade distribution determination.”⁸²

Stakeholder views on the draft rule and draft determination

NSW Farmers, NSW Irrigators Council and Cotton Australia considered that the final rule should ensure that the price adjustments for individual customer groups remain below an acceptable rate (10 per cent), protecting tariff classes through the tariff structure statement process.

3.3 Analysis and conclusions: final rule and determination

3.3.1 Reducing price volatility

The Commission’s research suggests that consumer preferences generally display a present bias.⁸³ Consumers place more weight on costs and benefits in the present than on costs and benefits at any point in the future. If a significant fall in prices were to occur, consumers would prefer to experience this benefit immediately. However, given the nature of a regulatory control period, this benefit is likely to be a one-off

⁸⁰ This is the scenario referred to in clause 8A.14.5 of the final rule

⁸¹ The AER also acknowledged in its submission that the 1 February 2019 date was supported by AER staff during discussion held as part of first round consultation.

⁸² Ausgrid, Ausgrid's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017, p.3.

⁸³ Oxera, Behavioural insights into Australian retail energy markets, report prepared for the AEMC, March 2016.

occurrence. This may ultimately result in a significant price rise the following year, which consumers would prefer not to experience.

This research has also suggested that consumer preferences are often time inconsistent. Consumers' interest in energy is sporadic and typically triggered by certain events, for example a sudden price shock. This supports the view that distorted price signals through price shocks could result in inefficient outcomes for consumers.

Data on consumer complaints and disconnections that EWON has provided in its submission to the draft rule confirms that price shocks could result in undesirable outcomes for consumers. Section 3.2.1 of this determination discusses this data in more detail.

Section 3.2.1 also discusses the support of stakeholders of the intent of the draft rule to reduce price volatility for consumers.

Taking into account research undertaken by the Commission and stakeholder submissions, the Commission has concluded that a mechanism that provides for the ability to reduce price volatility by smoothing the recovery of adjustment revenue across two regulatory control periods is less likely to result in inefficient outcomes for customers. The Commission therefore considers such a mechanism to be in the long term interests of consumers.

3.3.2 Method of minimisation of price volatility

The Commission considers that the smoothing mechanism proposed by the proponents in the rule change request is too prescriptive. While the mechanism does provide certainty, it is not sufficiently flexible to adapt to the different possible timeframes of remaking the distribution determinations for the current regulatory control period.

As discussed in section 3.1, the final rule balances the need for regulatory certainty with the desire to minimise price volatility between regulatory years and regulatory control periods. This promotes efficient decision making by consumers by minimising price volatility in a short period of time. Therefore, the final rule satisfies the principle that a network service provider should have incentives to promote economic efficiency with respect to direct control network services.

The Commission has conducted extensive consultation with the proponents and the AER throughout the rule change process. This has enhanced the Commission's understanding of the concerns of both the proponents and the AER. The Commission has also considered all submissions to the draft rule. The Commission considers that the final rule is better able to address the proponents' aim of minimising price volatility by balancing the following:

- providing proponents and stakeholders with regulatory certainty

- providing the AER with the discretion to flexibly respond to uncertain outcomes and timeframes for the remaking of the distribution determinations for the current regulatory control period.

The more preferable rule takes into account the different possible timeframes for the remaking of the distribution determinations for the current regulatory control period. It also provides the AER with the discretion to determine whether smoothing should occur between the current regulatory control period and the subsequent regulatory control period. Where the AER decides to smooth across the two periods, the more preferable rule also provides the AER with the discretion to determine the amount allocated to the respective periods.

Importantly, the more preferable rule does not change the NER’s application to the remaking of the 2015 determination. Figure 3.2 below illustrates the framework within which the decision will operate.

Figure 3.2 Analysis and conclusions: Participant derogation

Undertakings	Revenue Determination for current regulatory period	Revenue Determination for subsequent regulatory period	Participant Derogation
<ul style="list-style-type: none"> ▪ AER and NSP agreements on revenue allowances for years in the current regulatory period 	<ul style="list-style-type: none"> ▪ Revenue determination for NSPs resulting from review: remade determination 	<ul style="list-style-type: none"> ▪ Revenue determination for NSPs as part of revenue proposal and determination for subsequent period 	<ul style="list-style-type: none"> ▪ Rule change that will allow revenue smoothing across two regulatory periods; enable recovery of efficient costs ▪ Given effect through pricing proposal for current period and/or revenue determination for subsequent period
Pricing Proposals			Scope

The Commission considers that the proponents, the AER and other stakeholders have raised some important issues regarding the method of minimisation of price volatility that should be addressed. The key issues that the Commission has considered in relation to the detailed design of the final rule are as follows:

- **One step process for determining both the adjustment amount and smoothing mechanism.** In response to the Commission’s draft determination, Ausgrid submitted that determination of an adjustment amount and allocation/deferral of that amount in one step would not lead to a desirable outcome.⁸⁴ After extensive consultation with the proponents and the AER, the Commission considers a one-step approach to the adjustment determination process enables the AER an ability to make an informed decision that has been sufficiently consulted upon. Moreover, the Commission considers that this approach reduces the administrative burden for both the AER and the proponents. The

⁸⁴ Ausgrid, Ausgrid's submission on AEMC's draft rule determination on participant derogation - NSW DNSPs revenue smoothing - ERC0210, 20 June 2017, p.5.

Commission has therefore decided to maintain its position in the draft decision to have a one-step process.

- **Reference to final year in adjustment and variation amount references.** In line with submissions, the Commission has changed the basis of the calculation of the variation amount from the final year to all five years of the current regulatory control period. The Commission considers that this will provide greater clarity around the operation of the final rule.
- **Reference to undertakings in the definition of variation amount.** The AER's submission to the draft rule outlines the risks of referring to the undertakings. However, the Commission considers that retaining the reference to undertakings is necessary for the operation of the final rule.⁸⁵
- **Update of timeframe for the rule's scenarios 2 and 3 (in which adjustment is recovered in the subsequent period).** The AER considers that the cut-off date for scenario 2 that is outlined in the draft rule would not permit the option of the AER completing the remaking of the 2015 determinations concurrently with the adjustment determination and the distribution determinations for the subsequent regulatory control period. The Commission has updated the timeframes for scenarios 2 and 3 in line with the AER's submission.

3.3.3 Enabling the recovery of revenue that the proponents are entitled to

In addition to addressing the issue of minimising revenue volatility and the method of minimisation, submissions from the proponents and the AER have also raised concerns about the draft rule's ability to allow the proponents to recover the revenue they are entitled to under the remade 2015 determinations.

The Commission has considered these issues and have addressed these concerns through the following:

- **Inclusion of a revenue recovery principle.** Both the proponents and the AER agree that the inclusion of a revenue recovery principle would better assist in achieving the intended outcome of the rule. The Commission has included in the final rule a principle that is based on the AER and the proponents' submission to the draft determination. The principle included in the final rule provides that a NSW DNSP has the ability to recover the same, but no more, revenue (in net present value⁸⁶ equivalent terms) as they would have recovered if the remade 2015 determination had been in place from the commencement of the current

⁸⁵ In making the final rule, the Commission has assumed that the NSW DNSPs will enter into undertakings with the AER to determine how prices for 2018/19 will be set.

⁸⁶ The final rule provides the AER with discretion on deciding the discount rate used when calculating net present value. This discretion is consistent with the approach in other parts of chapter 6 (such as clause 6.5.9(b)(3) – X factor). The AER's submission to the consultation paper states that "The discount rate for the NPV calculation will be the relevant weighted average cost of capital in the remade 2015 determination, noting this will vary year-by-year because of annual updates to the cost of debt" – see page 17 of the AER's submission.

regulatory period, and any control mechanisms specified in the remade 2015 determination had been implemented in each relevant regulatory year. The principle applies in respect of the AER's determination of each of the relevant revenue adjustments under the final rule and provides the AER with the ability to make any necessary variations to the calculation of the adjustment amount, subsequent adjustment amount, distribution variation amount and transmission variation amount under the final rule to allow the relevant NSW DNSP to recover the revenue it would have been entitled to recover during the current regulatory control period under the remade determination.⁸⁷

- **Reference to control mechanism in the adjustment amount and variation amount definitions.** Both the proponents and the AER suggested alternative wording to reflect the intent of the rule with regard to the applicable control mechanisms. The Commission agrees that the reference to control mechanism in the draft rule should be clarified by including a reference to the formulae that give effect to the control mechanism and that certain other revisions to the definitions of the various revenue adjustments should be made.
- **Inclusion of a distribution variation amount and transmission variation amount.** The Commission considers that a distribution variation amount and transmission variation amount should be included in the final rule in order to enable the distinct control mechanisms to operate in respect of the revenue adjustments for distribution and transmission standard control services to be effected under the final rule.
- **Consideration of adjustment amount in schemes applied in the subsequent determination.** During second round consultation, proponents suggested that an additional clause should be included in the final rule to prevent revenue adjustment from being considered by the AER when determining whether any amount is payable or recoverable under any schemes that apply to the NSW DNSP's subsequent regulatory control period.⁸⁸ The proponents consider this would prevent 'double counting' of any benefit or penalty under the schemes. The Commission considers that changes proposed by the proponents aligns with the intended application of the final rule and therefore have incorporated the proponents' suggestion.

⁸⁷ See the definition of the revenue recovery principle in clause 8A.14.1 of the final rule.

⁸⁸ This was raised during consultation meetings between the Commission's staff, the proponents and the AER. The proponents have included a suggested clause in their second round submission. See p.24 of Ausgrid's submission to the draft determination.

3.3.3 Alignment with revenue and pricing principles

The Commission considers that the more preferable rule is consistent with the revenue and pricing principles discussed in section 3.1.3. The uncertainty around the timeframe of the remaking of the 2015 revenue determinations means that there is a possibility that an outcome may not be finalised until after the current regulatory control period has passed. In the absence of a rule change, the NSW DNSPs may be prevented from recovering the efficient costs of providing network services. The more preferable rule therefore provides certainty that the proponents have a reasonable opportunity to recover their efficient costs between two regulatory control periods.

As discussed in section 3.4.1, the more preferable rule balances the need for regulatory certainty with the desire to minimise price volatility between regulatory years and regulatory control periods. This promotes efficient decision making by consumers by minimising price volatility in a short period of time. Therefore, the final rule satisfies the principle that a network service provider should promote economic efficiency with respect to direct control network services.

4 Operation of the final rule

Whilst allowing the smoothing of revenue across two regulatory control periods and providing for the recovery of revenue for one regulatory control period in another regulatory control period is a relatively simple concept, the inclusion of such a mechanism in a rule requires a level of complexity as it involves processes that relate to the making and remaking by the AER of distribution determinations as well as the pricing proposal processes⁸⁹. This chapter therefore provides an explanation of the operation of the rule.

This chapter is structured as follows:

- section 4.1 provides a summary of the key objectives of the rule
- section 4.2 provides a summary of the key aspects of the rule
- section 4.3 outlines the key factors relevant to the operation of the rule
- sections 4.4, 4.5 and 4.6 detail the operation of the rule under each of the three scenarios that the Commission has considered.

4.1 Key objectives of the final rule

The key objectives of the final rule are:

- **Provide a mechanism to minimise price volatility.** The final rule provides a mechanism to allow for the minimisation of price volatility, which may occur as a result of the remaking of distribution determinations of NSW DNSPs for the current regulatory control period. As discussed in section 2.4.4, the Commission considers that stable prices allow consumers to make efficient decisions. The Commission also considers that allowing revenue smoothing across the current regulatory control period and subsequent regulatory control period would result in more efficient outcomes for consumers.
- **Provide the NSW DNSPs with an opportunity to recover efficient costs.** The remaking of distribution determinations for the current regulatory control period may not be finalised until after the pricing proposal process for 2018/19⁹⁰ has been completed or after the current regulatory control period ends. Should this scenario prevail, the Commission considers that the final rule should provide NSW DNSPs with the ability to recover the efficient costs of providing network services in the current regulatory control period in the subsequent regulatory

⁸⁹ The key processes are the DNSPs' preparation and the AER's subsequent review and approval of annual pricing proposals under Part I of Chapter 6 of the NER.

⁹⁰ 2018/19 being the final regulatory year of the current regulatory control period.

control period. This objective is supported by the inclusion of the revenue recovery principle in the final rule⁹¹. The revenue recovery principle states:

“...the NSW DNSP must be given the ability to recover the same, but no more, revenue (in net present value equivalent terms) as it would have recovered if:

- (a) the remade 2015 determination had been in force from the commencement of the current regulatory control period; and
- (b) the formulae giving effect to the control mechanisms specified in the remade 2015 determination had been applied in each regulatory year of the current regulatory period.”

4.2 Key aspects of the final rule

4.2.1 The final rule does not change the application of the NER to the process of remaking of the 2015 determination

The final rule does not change the application of the NER to the process of remaking of a 2015 distribution determination. The AER must remake the 2015 distribution determination in accordance with the Tribunal's orders (as varied by the Full Federal Court's decision), as well as the applicable NER provisions that cover the making of distribution determinations.

The final rule is designed to work alongside the existing regulatory framework⁹², and to provide a mechanism to allow smoothing and recovery of revenue across two regulatory control periods to minimise price volatility if the need arises. In circumstances where a NSW DNSP is not able to recover the revenue it is entitled to in the current regulatory control period, the final rule allows the revenue to be recovered in the subsequent regulatory control period.

The final rule also provides for certain limited circumstances in which a DNSP is not required to comply with specific existing rules relating to application of pricing principles, tariff structure statements and side constraints. This is only to the extent necessary to give effect to the operation of the final rule.⁹³ These modifications to the existing requirements under Chapter 6 and 6A of the NER are set out in clause 8A.14.8 of the final rule. The Commission considers such modifications to be appropriate to

⁹¹ The definition is in clause 8A14.1 of the final rule. The operation of the principle is in clauses 8A.14.4, 8A.14.5 and 8A.14.6

⁹² The final rule, as a participant derogation, provides for certain derogations away from aspects of Chapter 6 of the NER to allow for the objectives of the final rule to be achieved.

⁹³ For example, under clause 8A.14.8(c)(5) of the rule, the side constraint provisions (i.e. clause 6.18.6 of the NER) do not apply to the extent that a proponent's tariffs vary from tariffs which would otherwise result from complying with those provisions, due to the application of the participant derogation.

eliminate inconsistencies between the operation of the final rule and the parts of Chapter 6 that continue to operate concurrently with the adjustment determination.

The Commission has made some changes between the draft and final rules to incorporate some of the changes suggested by stakeholders in the second round consultation. These changes are discussed in section 2.4.3.

4.2.2 The AER's discretion under the final rule

Where the timeframe for remaking the 2015 distribution determinations for the current regulatory control period provides the opportunity to smooth the recovery of revenue across two regulatory control periods, the final rule provides the AER discretion to:

- decide whether revenue should be smoothed across two regulatory control periods; and
- if the AER decides to smooth the recovery of revenue across two regulatory control periods, decide how any adjustment is allocated between the two regulatory control periods.

Where the AER decides revenue should be smoothed across two regulatory control periods, it must be satisfied that doing so would be reasonably likely to minimise variations in NUOS⁹⁴ charges.

4.2.3 Provides transparency of process

The final rule requires the AER to make a decision in relation to revenue adjustment and smoothing that is separate from any distribution determination, and to publish that separate determination (referred to as an adjustment determination under the final rule) that sets out the reasons for its decision. Before making the adjustment determination, the AER must consult with the relevant NSW DNSP as well as any other persons the AER considers appropriate. The adjustment determination must also set out how the AER allocates revenue adjustments across the current regulatory control period and subsequent regulatory control period or just within the subsequent regulatory control period (as the case may be).⁹⁵

⁹⁴ The term 'NUOS charges' is not defined in the NER. For the purpose of this participant derogation, the term NUOS charges is defined to include the relevant DNSP's prices for distribution standard control services, designated pricing proposal charges and jurisdictional scheme amounts. The intention of this rule is to provide a mechanism to minimise the variation in the network component of the final consumers' prices.

⁹⁵ It is important to note that the adjustment determination also captures circumstances where adjustment is made to revenue allowances in the subsequent regulatory control period only – namely, where the AER does not provide for smoothing of revenue across regulatory control periods under clause 8A.14.4 of the final rule.

Once the AER has decided on the revenue adjustment required, it is given effect through the annual pricing proposal process for the current regulatory control period and the revenue determination process for the subsequent regulatory control period.⁹⁶ The final rule differs from the proposed rule in that the final rule does not provide either the AER or the proponents an opportunity to propose a different adjustment amount at the pricing proposal stage.

4.3 Matters relevant to the operation of the final rule

As a result of the Full Federal Court's decision on 23 May 2017, the AER is required to remake the 2015 distribution determinations in accordance with the Tribunal's orders (as varied by the Federal Court's decision) and the existing rules governing the making of distribution determinations in Chapter 6 of the NER.

Prior to discussing the detailed operation of the final rule, it is useful to outline the possible timeframes for the remaking of the distribution determinations for the current regulatory control period as they will affect the following:

- the price setting process for the final year of the current regulatory control period
- the distribution determination process for the subsequent regulatory control period.

4.3.1 Timeframe for remaking the distribution determinations for the current period

The timing of the remaking of the distribution determinations for the current regulatory control period will have a significant impact on how revenue is recovered in the current regulatory control period and the subsequent regulatory control period under the final rule. The draft rule provided for the Tribunal varying or affirming the distribution determinations for the current regulatory control period. The final rule does not include these provisions as the Full Federal Court's decision, and absence of appeal of that decision, means that the inclusion of such provision is no longer needed.⁹⁷ The Commission has considered three broad scenarios that the final rule would operate in. These scenarios are:

⁹⁶ In Scenario 3 (section 4.6 of this final determination), the adjustment determination is issued after the distribution determination of the subsequent regulatory control period is made but requires a re-opening of the distribution determination.

⁹⁷ On 4 July 2017, the Orders of the Full Federal Court were made in matters NSD415/2016 (regarding Ausgrid), NSD416/2016 (regarding Essential Energy) and NSD418/2016 (regarding Endeavour Energy). The deadline for filing an application with the High Court had passed before this final determination was made.

- **Scenario 1: recovery of revenue across the current regulatory control period and subsequent regulatory control period.**⁹⁸ This scenario applies where the relevant distribution determination is remade prior to 1 March 2018. Under this scenario, the distribution determinations for the current regulatory control period will be remade before the price setting processes⁹⁹ for the 2018/19 regulatory year¹⁰⁰. This provides the opportunity for the revenue to be recovered over the current regulatory control period and the subsequent regulatory control period.
- **Scenario 2: recovery of revenue in the subsequent regulatory control period only and no requirement for reopening of the distribution determination for the subsequent regulatory control period.**¹⁰¹ This scenario applies from 1 March 2018 and up to, but excluding, 1 May 2019. Under this scenario, relevant distribution determinations for the current regulatory control period are remade after the commencement of the price setting processes for the 2018/19 regulatory year, but before the AER has made the distribution determinations for the subsequent regulatory control period.¹⁰² As the price setting processes for the 2018/19 regulatory year have already commenced in this scenario, there is insufficient time to include an adjustment amount in the relevant DNSP's pricing proposal for that year. However, as the AER would not have finalised its decision for the subsequent regulatory control period, revenue adjustments can be included in the subsequent distribution determination.
- **Scenario 3: recovery of revenue in the subsequent regulatory control period only and reopening of the distribution determination for the subsequent regulatory control period is required.**¹⁰³ This scenario applies between 1 May 2019 and 1 December of the fourth last regulatory year of the subsequent regulatory control period.¹⁰⁴ Under this scenario, there is insufficient time for revenue to be included in the distribution determination of the subsequent regulatory control period. A limited re-opening of the subsequent regulatory control period's distribution determination would be required to incorporate the revenue.

⁹⁸ Clause 8A.14.4 of the final rule covers this scenario.

⁹⁹ The key processes are the DNSPs' preparation and the AER's subsequent review and approval of annual pricing proposals.

¹⁰⁰ This is the final regulatory year of the current regulatory control period.

¹⁰¹ Clause 8A.14.5 of the final rule covers this scenario.

¹⁰² The subsequent regulatory control period will commence on 1 July 2019. In accordance with clause 6.11.2 of the NER, the AER is required to publish the NSW DNSPs distribution determination by no later than 30 April 2019, which is two months before the commencement of the subsequent regulatory control period.

¹⁰³ Clause 8A.14.6 of the final rule covers this scenario.

¹⁰⁴ Clause 6.3.2(b) of the NER requires the length of the regulatory control period to be a minimum of five years and the AER has historically set distribution determination at this length. The Commission's intent in setting this end date is to ensure there is at least three full regulatory years for the subsequent adjustment amount to be recovered regardless of the length of the regulatory control period determined by the AER.

4.4 Operation of the final rule under scenario 1¹⁰⁵ - recovery of revenue in both current regulatory control period and the subsequent regulatory control period

In this scenario, to reduce price volatility, the AER may decide to increase a proponent's allowed revenue in the current regulatory control period by a specified amount and decrease its allowed revenue in the subsequent regulatory control period by an equivalent amount in NPV terms, or vice versa.

This scenario applies prior to 1 March 2018. Under this scenario, the process for remaking the distribution determination for the current regulatory control period is completed ahead of the pricing proposal process for the 2018/19 regulatory year.

4.4.1 The making of the adjustment determination

At the time of remaking the 2015 determination for the relevant proponent, the AER must make a separate but concurrent decision (adjustment determination) on whether to allow revenue to be recovered over the current regulatory control period and subsequent regulatory control period, and how much to recover in each period. The adjustment determination must be published at the same time as the AER publishes the remade 2015 distribution determination.

For the avoidance of doubt, the AER is required to make and consult on an adjustment determination even if it decides not to smooth revenue across the current and subsequent regulatory control periods.

4.4.2 Determining the adjustment amount and subsequent adjustment amount

If the AER determines to allow revenue recovery across both the current regulatory control period and subsequent regulatory control period, the adjustment determination must set out how the AER determines the following:

- **Adjustment amount.** The adjustment amount is a revenue increase/decrease to the total annual revenue for distribution standard control services that may be earned by the relevant proponent for 2018/19 in accordance with the applicable annual revenue requirement and the formulae that give effect to the applicable control mechanism under the remade 2015 distribution determination. In determining the adjustment amount, the AER is also required to incorporate any adjustments it considers necessary to achieve the revenue recovery principle.¹⁰⁶

¹⁰⁵ Clause 8A14.4 of the final rule covers this scenario.

¹⁰⁶ More specifically, the AER must incorporate any adjustments necessary for it to be satisfied that the amount provides the NSW DNSPs the ability to recover the same, but no more, revenue (in NPV terms) as it would have recovered if the remade 2015 determination had been in force from the commencement of the current regulatory control period and the control mechanisms specified in the distribution determination had been applied in each regulatory year of the current regulatory control period. Such adjustments may include, but are not limited to, adjustments for under and over recovery of revenue during the current regulatory control period or adjustments for amounts payable or recoverable by the DNSP as a result of the application of schemes that apply to the

This amount represents the revenue that is re-allocated to the subsequent regulatory control period to minimise price volatility.

- **Subsequent adjustment amount.** The subsequent adjustment amount is equivalent in net present value terms to the adjustment amount, incorporating any adjustments the AER considers necessary to achieve the revenue recovery principle. This amount represents the revenue re-allocated from the current regulatory control period to the subsequent regulatory control period to minimise price volatility. This amount is to be included in the annual revenue requirement of the first regulatory year of the subsequent regulatory control period.¹⁰⁷

In determining the above amounts, the AER must be satisfied of the following:

- The relevant DNSP recovers the same revenue (in net present value equivalent terms), but no more than it would have, had the remade 2015 determination been in place from the commencement of the current regulatory period, and had all control mechanisms specified in the remade 2015 determination been implemented in each relevant regulatory year (i.e. achieves the revenue recovery principle).
- The revenue adjustment would be reasonably likely to minimise variation in the NUOS charges¹⁰⁸ between the penultimate and final regulatory years of the current regulatory control period (2017/18 and 2018/19) and between the final year of the current regulatory control period and the first year of the subsequent regulatory control period.

4.4.3 Recovery of adjustment amount in the current regulatory control period

In the current regulatory control period, the AER's adjustment decision is given effect through the pricing proposal for 2018/19. The pricing proposal for 2018/19 must provide for the recovery of the following amount:

- total annual revenue for the distribution standard control services for final regulatory year, determined in accordance with the applicable annual revenue requirement and formulae that give effect to the applicable control mechanism

DNSP for the current regulatory control period. The participant derogation defines the term 'scheme' in the definition section - 8A.14.1.

107 The Commission considers that the AER has the discretion to smooth the subsequent adjustment amount over the subsequent regulatory control period through the application of the X factor.

108 The term 'NUOS charges' is not defined in the NER. For the purpose of this participant derogation, the term 'NUOS charges' is defined to include the relevant DNSP's prices for distribution standard control services, designated pricing proposal charges and jurisdictional scheme amounts. The intention of this rule is to provide a mechanism to minimise the variation in the network component of the final consumers' prices.

under the remade 2015 distribution determination,¹⁰⁹ plus or minus (as applicable)

- the adjustment amount, incorporating any adjustments the AER considers necessary to achieve the revenue recovery principle.

4.4.4 Recovery of the subsequent adjustment amount in the subsequent regulatory control period

As discussed above, the subsequent adjustment amount is to be included as an increase or decrease in the annual revenue requirement for the first regulatory year of the subsequent regulatory control period. AER may smooth this amount across the whole of the subsequent regulatory control period under the AER's normal process of setting smoothed revenue through the application of X factor.

The final rule incorporates a provision that requires the AER not to consider any subsequent adjustment amount included in the subsequent distribution determination when determining whether any amount is payable or recoverable by the relevant NSW DNSP under any scheme that applies to that DNSP for the subsequent regulatory control period. This is to prevent the possibility of 'double counting' as discussed in section 3.3.2.

4.5 Operation of the final rule under scenario 2¹¹⁰ - recovery of revenue in the subsequent regulatory control period only and no reopening of the subsequent distribution determination is required

This scenario applies between 1 March 2018 and 1 May 2019. Under this scenario, the distribution determinations for the current regulatory control period are remade after the commencement of price setting processes for the 2018/19 regulatory year, but before the AER has made the distribution determinations for the subsequent regulatory control period.

In this scenario, the AER must increase or decrease a proponent's allowed revenue in the subsequent regulatory control period by a specified amount to adjust for the difference between the revenue that the proponent was entitled to recover under the remade distribution determination and revenue it was entitled to recover under the 2015 determination or applicable undertakings (depending on the relevant regulatory year).

¹⁰⁹ The relevant DNSP would set its prices to achieve this as their target revenue in the absence of this rule.

¹¹⁰ Clause 8A14.5 covers this scenario.

4.5.1 The making of the adjustment determination

Similar to scenario 1, at the time of remaking the 2015 distribution determination for the relevant proponent, the AER must make an adjustment determination that is separate to, but made concurrently with the remade determination. The adjustment determination must be published at the same time that the AER publishes the remade 2015 distribution determination.

Any adjustments to revenue would occur in the subsequent regulatory control period only as there is insufficient time for adjustments to be included in the 2018/19 pricing proposal.

4.5.2 Determining the variation amounts¹¹¹

The adjustment determination must set out how the AER determines the following amounts:

- **Distribution variation amount.** For each of the NSW DNSPs, the distribution variation amount is:
 - (a) the sum of the total annual revenue for distribution standard control services for each regulatory year of the current regulatory control period in accordance with the annual revenue requirement and the formulae that give effect to the applicable control mechanism under the remade 2015 distribution determination; minus
 - (b) the sum of the following¹¹²:
 - i. For the first and second regulatory years of the current regulatory control period (i.e. 2014/15 and 2015/16): the total annual revenue for distribution standard control services in accordance with the annual revenue requirement and the formulae that give effect to the applicable control mechanism under the 2015 determination; and
 - ii. For the remaining years of the current regulatory control period (i.e. 2016/17 to 2018/19): the total annual revenue for distribution standard control services under the undertakings that apply for those regulatory years.

Such amount must include any adjustments¹¹³ made by the AER which it considers necessary in order to achieve the revenue recovery principle.

¹¹¹ This aspect of the final rule is different to that of the draft rule. This was amended to incorporate stakeholders' feedback on the operation of the rule.

¹¹² This aspect of the final rule allows for the difference between how total annual revenue is set in the current regulatory period. In 2014/15 and 2015/16, the DNSPs total annual revenue were set in accordance with the transitional distribution determination and 2015 determination respectively. As the 2015 determination was set aside in February 2016, total annual revenues for 2016/17 to 2018/19 were (or would be) set based on undertakings that the DNSPs entered into with the AER.

- **Transmission variation amount.**¹¹⁴ The transmission variation amount is calculated in a similar fashion to the distribution variation amount. The amount is
 - (a) the sum of the total annual revenue for transmission standard control services for each regulatory year of the current regulatory control period in accordance with the annual revenue requirement and the formulae that give effect to the control mechanism under the remade 2015 distribution determination; and
 - (b) the sum of the following:
 - i. For the first, second and third regulatory years¹¹⁵ of the current regulatory control period (i.e. 2014/15 to 2016/17): the total annual revenue for transmission standard control services in accordance with the annual revenue requirement and the formulae that give effect to the applicable control mechanism under the 2015 determination; and
 - ii. For the remaining years of the current regulatory control period (i.e. 2017/18 to 2018/19): the total annual revenue for transmission standard control services under the undertakings that apply for those regulatory years.

Under the relevant provisions of the final rule, if the AER sets either the distribution or transmission variation amount¹¹⁶ to zero, then no adjustment is made to the revenue of the subsequent distribution determination.

¹¹³ More specifically, the AER must incorporate any adjustments necessary for it to be satisfied that the amount provides the NSW DNSPs the ability to recover the same, but no more, revenue (in NPV terms) as it would have recovered if the remade 2015 determination had been in force from the commencement of the current regulatory control period and the control mechanism specified in the distribution determination had been applied in each regulatory year of the current regulatory control period. Such adjustments may include, but are not limited to, adjustments for under and over recovery of revenue during the current regulatory control period or adjustments for amounts payable or recoverable by the DNSP as a result of the application of schemes that apply to the DNSP for the current regulatory control period. The participant derogation defines the term 'scheme' in the definition section – 8A.14.1.

¹¹⁴ This aspect of the final rule is different to that of the draft rule. This was amended to incorporate stakeholders' feedback on the operation of the rule.

¹¹⁵ This part differs from the distribution variation amount calculation as the undertakings for 2016/17 provided for price escalation at the NUOS level and did not specifically define how revenues for transmission standard control services were to be determined. The Ausgrid undertaking for 2017/18 separately sets out the calculation of the total annual revenue for distribution and transmission standard control services.

¹¹⁶ In practice, the transmission variation amount would only be applicable to Ausgrid as it is the only DNSP amongst the proponents that have transmission assets.

Similar to scenario 1, when determining the above amounts, the AER must be satisfied of the following:

- The relevant DNSP recovers the same revenue (in net present value equivalent terms), but no more than it would have, had the remade 2015 determination been in place from the commencement of the current regulatory period, and had all control mechanisms specified in the remade 2015 determination been implemented in each relevant regulatory year.
- The distribution and transmission variation amount must be included in the subsequent distribution determination in equivalent in net present value terms.

4.5.3 Recovery of the variation amounts in the subsequent regulatory control period

The variation amounts are to be included as an increase or decrease (as applicable) in the annual revenue requirement of the first regulatory year of the subsequent regulatory control period. This amount may be smoothed across the whole of the subsequent regulatory control period under the AER's normal process of setting smoothed revenue through the application of X factor.

Similar to scenario 1 above, the variation amount is able to be included in the annual revenue requirement for the subsequent regulatory control period as the adjustment determination would be published in advance of the subsequent distribution determination. The AER is not to consider any variation amount included in the subsequent distribution determination when determining whether any amount is payable or recoverable by the relevant NSW DNSP under any scheme that applies to that DNSP for the subsequent regulatory control period.

4.6 Operation of the final rule under scenario 3¹¹⁷ - recovery of revenue in the subsequent regulatory control period only and reopening of distribution determination is required

In this scenario, the rule operates in the same way as in scenario 2, except that a limited reopening of the subsequent distribution determination is needed to incorporate the revenue adjustment. This is because the remaking of the 2015 determinations would occur after the making of the distribution determinations for the subsequent regulatory control period is completed.

This scenario applies on or after 1 May 2019 but will not extend beyond 1 December of the fourth last regulatory year of the subsequent regulatory control period. The Commission's intent in setting this end date is to ensure there is at least three full

¹¹⁷ Clause 8A.14.6 covers this scenario.

regulatory years for the adjustment amounts to be recovered regardless of the length of the regulatory control period determined by the AER.¹¹⁸

4.6.1 The making of the adjustment determination

The requirement for the AER to make a separate adjustment determination in this scenario is the same as scenarios 1 and 2. The adjustment determination must be published at the same time as the remade 2015 distribution determination is published.

4.6.2 Determining the variation amounts

The process of determining the distribution and transmission variation amount is the same as that described in section 4.5.

As per scenario 2, when determining the above amounts, the AER must be satisfied of the following:

- The relevant DNSP recovers the same revenue (in net present value equivalent terms), but no more than it would have, had the remade 2015 determination been in place from the commencement of the current regulatory period, and had all applicable control mechanisms specified in the remade 2015 determination been implemented in each relevant regulatory year.
- The distribution and transmission variation amount must be included in the remaining years of the subsequent distribution determination in equivalent net present value terms.

4.6.3 Recovery of the variation amounts in the subsequent regulatory control period

Under this scenario, the final rule requires the AER to:

- revoke the subsequent distribution determination and make a substituted determination covering the remainder of the subsequent regulatory control period
- include the distribution and transmission variation amount as a revenue increase or decrease (as applicable) to one or more regulatory years for the remainder of the subsequent regulatory control period.

Where the AER decides to allocate the variation amounts over more than one regulatory year, the sum of the amount allocated across each regulatory year must be equivalent in net present value terms to the variation amount.

¹¹⁸ Clause 6.3.2(b) of the NER requires the length of a regulatory period to be a minimum of five years and the AER has historically set regulatory control period at this length. However, the AER may decide to set a regulatory period for longer than five years.

In addition, the substituted distribution determination must only vary from the revoked distribution determination to the extent necessary to reflect the inclusion of the revenue increase or decrease referred to above. It is not the Commission's intention for the reopened subsequent distribution determination to be amended to include amounts items unrelated to the application of the participant derogation.

As per scenario 1 and 2, the AER is not to consider any variation amount included in the subsequent distribution determination when determining whether any amount is payable or recoverable by the relevant NSW DNSP under any scheme that applies to that DNSP for the subsequent regulatory control period.

4.7 Application of Chapter 6 of the NER under this participant derogation

The recovery of revenue adjustment across the current and subsequent regulatory control period could affect the proponents' compliance with certain provisions of Chapter 6 of the NER. The final rule therefore provides that certain Chapter 6 provisions do not apply to the extent that the NSW DNSP's non-compliance with the relevant provision is due to the operation of the final rule.¹¹⁹ Some of the key exclusions addressed by the final rule are:

- **Compliance with the tariff structure statement.** A NSW DNSP's tariffs do not need to comply with its tariff structure statement to the extent necessary to allow for the submission of a pricing proposal (and subsequent approval by the AER) in accordance with the requirements of this final rule.¹²⁰
- **Compliance with long run marginal cost, standalone/avoidable cost and efficient cost of supply provisions.** To the extent that a DNSP's tariffs do not comply with the pricing principles set out in clauses 6.18.5(e) to 6.18.5(g) of the NER due to the operation of the final rule, such variation is deemed to be a permitted variation under the NER.¹²¹
- **Application of side constraints.** The final rule provides that the side constraint provision¹²² does not apply to the extent necessary to allow for the application of this rule.¹²³

119 These exemptions are contained in section 8A.14.8 of the final rule.

120 See clause 8A.14.8(c)(1)

121 Clause 6.18.5(c). of the NER

122 Clause 6.18.6 of the NER.

123 See clause 8A.14.8(c)(5).

- **X factor.** Clause 6.5.9(b)(2) of the NER requires the AER to set the X factor to minimise, as far as reasonable possible, variance between expected revenue (i.e. smoothed revenue) for the last regulatory year of a regulatory control period and the annual revenue requirement (i.e. unsmoothed revenue) of that regulatory year. If scenario 3 applies, the final rule allows the AER to depart from this requirement so that revenue adjustments can be incorporated into the remaining years of a substituted distribution determination.¹²⁴

¹²⁴ See clause 8A.14.8(c)(7).

Abbreviations

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
DNSP	Distribution network service provider
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National Electricity Rules
NPV	Net present value
NUOS	Network use of system

A Summary of other issues raised in submissions

This appendix sets out other issues raised in the second round of consultation on this rule change request, and the Commission's response to each issue. If an issue raised in a submission has been discussed in the main body of this document, it has not been included in this table. For completeness, the Commission has also replicated the table of issues from the first round consultation.

A.1 Summary of other issues raised in second round consultation

Issue	Stakeholder	Commission's Response
The NPV neutral principle is not clear in the adjustment amount or variation amount definitions.	Ausgrid (p. 4)	The Commission considers that the principle of NPV neutrality is clear articulated in all aspect of the more preferable rule.
The draft rule does not clearly articulate the relationship between total annual revenue, control mechanism and annual revenue requirement.	Ausgrid (p. 4)	The Commission agrees that the intent of including reference to control mechanism and annual revenue requirement in the draft rule requires clarity and has included this in the more preferable final rule.
The term "variation amount" as defined in the rule is not required, and may be confusing.	Ausgrid (p. 6) AER (Attachment C, p. 4)	The Commission considers that the definition of variation amount provides sufficient clarity regarding operation of the more preferable final rule. The Commission has amended the definitions to provide further clarity.
The draft rule does not consider the New South Wales price guarantee.	PIAC (p. 1)	The Commission is required to decide whether to make a rule based on the NEO. The NSW price guarantee is not a relevant matter for the Commission to consider. The Commission considers the NSW price guarantee is a matter that applies to the relevant NSW DNSP in addition to this final rule.
The AER will make a determination on remittal	AER (Attachment C, p. 4)	The Commission considers this recommendation to be appropriate.

Issue	Stakeholder	Commission's Response
for the NSW DNSPs, following the outcome of the Full Federal Court judicial review proceedings. Therefore, all references to the Tribunal affirming or varying the 2015 determination can be removed from the final rule.		References to the Tribunal affirming or varying the 2015 determination have been removed in the final rule.
The definition of regulatory year in the rule should be further modified.	AER (Attachment C, p. 6)	The Commission considers these to be locally defined terms that are required to facilitate the operation of the rule. The Commission has decided to maintain the definition from the draft determination.
The term "subsequent regulatory control period" in the rule should be replaced by "future regulatory control period".	AER (Attachment C, p. 6)	
The terms "revenue increment/decrement" in the subsequent adjustment amount definition in the rule should be changed to "revenue increase/decrease".	AER (Attachment C, p. 7)	The Commission agreed with the AER has adopted this change.
There could be outcomes outside the three scenarios that are captured by the draft rules.	AER (Attachment C, p. 11)	The Commission acknowledges that other scenarios not contemplated by the rule may occur. However, the Commission considers that by using timeframes to define the scenarios as opposed to specific events combined with the discretion provided to the AER provides sufficient flexibility to the AER to respond to different scenarios.

A.2 Summary of other issues raised in first round consultation

Issue	Stakeholder	Commission's Response
Note that the discount rate for the NPV calculation will be the relevant weighted average cost of capital in the remade 2015 determination, noting that this will vary year-by-year because of annual updates to the cost of debt.	AER, p.17	The draft rule gives AER discretion to determine the discount rate.
Agree that it is the AER's task to ensure NPV neutrality in setting X factors within the constraints of the NER.	Ausgrid, p.2	The draft rule gives AER discretion to determine the applicable discount rate consistent with the existing provisions of Chapter 6 of the NER.
Consider that the proposal should take the form of general rule change to apply in future to all DNSPs in these circumstances.	Energy Consumers Australia, p.2	This is outside the scope of the rule change request.
Consider that a 'one-off' steep fluctuation and return in prices may not necessarily be a worse outcome than steady increases over 6-7 years, especially if mitigated for the most vulnerable consumers by 'one-off' supplementary payments.	Ethnic Communities' Council of NSW, p.2	The AEMC considers that reducing price volatility best promotes the National Electricity Objective.
Consider whether the likely effect of the proposed derogation would be to increase the amount of revenue that could be recovered in the absence of the derogation, regardless of the final adjustment amount.	Public Interest Advocacy Centre, p.3	The draft rule requires a revenue outcome that is neutral in Net Present Value terms.
Note that the best method to reduce volatility may be to retain the existing rules, including	Public Interest Advocacy	The draft rule is not inconsistent with existing NER rules on side constraints and pricing principles. The draft rule provides that the side

Issue	Stakeholder	Commission's Response
the remaining side constraints and the customer impact principle.	Centre, p.3	constraint provision (clause 6.18.6 of the NER) does not apply to the extent that the proponents' tariffs vary from tariffs that would otherwise result from complying with the side constraints, due to the application of the participant derogation (clause 8A.15.8(b)(5) of the NER).
Note that movements in regulated revenue may not necessarily result in volatility.	Public Interest Advocacy Centre, p.5	The draft rule gives AER discretion to determine, in consultation with the relevant proponent and such other persons that the AER considers appropriate, whether or not to smooth revenue across the current regulatory control period and the subsequent regulatory control period under the requirement of minimising price volatility.
Consider that review of the interaction between the network pricing objective and the pricing principles, and the impact of under recovery of the adjustment amount on capital costs for networks, is important.	Public Interest Advocacy Centre, pp. 6-7	The draft rule is not inconsistent with existing NER rules on pricing principles, and is consistent with the network pricing objective in so far as it allows the recovery of efficient costs of providing direct control services for the current regulatory control period (refer to Chapter 4 of the Draft Determination).
Consider that temporary rules that prescribe variances to the method for revenue smoothing normally adopted by the AER should only be on grounds for reducing compensation for the time value of money, rather than being overly generous to networks by increasing total amount of revenue recovered.	Public Interest Advocacy Centre, p.7	The draft rule is consistent with the revenue and pricing principles (refer to section 3.3 of the draft determination), and requires that any revenue adjustment be equivalent in net present value terms.
Question whether derogation is required given significant uncertainty associated with the judicial review, and whether Commission should wait for the outcome before issuing a rule change determination.	Red and Lumo Energy, p.2	The draft rule reduces the regulatory uncertainty that is associated with the judicial review, and incorporates various timeframes and outcomes of the judicial review.
Consider that any revenue smoothing derogation that avoids required network price	Red and Lumo Energy, p.2	The draft rule is consistent with the revenue and pricing principles

Issue	Stakeholder	Commission's Response
adjustments in favour of revenue smoothing may breach the revenue and pricing principles in the NEL.		(refer to section 3.3 of the draft determination).

B Legal requirements under the National Electricity Law

This appendix sets out the relevant legal requirements under the National Electricity Law (NEL) for the Commission to make this final rule determination.

B.1 Final rule determination

In accordance with section 102 of the NEL the Commission has made this final rule determination in relation to the rule proposed by the NSW DNSPs.

A copy of the more preferable rule is published with this final rule determination. Its key features are described in section 2.4.

The Commission's reasons for making this final rule determination are set out in Chapter 3.

B.2 Power to make the rule

The Commission is satisfied that the more preferable rule falls within the subject matter about which the Commission may make rules. The more preferable rule falls within section 34 of the NEL as it relates to the activities of persons participating in the national electricity market or involved in the operation of the national electricity system.¹²⁵

B.3 Additional rule making test – Northern Territory

From 1 July 2016, the NER, as amended from time to time, apply in the Northern Territory, subject to derogations set out in regulations made under the Northern Territory legislation adopting the NEL.¹²⁶ Under those regulations, only certain parts of the NER have been adopted in the Northern Territory.¹²⁷

The *National Electricity (Northern Territory) (National Uniform Legislation) Act 2015* allows for an expanded definition of the national electricity system in the context of the application of the NEO to rules made in respect of the Northern Territory, as well as providing the Commission with the ability to make a differential rule that varies in its terms between the national electricity system and the Northern Territory's local electricity system.

The Commission has considered whether a differential rule is required for the Northern Territory electricity service providers and concluded that it is not required in

¹²⁵ Refer to section 34(1)(a)(iii) of the NEL.

¹²⁶ Refer to National Electricity (Northern Territory) (National Uniform Legislation) (Modification) Regulations.

¹²⁷ For the version of the Electricity Rules that applies in the Northern Territory, refer to: [http://www.aemc.gov.au/Energy-Rules/National-electricity-rules/National-Electricity-Rules-\(Northern-Territory\)](http://www.aemc.gov.au/Energy-Rules/National-electricity-rules/National-Electricity-Rules-(Northern-Territory))

this instance. This is because the provisions of the final rule have no practical effect in the Northern Territory because they relate to a participant derogation for New South Wales distribution network service providers, and are not relevant to participants in the Northern Territory.

B.4 Participant derogations

Under the NEL,¹²⁸ the Commission may make a rule (participant derogation) at the request of a person who is conferred a right, or on whom an obligation is imposed, under the Rules (including a Registered participant), that:

- (a) exempts, in a specified case or class of cases, that person or a class of person of which that person is a member, from complying with a provision, or a part of a provision, of the Rules; or
- (b) modifies or varies the application of a provision of the Rules, (with or without substitution of a provision of the Rules or a part of a provision of the Rules) to that person or class of person of which that person is a member.

The Commission must not make a participant derogation unless the derogation specifies a date on which it will expire.¹²⁹

B.5 Commission's considerations

In assessing the rule change request the Commission considered:

- its powers under the NEL to make the rule
- the rule change request
- submissions received in response to the consultation paper and the draft determination
- the Commission's analysis as to the ways in which the proposed rule will or is likely to, contribute to the national electricity objective and the Revenue and Pricing principles.

There is no relevant Ministerial Council on Energy (MCE) statement of policy principles for this rule change request.¹³⁰

¹²⁸ Refer to section 91(5) of the NEL

¹²⁹ Refer to section 103 of the NEL

¹³⁰ Under section 33 of the NEL, the Commission must have regard to any relevant MCE statement of policy principles in making a rule. The MCE is referenced in the Commission's governing legislation and is a legally enduring body comprising the Federal, State and Territory Ministers responsible for Energy. On 1 July 2011 the MCE was amalgamated with the Ministerial Council on Mineral and Petroleum Resources. The amalgamated council is now called the COAG Energy Council.

The Commission may only make a rule that has effect with respect to an adoptive jurisdiction if it is satisfied that the proposed rule is compatible with the proper performance of Australian Energy Market Operator's (AEMO's) declared network and system functions.¹³¹ The final rule is compatible with AEMO's declared network and system functions because it is unrelated to them and therefore does not affect the performance of those functions.

B.6 Power to make a more preferable rule

Under section 91A of the NEL, the Commission may make a rule that is different (including materially different) from a proposed rule if the Commission is satisfied that, having regard to the issue or issues that were raised by the proposed rule (to which the more preferable rule relates), the more preferable rule will, or is likely to, better contribute to the achievement of the NEO. As discussed in Chapter 2, the Commission has determined to make a more preferable rule. The reasons for the Commission's decision are set out in Chapter 3.

B.7 Civil penalties

The Commission's more preferable rule does not amend any clauses that are currently classified as civil penalty provisions under the NEL.

The Commission does not propose to recommend to the COAG Energy Council that any of the provisions of the more preferable rule be classified as civil penalty provisions.

¹³¹ Refer to section 91(8) of the NEL