Ref: BN/TF/JD

Date: 7 October 2012

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Mr Richard Khoe
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Dear Mr Khoe

SUBMISSION ON THE ECONOMIC REGULATION OF NETWORK SERVICE PROVIDERS DRAFT DETERMINATION

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 Draft Determination.*

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*

Draft Determination

Australian Energy Market Commission

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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 *Economic Regulation of Network Service Providers* Draft Determination.

In response to the AEMC's invitation to provide comments on the Draft Determination, Ergon Energy has focused on the five broad areas in which changes have been proposed under Chapter 6 of the National Electricity Rules (Rules), including:

- Rate of return;
- Cost of debt;
- Capital expenditure and operating expenditure allowances;
- Capital expenditure incentives; and
- Regulatory process.

Ergon Energy has also offered comments on the categorisation of confidentiality claims and guidelines.

Section 2 of this submission detail's Ergon Energy's response to each of the main issues raised by the AEMC in its Draft Determination.

Ergon Energy is a member of the Energy Networks Association (ENA), the peak national body for Australia's energy networks. The ENA has prepared a comprehensive submission addressing the AEMC's Draft Determination. Ergon Energy is fully supportive of the arguments contained in their submission. Ergon Energy also supports the detailed submission prepared by Queensland Treasury Corporation (QTC) on rate of return and cost of debt issues.

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 each of the main issues raised by the AEMC in its Draft Determination.

2.1. Rate of Return

Ergon Energy generally supports the AEMC's new common rate of return framework for electricity and gas service providers and considers the changes are a significant improvement on the current approach. However, there are a number of elements within this framework which raise concerns for Ergon Energy. These are detailed in the following sub-sections.

2.1.1 Allowed rate of return objective

The draft rules define the allowed rate of return objective as:

> *The allowed rate of return is to correspond to the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services.*

Ergon Energy suggests that greater clarity is required regarding the meaning of certain terms such as '*benchmark efficient entity with a similar degree of risk'* used in the objective, and further, in defining the limits that will apply for the purposes of some of those terms. Ergon Energy also has concerns regarding the terms used in the Draft Rules relating to the setting of the Rate of Return Guidelines (the Guidelines), which are discussed in more detail in section 2.1.2 of this submission.

Furthermore, Ergon Energy notes that the ENA has raised a number of other concerns with the drafting of the allowed rate of return provisions (clauses 6.5.2(b)-(d)) and has proposed some minor amendments to improve clarity of the AEMC's intent. Ergon Energy supports these concerns and the proposed amendments.

2.1.2 Rate of return guidelines

Ergon Energy notes the Australian Energy Regulator (AER) is required to undertake an open and consultative process at least every three years to develop a set of <u>non-binding guidelines</u> outlining its approach (with the first guideline commencing in November 2013). The Draft Determination appears to provide significantly increased discretion and flexibility to the AER in determining the rate of return for Network Service Providers (NSPs). Ergon Energy is concerned that the accountability measures imposed on the AER are not comparable to the increased discretion and flexibility, and are insufficient to achieve the AEMC's intended objective under the new rate of return framework. This is especially concerning given that it now extends to the return on equity as well as return on debt.

Past experience suggests that the AER has consistently chosen data sources and approaches that give the lowest estimate, which has resulted in several recent decisions being over-turned by the Australian Competition Tribunal. Ergon Energy considers there may be a need for additional consequences for the AER if errors are continually made during their regulatory decision making processes regarding the return on debt and return on equity. As such, Ergon Energy recommends the AEMC further consider the accountability measures imposed under the new framework to ensure that they are sufficient in the context of the significant increase in discretion and flexibility afforded to the AER.

The ENA has raised concerns in its submission relating to the removal of the 'persuasive evidence test'. The ENA believes that the materiality and uncertainty in estimating the appropriate rate of return reinforces the need for a strengthening of the process set out in the Rules; specifically a requirement for parties to provide reasons and evidence for departing from the Guidelines, or where the AER departs from the approach specified in previous guidelines. Notwithstanding, it is noted that clause 6.2.8(c) does, to some extent, provide for such a requirement if the AER makes a distribution determination that is not in accordance with [the] Guidelines. Nonetheless, the draft rules also allow the AER to make administrative or minor amendments to any guideline without complying with the distribution consultation procedures. Ergon Energy suggests greater clarity is required regarding the limits of what constitutes ‘minor amendments’, and supports the ENA call for greater strengthening of the provisions of clause 6.2.8(c), particularly where the AER departs from the approach specified in the previous guideline.

As noted above, Ergon Energy suggests greater clarity is required to define a ‘benchmark efficient entity with a similar nature and degree of risk’. Ergon Energy notes the AEMC recognises that the risk characteristics of the benchmark efficient service provider are not the same for all service providers, and that the regulator may consider this issue in developing its guidelines. Consequently, Ergon Energy suggests that the Guidelines should outline the specific factors considered by the AER in determining the risk profile of the service provider. For example, in the case of Ergon Energy it would be prudent to consider the size and rural nature of Ergon Energy’s business, including its exposure to severe weather events.

Ergon Energy welcomes the requirement to take account of all relevant estimation methods, financial models, market data and other evidence in determining the rate of return and considers that this will ensure transparency and consistency in rate of return outcomes by the AER. Ergon Energy also considers that taking the above mentioned issues into account in determining the rate of return will enable NSPs and customers to accurately predict and replicate the AER’s methodology in estimating the final rate of return. However, Ergon Energy is concerned the AER will meet the requirements of the draft rule by ‘considering’ a wider range of information but choose a method that produces a low return on debt and/or equity, which could occur if the AER is not required to publish the quantitative weightings it will apply to various estimation methods in the Guidelines. Although NSPs have an opportunity as part of their regulatory determination process to argue for a different approach to that proposed in the Guidelines, the onus of proof is firmly placed on NSPs to explain why their approach better meets the overall rate of return objective than the AER’s approach in the Guideline. In this regard, Ergon Energy considers that the ENA’s proposed amendment requiring parties to provide reasons and evidence for departing from the Guidelines is likely to address this issue.

Further the ENA submission also raises similar concerns that the increased discretion afforded to the AER will not meet the policy objective of increased stakeholder engagement. In particular, the application of several financial models is likely to generate a wide range of cost of equity estimates, which does not provide stakeholders with any useful information to understand the AER’s current position.

The ENA also argues that the current timeframes are insufficient to effectively engage stakeholders with any substantive issues that arise from either the consultation paper or draft decision. Similarly, Ergon Energy considers that the timeframe for stakeholders to respond to the regulator’s consultation paper and draft rate of return guidelines should be increased from not less than 30 days to not less than 60 days. This timeframe would be more appropriate given the range of issues that are likely to be raised in the development of the guidelines.

2.2. Cost of debt

Ergon Energy considers that the inclusion of an historical trailing average approach in the Rules for determining the benchmark return on debt is a positive outcome for NSPs with large debt portfolios. NSPs with large debt portfolios are currently unable to align their actual debt costs with the return on debt allowance under the current approach. Ergon Energy considers that no explicit adjustments to the allowed return on equity are required if NSPs are able to align their actual debt costs with the return on debt allowance via one of the three return on debt approaches listed in the draft Rules (i.e. prevailing cost of funds approach, historical trailing average approach, or some combination of these two approaches). Ergon Energy acknowledges that QTC has made a detailed submission on the rate of return framework, including the return on debt and return on equity, and refers the AEMC to the QTC’s submission, which as discussed above, Ergon Energy supports.

Contrary to the AEMC’s views, Ergon Energy does not consider that the AER is in the best position to determine the most suitable approach to estimating the return on debt, as the regulator is not experienced in issuing debt and/or managing interest rate risk. On this basis, Ergon Energy considers that NSPs who are actually responsible for implementing interest rate risk management strategies are in the best position to determine the debt management approach that is most appropriate for their business. Consequently, Ergon Energy proposes that the AER should be required to give significant weight to the NSP's return on debt proposal and agrees with QTC's view that the NSP's proposal should be used as the starting point for determining the return on debt allowance.

The ENA suggests the factors in clause 6.5.2(h) to which the AER should have regard in determining the 'methodology' referred to in clause 6.5.2(f) do not provide adequate guidance to the AER and are unlikely to be consistent with the National Electricity Objective, National Gas Objective or Revenue and Pricing Principles (RPP). Furthermore, the ENA suggest that the 'methodology' also requires clarification to prevent opportunistic conduct that has the potential to undermine financing decisions that are efficient and prudent in the long term.

The ENA also recommends that businesses be required to propose a methodology for applying the cost of debt that is consistent with the allowed rate of return objective and the return on debt methodology principles. In this regard, the ENA further recommends that, subject to the proposed methodology meeting these requirements, the AER should be required to accept the businesses proposal; else the methodology must revert to that which applied in the immediately preceding regulatory control period. Ergon Energy supports this position.

Furthermore, Ergon Energy reaffirms our previous view that the benchmark cost of debt should continue to be based on a risk free interest rate and debt risk premium that corresponds to a ten year term, reflecting that this borrowing tenor represents the most prudent debt management strategy for NSPs with long-lived assets in the absence of regulation.

Ergon Energy also confirms its continued support for QTC's proposal[1] for the benchmark return on debt to equal a ten-year moving average of the ten-year total corporate cost of debt and agrees with Strategic Finance Group Consulting's view that QTC's proposed moving average approach is one way of avoiding the potential for investment distortions on new borrowings.

2.3. Capital and operating expenditure forecasting

2.3.1 AER forecasting methodology

Ergon Energy supports the ENA's position on this issue. More specifically, it is not appropriate that the AER be able to specify a particular forecasting methodology which the NSP is then required to incorporate in its regulatory proposal. The ENA suggests that a regulatory proposal should contain the NSP's best information. That is, information based upon the practices that the NSP uses on a day-to-day basis to plan and run its network, which include the methodologies the NSP uses to forecast capital and operating expenditure. The ENA submits that requiring a NSP to incorporate in its regulatory proposal forecasts that were based on methodologies that the NSP does not itself use or necessarily believe are forecasts that are consistent with the requirements of the Rules would weaken the overall effectiveness of the framework. Furthermore, this requirement would result in duplication of efforts, not only for the NSP, but also the AER, who would be required to asses the NSP's proposed forecast as well as a forecast prepared on the prescribed basis, which was not supported by the NSP.

2.3.2 Consideration of individual circumstances of businesses

The AEMC has removed reference to the individual circumstances of the NSP in forecast assessment clauses. The ENA argues that removal of this reference does not adequately recognise the importance of the individual characteristics of a NSP in the AER's assessment of that NSP's expenditure forecasts. Furthermore, the ENA reiterates its position that no evidence or material has been provided to suggest that the operation of the Rules have in any way limited or otherwise hampered the AER in using benchmarking information. As such, the ENA does not support this amendment to the Rules. Likewise, Ergon Energy does not support the amendment.

[1] Cost of Debt issues for the Economic Regulation of Network Service Providers Rule Change Requests, Additional round of consultation, June 2012

2.3.3 Small scale incentive schemes

There is scope for the AER to trial various small scale incentive schemes, affecting up to 0.5 per cent of revenue for a regulatory year, and subject to the approval of the NSP, up to 1 per cent of revenue for a regulatory year. Ergon Energy generally supports this approach as a compromise between the AER and industry positions, though concurs with the ENA's suggestion that the framework could be strengthened by making minor enhancements, such as requiring consideration of the likely costs and benefits of implementing a scheme; and clarifying that any small scale incentive scheme that is to apply to a NSP is made known at the Framework and Approach stage, or where this is not the case, only to apply when agreed by the business.

2.3.4 Benchmarking

Ergon Energy notes that the ENA supports improving the collection of information by the AER, to facilitate the application of benchmarking. However, Ergon Energy suggests that due consideration is also given to the costs associated with any additional reporting burden over and above that which is already provided for the Regulatory Information Notice.

The draft rule determination suggests exogenous factors should be taken into account when benchmarking NSPs. Ergon Energy's experience is that fundamental Australian NSP characteristics such as customer density, line length, network geography, topography, propensity for climate extremes, voltage levels, vegetation growth rates, customer types etc are widely varying to the extent that benchmarking techniques are not capable of delivering the necessary precision of analysis to guide assessment of efficient capital or operational expenditure levels.

Ergon Energy proposes that the AER should have the discretion to not publish an annual benchmarking report if it arrives at a view consistent with that of Ergon Energy, that it is not possible to unwind or take into account the 'differences in the environment of the different NSPs'. In the event that the AER is required to publish a report, the AER should not be directed to have particular regard to it given the last available report may lag the proposed forecasts by one or two years. Furthermore, Ergon Energy considers that the publication of such a report would be likely to mislead less informed market participants. On this basis, Ergon Energy's view is that the draft rule determination suggestion to 'set out the relative efficiencies of distribution and transmission NSPs, taking into account the exogenous factors that distinguish them' is not possible. Ergon Energy agrees with the ENA that the AER's annual benchmarking report is most likely to be useful as a means of identifying anomalies that require more detailed examinations.

2.3.5 Uncertainty mechanism – materiality for pass through for distribution

Ergon Energy agrees with the ENA's suggestion that if any materiality threshold for pass through events is to be specified in the Rules, the threshold should be expressed to apply cumulatively. As cited by the ENA in its submission, failure to have a threshold that applies cumulatively risks being inconsistent with the RPP, in particular that a NSP should be provided with a reasonable opportunity to recover at least the efficient costs that it incurs in providing services and complying with regulatory obligations or requirements, or making a regulatory payment.

2.3.6 Shared assets

Ergon Energy concurs with the comments by the ENA on this issue that are included in its submission. Ergon Energy also supports the proposition that assets should be allocated between different activities rather than capital expenditure, on the basis that it provides a long term fairer and more efficient means of allocating costs between prescribed and other activities.

Ergon Energy supports its existing transitional arrangements being accommodated in the revised Rules. As noted by the ENA, further changes to the Rules are required to allow the full cost of any assets required to provide Standard Control Services to be included in the Regulatory Asset Base (RAB). From this initial RAB value an allocation can be made between services using a revenue adjustment as proposed by the AEMC.

Ergon Energy also notes that the AEMC indicated in its Draft Determination that an allocation should also occur for assets shared between Standard Control Services and Alternative Control Services. Ergon Energy supports this approach as being consistent with its current practice. However, the proposed change is not reflected in the draft Rules. Ergon Energy therefore requests further amendment to the Rules to give effect to this requirement. Ergon Energy would welcome further discussion with the AEMC on any necessary changes to the Rules.

2.4. Capital expenditure incentives

2.4.1 Capital expenditure sharing scheme

Ergon Energy concurs with the ENA's support for Rules allowing the AER to strengthen the incentives for efficient capital expenditure through an ex-ante incentive scheme. However, Ergon Energy does not support the implementation of an asymmetric incentive scheme, as it does not provide an NSP with a reasonable opportunity to recover at least its efficient costs, which is inconsistent with the RPP. The ENA submission provides a more detailed analysis of the capital expenditure incentive objective and guideline, and although the ENA supports the intent of the objective and guideline, suggests that these are also inconsistent with the RPP.

2.4.2 Ex-post review of capital expenditure

The ENA submission does not support the option to use an ex-post expenditure review due to the difficulty in restricting the application of hindsight by a regulator in practice. It is possible that the assessor is able to learn from subsequent events, either by unconsciously taking account of subsequent facts, or using the subsequent experience to apply more weight to information at the time than would have been prudent at the time. Ergon Energy shares this view and requests the removal of the option for the AER to undertake an ex-post review of capital expenditure. However, if it is retained, it is necessary to improve the guidance to the AER so that it has proper regard to the costs and risks of deciding to adopt such a tool and of undertaking such a review.

2.5. Regulatory process

Ergon Energy generally supports the lengthened process and the preparation of an initial issues paper by the AER. Further, Ergon Energy notes that the ENA considers that there is remaining scope to amend the rules to more efficiently streamline the timing of the various steps to the regulatory process and to enhance stakeholder engagement.

2.5.1 Framework and approach paper

As drafted, the Rules enable the AER to apply its subjective judgement in determining whether the framework and approach paper in place may be revisited at the commencement of the regulatory process, thus providing the AER the ability to unilaterally decide to amend one or more components of the framework and approach paper as it sees fit. Ergon Energy believes that the NSP should also be able to trigger consultation on the framework and approach paper. The ENA also suggests that given the significant expansion of the framework and approach paper, the framework and approach paper process should be mandatory and Ergon Energy agrees with this position.

There appears to be a typo in the Note to clause 6.8.1(b)(1). The reference to clause 6.25(6) should be clause 6.25(b).

2.5.2 Transitional arrangements

Although transitional arrangements are not specifically addressed in this consultation, Ergon Energy is concerned that the AEMC has proposed affected NSPs will be required to undertake a stand alone piece of work for a 1 year proposal followed by a 5 year proposal, with a quantity of the work being required to be undertaken at the same time. Ergon Energy wishes to express concerns with the efficacy of this approach. Detailed comments will be provided in a separate submission to the AEMC's consultation on savings and transitional arrangements.

2.6. Categorisation of confidentiality claims and guidelines

Ergon Energy suggests that ‘personal affairs’ be replaced with ‘personal information’. This will ensure alignment with the terminology used in current commonwealth and jurisdictional legislation dealing with ‘personal information’ and ‘information privacy’. Further, Ergon Energy recommends that ‘personal information’ not be categorised as ‘confidential information’ on the basis that ‘personal information’ has its own statutory definitions and protections, and is to be distinguished in many cases from ‘confidential information’.