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Mr Richard Khoe
Australian Energy Market Commission
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Email: submissions@aemc.gov.au

Dear Mr Khoe

SUBMISSION ON THE ECONOMIC REGULATION OF NETWORK SERVICE PROVIDERS SAVINGS AND TRANSITIONAL ARRANGEMENTS CONSULTATION PAPER – ERC0134/ERC0135/GRC0011

Ergon Energy Corporation Limited, in its capacity as a Distribution Network Service Provider in Queensland, welcomes the opportunity to provide a submission to the Australian Energy Market Commission on its *Economic Regulation of Network Service Providers Savings and Transitional Arrangements Consultation Paper.*

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact either myself on (07) 4092 9813 or Trudy Fraser on (07) 3228 2144.

Yours sincerely

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Encl: Ergon Energy's submission.

Ergon Energy Corporation Limited

Submission on the *Economic Regulation of Network Service Providers – Savings and Transitional Arrangements*

Consultation Paper

Australian Energy Market Commission

25 October 2012

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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 *Economic Regulation of Network Service Providers – Savings and Transitional Arrangements* Consultation Paper.

Ergon Energy is concerned that elements of the proposed transitional arrangement, particularly the requirement to prepare a 1 year mini-proposal at the same time as the subsequent 5 year proposal under different versions of the National Electricity Rules (the Rules) will potentially create duplication of effort, may generate confusion amongst stakeholder groups in responding to the various rounds of consultation and could increase the potential for regulatory error or uncertainty over merits/appeals processes applying to two sets of determinations. Ergon Energy suggests an alternative approach, such as that proposed by the Australian Energy Regulator (AER) or a variant on it, would provide a more feasible and pragmatic approach to transitioning to the new Rules. These concerns and suggestions will be detailed in Section 2 of this submission.

Ergon Energy is a member of the Energy Networks Association (ENA), the peak national body for Australia's energy networks. Ergon Energy is fully supportive of the comments contained in the ENA's submissions of 10 September 2012 and 2 October 2012, as well as the detailed submission prepared by Queensland Treasury Corporation (QTC) on rate of return and cost of debt issues of 25 October 2012.

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

2. SPECIFIC COMMENTS

This section provides a detailed response to the elements of the AEMC's proposed arrangements which Ergon Energy does not support, as well as providing alternative arrangements for consideration.

2.1. Transitional Determination

Ergon Energy is concerned that the preparation of a one year 'mini regulatory proposal', albeit a truncated process with a 'roll forward' of many of the constituent decisions, while simultaneously preparing the subsequent full five year regulatory proposal is unnecessarily complex. Furthermore, given that the two proposals will be prepared under different Rules, it creates significant risk of regulatory error. There is also the likelihood that running two sets of determination processes close together in time will potentially create duplication of effort, may generate confusion amongst stakeholder groups in responding to the various rounds of consultation and could increase the potential for regulatory error or uncertainty over merits/appeals processes applying to two sets of determinations.

Ergon Energy supports TransGrid's proposal (as submitted to the AEMC on 8 October 2012 and published on the AEMC's website) for a single regulatory determination to be made for the next regulatory control period, incorporating as much of the new Rules as possible, with a one year transitional 'placeholder' arrangement. However, Ergon Energy recommends an alternative approach be considered for the 'placeholder' year. More specifically, Ergon Energy supports the 'hybrid' approach tabled at the AEMC Workshop on 23 October 2012 (see Attachment 1), which is a variant of the TransGrid/AER proposal. This approach proposes that the placeholder revenue may be either below a cap specified in the Rules (for example, increase by the consumer price index, in which case it will automatically comply with the Rules; or above the cap, in which case the AER must undertake a review of the proposal.

Where, under the 'hybrid' approach, a Network Service Provider (NSP) proposes a placeholder revenue above the cap, they must submit to the AER a placeholder revenue statement supported by indicative range-based information provided by the DNSP, including:

- the forecast revenue in the last year of the current regulatory control period;
- the indicative opening Regulatory Asset Base (RAB) at the beginning of the next regulatory control period; and
- the possible high and low range of total annual revenue requirements and annual revenue requirements for the next regulatory control period (both smoothed and unsmoothed) based on indicative inputs including:
  - a range of indicative opex forecasts;
  - a range of indicative capex forecasts;
  - a range of Weighted Average Cost of Capital (WACC) forecasts, taking into account recent regulatory decisions, available market information, expected market trends and having regard to the rate of return guidelines;
  - an indicative CPI;
  - a summary of overall plans for expenditure over the transitional regulatory control period and an indication of how the placeholder revenue requirement fits within that plan; and
  - any other inputs necessary for determining a range of annual revenue requirements.

Prior to the commencement of year 2, a full review of the revenue requirement for years 2-5 and the placeholder year, would be undertaken in accordance with the new Rules and guidelines. A net present value 'true-up' mechanism would then be applied to account for any differences between the placeholder revenue and the revenue requirement established through the full determination process. In order for the smoothing of the true-up mechanism to work correctly, Ergon Energy suggests that clause 6.5.9((b)(2) in the Rules will need to be amended to support this process.

Despite Ergon Energy's support for this proposed model, there are still a number of transitional arrangements which require further consideration for Queensland DNSPs and Ergon Energy in particular. These concerns are outlined below.

2.2.1 Transitional arrangements for Queensland DNSPs

Ergon Energy notes that discussions to date have focused solely on Standard Control Services (SCS) and suggests that Alternative Control Services (ACS) also need to be considered in the transitional arrangements. However, it is recognised that a standard arrangement may not be able to be applied across NSPs. Ergon Energy suggests that our ACS Street Lighting be treated the same as SCS, given that it is based on a limited building block approach. Remaining ACS would need to be treated separately, as there is no avenue for a 'true-up' given these services are provided on a one-off basis to customers. Ergon Energy's ACS are price capped through a formula based approach. For those formula components that the AER sets through the Distribution Determination process, Ergon Energy suggests a similar methodology to the hybrid model could be used. For example if the increase to labour rates is at or below the cap then they would be approved. However, if Ergon Energy believed a higher rate was justified then we would need to provide such justification to the AER for their review.

In terms of the Distribution Service Target Performance Incentive Scheme, Ergon Energy recommends that the AER deem the target and revenue at risk in year one of the transitional regulatory control period to be the target and revenue at risk that applied in the last year of the previous regulatory control period. Normal arrangements would apply for setting targets for years two to five as part of the full determination, with the AER setting out its proposed approach in the Framework and Approach paper.

Further, Ergon Energy believes that a number of arrangements in place in the current regulatory control period will need to continue to apply in the transitional year. These include, the cost pass through events specified in the current Distribution Determination, the continuation of the transitional arrangements provided for in clauses 11.16.10 (Capital Contribution Policies) and 11.16.3 (RAB in relation to shared assets) for Queensland.

In order to ensure that all aspects of the new Rules are delayed appropriately, the relevant transitional time limits would need to be addressed in the draft Rules. For example, the draft Rules should specify the due date for the Framework and Approach paper, and all administrative steps in the development of that paper; the submission due date for the NSP's proposal and any required associated documents; and that the making of the AER's regulatory decisions on the proposal are delayed for 12 months for the transitional regulatory control period.

2.2 Return on debt

Ergon Energy considers that the transitional arrangements proposed by the AEMC are likely to create additional interest rate risks for NSPs with large debt portfolios. It is not possible in practice for these NSPs to lock in a fixed base interest rate on existing debt for a one year period and then fully reset the base rate again prior to the start of the delayed full regulatory control period.

Ergon Energy's preference is for a continuation of the current five-yearly regulatory determination process where the return on debt component of the WACC would be determined once prior to the start of the transitional year and for the return on debt to apply to all years in the five-year regulatory period. This approach would enable NSPs with large debt portfolios to refinance their debt once.

Due to the significant increase in debt balances held by some NSPs since the WACC parameter review was completed by the AER in 2008-09, Ergon Energy considers that the current 40 day maximum averaging period should be increased to a minimum period of at least six months. Ergon Energy further considers that it may be appropriate for the averaging period to be extended to between six and twelve months for NSPs who are transitioning to a different return on debt approach such as a long-term trailing average of the total return on debt. In this instance, the transitional year could be used as an extended averaging period for determining the final return on debt.

A longer averaging period would enable NSPs with large debt portfolios to align their actual financing costs with the return on debt allowance, which would be of benefit to NSPs and customers over the longer term. It is Ergon Energy's view that each NSP is in the best position to determine the transitional arrangements that are most applicable to its circumstances and should have the ability to choose the averaging period which applies, provided the averaging period chosen is in the future and forward looking to prevent gaming by the NSP. As such, the timing and length of the single averaging period could be discussed and agreed between the AER and the NSP during the Framework and Approach process. Ergon Energy considers the single averaging period for the benchmark return on debt should end just prior to the start of the transitional year.

In relation to TransGrid's proposal, a subset of the single averaging period could be used to determine the indicative WACC for the placeholder revenue for the transitional year with true-up calculations performed when the final determination WACC is known. The dollar value difference between the indicative WACC and the final WACC would be amortised on a present value neutral basis over the shortened four-year regulatory period. In relation to the 'hybrid' model, there is potential cost of carry benefits for NSPs if the longer averaging period is allowed to run up and until 30 June 2015 and/or possibly extend over into the transitional year. This benefit can potentially equate to a quarter of a year cost of carry in relation to the average debt term of the NSP.

Ergon Energy acknowledges and supports QTC's detailed comments on the AEMC transitional arrangements and TransGrid's transitional model as they relate to the return on debt provisions.

Hybrid Approach – 2nd Variant of TransGrid/AER

- Placeholder revenue may be either:
  - *below cap specified in Rules* - in this case the proposal would automatically comply with the Rules and no public consultation would be required; or
  - *above cap specified in Rules* – in this case the AER would be required to conduct a more detailed assessment of the proposal using the approach set out in the TransGrid/AER proposal (see slide 4 above).
- Full review of revenue requirement for years 2-5 and placeholder year in accordance with new rules/guidelines. Review undertaken in the lead up to the commencement of year 2.
- True up mechanism to account for any difference between the placeholder revenue and the revenue requirement established through the full determination process (in net present value terms).