Ref: JD/RC

Date: 5 July 2012

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Dear Mr Khoe

SUBMISSION ON COST OF DEBT ISSUES FOR THE ECONOMIC REGULATION OF NETWORK SERVICE PROVIDERS RULE CHANGE REQUESTS

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider in Queensland, welcomes the opportunity to provide comment to the Australian Energy Market Commission on its additional round of consultation on *Cost of Debt Issues for the Economic Regulation of Network Service Providers Rule Change Requests.*

Ergon Energy is generally supportive of the revised approach to estimating cost of debt allowance advocated by the Queensland Treasury Corporation in their June 2012 supplementary submission.

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact me on (07) 4092 9813.

Yours sincerely

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Encl: Ergon Energy's submission.

Ergon Energy Corporation Limited

Submission on *Cost of Debt Issues for the Economic Regulation of Network Service Providers Rule Change Requests*

Additional Round of Consultation

Australian Energy Market Commission

5 July 2012

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This submission, which is available for publication, is made by:

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1. INTRODUCTION

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider (DNSP) in Queensland, welcomes the opportunity to provide comment to the Australian Energy Market Commission (AEMC) on its additional round of consultation on *Cost of Debt Issues for the Economic Regulation of Network Service Providers (NSPs) Rule Change Requests*.

Ergon Energy is generally supportive of the revised approach to estimating cost of debt allowance advocated by the Queensland Treasury Corporation (QTC) in their June 2012 supplementary submission. However, we remain concerned that important transitional issues could be overlooked given transitional issues are being considered in an environment where there is no fully defined rule change proposal and the AEMC is still consulting on different potential models. Therefore, Ergon Energy believes that this proposal should be pursued outside the constraints of the current Australian Energy Regulator/Energy Users Rule Change Committee rule change proposal.

Ergon Energy also believes that there may be significant transaction costs from imposing a single framework and therefore each firm should have the option of proposing the framework that best suits their specific circumstances. Further, Ergon Energy believes that regardless of the approach selected, the measurement of the debt benchmark should continue to be a reviewable decision. Section 2 outlines our detailed responses, in tabular form, to the consultation questions posed by the AEMC.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AEMC require.

2. TABLE OF DETAILED COMMENTS

Question(s)	Ergon Energy Response
1. As compared to the proposal put forward by the EURCC in the rule change proposal and ETSA/Citipower/Powercor's proposal in response to the Directions Paper, what are the advantages and disadvantages of QTC's proposal?	QTC's proposal significantly reduces interest rate mismatch by allowing for the application of the prevailing rate to new borrowings. This will help eliminate investment distortions. This methodology can be replicated by both private and government-owned NSPs. This means there would be no disadvantage to any party. The proposed strategy also allows NSPs to use a 10 year moving average approach which is more consistent with the funding strategy of other non-regulated entities that manage long life assets. Ergon Energy notes that the Energy Networks Association has identified some advantages and disadvantages of both approaches.
2. If QTC's proposal was to be implemented, how would such a move affect a NSP's current financing practices? What impact would it have on its risk management practices?	QTC's proposal would reduce both refinance risk and interest rate risk, and allow NSPs to achieve more alignment with regulated costs. It would also allow NSPs to take advantage of market opportunities and not be restricted to a 40 day refinancing window. Over time, this may lead to more stable costs and reduce the impact on price changes to customers every five years.
3. Would QTC's approach reduce the overall level of risk associated with debt financing for NSPs? If so, are there any implications for cost of equity?	As mentioned above, Ergon Energy believes the overall level of risk would be reduced. Ergon Energy is currently required to refinance in a 40 day window at the same time as Energex, and our combined debt levels have the potential to move the market and/or lead to other parties using this situation to their financial advantage. It should be noted that if there are reductions in the cost of equity this should be visible in the cost of equity beta.
4. What changes (if any) should be made to the approach to calculation of the cost of equity if this moving average approach is applied to debt to ensure a consistency of approach?	For consistency, a 10 year moving average approach for equity may be more appropriate. This would lead to a more natural alignment along with a combined longer term view on debt and equity. This should also reduce the likelihood of having situations where the cost of equity is lower than the cost of debt.
5. If the moving average approach is adopted, should the average be calculated based on dollar-weighted average of the rates or by calculating the effective interest rate (the IRR of all future payments on the debt) or some other method?	Ergon Energy agrees with QTC's position and we prefer the effective interest rate approach. This is a more accurate measure of the forward-looking cost of debt as it takes into account both the size and timing of the future principal and interest payments. We agree that this also aligns with the methodology employed by QTC to determine the annual interest rate and it is consistent with the accounting standards.
6. Is the proposal for re-calculating the cost of debt on a quarterly basis reasonable? What other frequency of data points (to be	Ergon Energy supports an annual calculation using quarterly data. Ergon Energy believes if it is performed more frequently (i.e. daily, weekly or monthly), it will only add

proposed quarterly basis) could be used in calculating the cost of debt and why would this be an improvement?	extra administrative and overhead costs without any significant changes to the rates applied. To avoid potential market volatility, we would prefer calculations not to be done at the end of the month. Another date could be agreed upon between the AEMC and the NSP.
7. Should this approach be an option under the rules? If so, should the regulator or the NSP have the discretion to exercise the option and why?	Ergon Energy believes this should be an option under the National Electricity Rules, and NSPs should have the discretion to choose this as an option. It is highly unlikely that an NSP would revert back and forth at the start of different regulatory periods as there would be no advantage to do this. The proposed approach does not allow NSPs to gain a competitive advantage by changing and, overall, this approach will lead to reduced refinance and interest rate risk.