



Final Decision

Amendment to Electricity Distribution: Determination of Prescribed Services

August 2007

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1. BACKGROUND

The Authority's *Electricity Distribution: Determination of Prescribed Services* (September 2000) classified all services performed by a distribution network service provider (DNSP) that are associated with, or ancillary to, access to the network for the supply of electricity as prescribed services.

The provision of prescribed services underpins the build-up of costs upon which the DNSPs' revenue caps were determined in 2001 and again in 2005.

The Authority's *Final Determination: Regulation of Electricity Distribution* (April 2005) therefore included costs associated with the provision of all prescribed services. The majority of these costs were associated with the provision of services via the distribution network (Distribution Use Of System (DUOS) services). The remaining costs related to the provision of services ancillary to the main network services (non-DUOS services).

In 2005, these non-DUOS services accounted for less than 5 per cent of total services revenue.

Under the revenue cap form of regulation applied by the Authority to DNSPs, revenue raised in any year above (or below) the set revenue cap must be returned to (recovered from) customers in subsequent years. In this way, a DNSP is assured of raising revenue equal to the revenue cap, providing a degree of certainty to both distributors and customers during the regulatory period.

As non-DUOS revenue was included within the revenue cap, any unanticipated and significant change in the amount of revenue received for these services will impact on DUOS prices in order to maintain the revenue cap at its approved level.

Provided non-DUOS revenue remains reasonably stable and consistent with the forecast adopted at the start of the revenue period (as has generally been the case), this approach raises no cause for concern.

However, with the sale of the retail arms of Energex and (much of) Egron Energy, combined with the introduction of competition in the retail energy market, the DNSPs anticipate that there will be a significant increase in the demand for non-DUOS services and hence they expect non-DUOS revenue to rise sharply. Under the current arrangements, this would result in DUOS prices being held artificially low in order to balance the unexpectedly higher level of non-DUOS revenue.

In effect, non-DUOS services would be cross-subsidising DUOS services. This would be an unintended (and undesirable) outcome of the Authority's decision to apply a fixed revenue cap form of regulation and the introduction of FRC.

The Authority's Prescribed Services Determination provides a framework whereby certain distribution services can be excluded from regulation under the fixed revenue cap form of regulation. However, this provision requires that the service to be excluded can be shown to be available within a competitive market segment and not solely provided by the monopoly service provider. While this is an important criterion for determining whether a particular service should be treated as an excluded service, it is by no means the only criterion that could be applied.

In its Prescribed Services Determination, the Authority noted (at Appendix B) a range of services identified in the National Electricity Code (subsequently amended to the National Electricity Rules) as being activities the jurisdictional regulator might define as excluded services. This list includes many activities that form the non-DUOS services now identified by the distributors where demand is likely to substantially increase. However, the provision the Authority included in its Prescribed Services Determination to allow for services to be excluded from coverage under the revenue cap form of regulation is not broad enough to allow many of these non-DUOS services to actually be excluded. In

other jurisdictions, similar non-DUOS services are already treated as excluded services or otherwise subjected to a lighter form of regulation than DUOS services.

2. PROPOSED AMENDMENTS

Given the potential and unintended impact of increased revenue from non-DUOS services on efficient pricing for DUOS services, the Authority proposed to amend its Prescribed Services Determination to include broader criteria for excluding services, consistent with the intention of the National Electricity Rules. The proposed amendments provide the Authority with an option to exclude certain services from the fixed revenue cap form of regulation and apply an alternative and lighter-handed form of regulation to these services.

In particular, the Authority proposed to make the following amendments to its *Electricity Distribution: Determination of Prescribed Services* (September 2000).

Section 3 (p.8):

Following the second bullet point, insert the following text (*italics used for emphasis only*):

- *the Authority may deem a service to be excluded having regard to the criteria set out in section 6.2.4(a) of the National Electricity Rules.*

Section 5 (p.10):

At the end of the existing text, insert the following text (*italics used for emphasis only*)

Notwithstanding the above, where a contestable market cannot be demonstrated, the Authority may deem a service to be excluded having regard to the criteria set out in section 6.2.4(a) of the National Electricity Rules and may choose to apply a form of “light handed” regulation to these services.

As responsibility for the regulation of electricity distribution services is scheduled to pass from the Authority to the Australian Energy Regulator (AER) in the near future, the Authority decided not to undertake an extensive review of its prescribed service determination. The AER will no doubt review the determination of prescribed services once it assumes this responsibility.

The Authority released its proposed amendments to the Prescribed Services Determination on 26 June 2007. Submissions on the proposed amendments were invited from interested parties and closed on 27 July 2007.

3. SUBMISSIONS

The Authority received submissions from Energex, Ergon Energy and TRUenergy following the release of its proposed amendment to the Prescribed Services Determination.

Energex supported the Authority's proposed amendment as it would overcome a deficiency in the Prescribed Services Determination and provide a transparent mechanism to refine the regulatory requirements.

Ergon Energy supported the Authority's proposed amendment but suggested including a requirement for the Authority to consult with the affected distributor(s) prior to the Authority making a decision to exclude a particular service of the affected DNSP.

The Authority would, as a matter of course, undertake appropriate consultation before making such a decision. This consultation would include, but not be limited to, the affected distributor.

While TRUenergy did not object to the Authority's proposal, it indicated a preference that the existing services included within the revenue cap continue to be regulated in that manner. However, TRUenergy agreed that, where services were to be excluded from the revenue cap form of regulation, those services with monopoly characteristics should continue to be subjected to some form of regulation and only those services provided in a competitive environment should be eligible to be unregulated.

The Authority's objective in proposing this amendment is in line with the suggestions made by TRUenergy. The Authority's proposed amendment would not result in monopoly services being unregulated. Rather, it would provide an opportunity for services which are not central to the operation of the distribution network to be regulated in a more light-handed manner while also addressing the unintended pricing implications of fluctuating demand for these services. The form of alternate regulation that might be applied to newly excluded services would best be determined in the context of considering the characteristics of the particular service.

The Prescribed Services Determination already provides a mechanism to consider the exclusion of service provided in a competitive market and this mechanism is not affected by the proposed amendments.

4. FINAL DECISION

In view of the support provided in submissions for the Authority's proposed amendment to its Prescribed Services Determination, and the absence of any strong objections, the Authority has decided to implement its proposed amendment as set out in section 2.

The Authority's amended Prescribed Services Determination is summarised in Attachment 1.

ATTACHMENT 1**SUMMARY OF THE AUTHORITY'S APPROACH TO DETERMINING PRESCRIBED AND EXCLUDED SERVICES**

The Authority has adopted an approach whereby:

- initially, all services performed by each DNSP that are associated with, or ancillary to, access to that DNSP's network for the supply of electricity within that DNSP's service area are to be declared as 'prescribed services' and therefore subject to economic regulation by the Authority;
- DNSPs, or any other interested party, may apply on a case by case basis to have specific services treated as excluded services where it can be demonstrated that the market for such services is 'contestable', that is subject to potential – if not actual – competition; and
- the Authority may deem a service to be excluded having regard to the criteria set out in section 6.2.4(a) of the National Electricity Rules.

Any case put to the Authority for a service to be treated as excluded because it is subject to competitive provision, will need to provide evidence that there is a contestable market for that service.

A contestable market will be determined to exist if:

- the market is one where the DNSP does not have substantial market power, that is, the DNSP does not dominate the market – in the absence of evidence to the contrary, this will be assumed to be the case where the DNSP has a less than 40% market share; or
- the market is nonetheless contestable (that is lacks significant barriers to entry).

Prescribed Distribution Network Access Services

Distribution network access services relate to:

- the transportation and delivery of electricity;
- the carrying out of works or the provision of maintenance or repairs for the purpose of carrying out transportation of electricity; and
- the provision, installation and maintenance of any meter, switchgear or other electrical plant essential to the transportation and delivery of electricity.

The initial presumption underpinning the Authority's approach to determining prescribed services is that the above services provided by a DNSP are subject to certain market barriers to entry which make their provision in a particular geographical area a 'natural monopoly', and therefore result in market power accruing to the DNSP.

Unless insurmountable difficulties arise in the allocation of joint or common costs and assets between regulated and non-regulated activities, a service provided by a DNSP which does not qualify as a distribution network access service should be excluded from the revenue or price caps determined by the Authority.

Characteristics of Excluded Services

A distribution network access service may only be granted excluded status where it satisfies the Authority's operational guidelines. Under these guidelines, onus is placed on the applicant to provide the Authority with the evidence required to justify the exclusion of specific services.

Drawing on the requirements of the National Electricity Rules and the experiences of other jurisdictions, the Authority's basic approach to determining whether a service qualifies as an excluded service is to determine whether the DNSP possesses substantial market power in the market in question.

- Only if the DNSP is found to lack substantial influence in the market (specifically the ability to raise prices above the efficient costs of supply or earn an excessive rate of return based on efficient operation and investment), will the service be defined as an excluded distribution service, and not be subject to economic regulation.
- If the DNSP possesses substantial market power in the relevant market, the service will remain as a prescribed distribution service subject to some form of economic regulation by the Authority under the provisions of the National Electricity Rules.

Notwithstanding the above, where a contestable market cannot be demonstrated, the Authority may deem a service to be excluded having regard for the criteria set out in section 6.2.4(a) of the National Electricity Rules and may choose to apply a form of "light handed" regulation to these services.

Applying for Declaration of an Excluded Service

Where a DNSP or any other interested party wishes a specific service to be treated as an excluded service because it is subject to competitive provision, they must make an application to the Authority. Each application will be assessed on a case by case basis and will need to provide detailed evidence justifying the service's treatment as an excluded service in line with the Authority's Contestability Test for Excluded Services (Appendix A of the Prescribed Services Determination). In particular, the application must:

- define the market; and
- demonstrate that the current level of competition or, alternatively, the lack of significant barriers to entry mean that the DNSP lacks substantial influence in the market.

The Authority will then investigate the application and make a determination as to the regulatory status of the service.

Effect of a Service Being Prescribed

The Authority, in determining that a service is (or remains) a prescribed service, does not:

- prohibit such services from being provided by suppliers other than the DNSP;
- regulate the terms and conditions on which such services are provided by third parties; or
- restrict/eliminate the scope for negotiation of prices and/or the standard of service provision.

All that prescription means is that the rate of return which DNSPs can plan to earn on such services is both guaranteed and limited to a regulated maximum rate determined by the

regulatory regime adopted by the Authority. The rates of return which DNSPs can earn on excluded services provided in a competitive market are not constrained to any regulated maximum, but are constrained instead by competition and the risk of competition.

Services for which the relevant market is contestable must be excluded from the Authority's revenue/price caps. Otherwise, the DNSP will be guaranteed a rate of return on its activities in the contestable market, irrespective of its efficiency or success in that market.

Exclusion of services requires that the assets and costs associated with the delivery of those services be excluded from the asset and cost bases used for the purpose of determining the revenue or price caps to apply. Where joint assets or costs are involved, an appropriate allocation mechanism is required.