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Manager – MCE Secretariat
Department of Industry, Tourism and Resources
GPO Box 9839
Canberra ACT 2601

MCEMarketReform@industry.gov.au

61 Mary Street
Brisbane QLD 4000
PO Box 107 Albert Street BC
Brisbane QLD 4002
www.ergon.com.au
Telephone 07 3228 8222
Facsimile 07 3228 8118

Dear Sir/Madam

**MINISTERIAL COUNCIL ON ENERGY STANDING COMMITTEE OF OFFICIALS
PUBLIC CONSULTATION ON A NATIONAL FRAMEWORK FOR ENERGY DISTRIBUTION AND
RETAIL REGULATION**

Ergon Energy is pleased to make this submission with respect to the Public Consultation Paper prepared by NERA Economic Consulting and Gilbert + Tobin (the Consultation Paper) in its capacity as an electricity Distribution Network Service Provider in Queensland.

Ergon Energy notes that the Consultation Paper addresses many issues which have been the subject of recent public consultation by the AEMC in its current review of electricity transmission revenue and pricing rules. The views expressed in this submission are consistent with those developed in Ergon Energy's response to the AEMC consultation papers.

In responding to the various consultation papers developed as part of the current move to a national energy regulatory framework, Ergon Energy has consistently argued that the Rules should not seek to impose unnecessary prescription but rather should establish high level principles and provide the AER with discretion in undertaking its task. Ergon Energy believes that an incentive based propose/respond model should be adopted whereby network service providers are able to submit a preferred approach consistent with the Rules and reflecting their individual commercial and operating issues. This model should include stronger incentives for future productivity by providing network service providers with a property right to a greater percentage (at least 50%) of the benefits accruing from efficiency improvements attributable to their actions. The AER should only be able to reject the proposal where it is inconsistent with the Rules or where parameter values are outside a reasonable range. The ability of the AER to reject network service providers' proposals means that it is essential that network service providers have access to merits review.

In responding to the Consultation Paper, Ergon Energy has continued to develop the above themes. The following comments follow the structure of the Consultation Paper.

Part B: Price Regulation of Distribution

Section 1. Overview

Ergon Energy considers that the criteria for best practice distribution price regulation outlined in the Consultation Paper require revision to ensure that an appropriate test for applying best practice distribution price regulation is developed which is more consistent with the NEL's objective clause, namely:¹

'The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.'

Ergon Energy considers that a more suitable suite of principles would be:

- that regulation should be light handed and incentive based and seek to maximise social surplus² rather than to minimise cost;
- that regulatory intervention should be limited to situations where there is a demonstrated need;
- the regulated business should be remunerated so as to recover the stand alone cost of the regulated service;
- that the regulated business must earn (at least) a commercial return on its investment (so that the circumstances in which less than full cost recovery is achieved are specifically set out – and perhaps limited to situations where the investment can be shown to have been imprudent at the time that it was made or where the business is demonstrably inefficient or has demonstrably and unreasonably low levels of service quality);
- DNSPs should secure an enforceable property right to a predefined proportion of any efficiency gain that it achieves. The concept of an efficiency gain is to be defined widely to encompass dynamic efficiency improvements such as improvements in asset utilisation;
- regulation should contain sufficient flexibility to address unique commercial and operational characteristics of DNSPs;
- that the regulatory framework should include mechanisms to ensure transparency and accountability;
- regulators to have regard to the imprecision of inputs and to the asymmetric consequences of regulatory error;
- outcomes of regulatory processes should be consistent with workably competitive markets; and
- users should be allowed to signal preferred standards of service with inclusion of safety net arrangements appropriate for an essential service.

Ergon Energy broadly supports the Consultation Paper's Overview of Recommended Approach (section 1.3) with the proviso that the Rules, in providing high level principles and direction to the AER, should not unnecessarily restrict the discretion available to the AER. Rather, the principles should provide overarching guidance to the AER together with access to suitable review mechanisms to enable the continued evolution of the regulatory framework while providing suitable protections to the legitimate interests of service providers.

¹ *National Electricity (South Australia)(New National Electricity Law) Amendment Act 2005 section 7*

² Social surplus refers to the sum of producer and consumer surplus. The maximisation of social surplus over time focuses consideration on the delivery of dynamic efficiency gains.

Section 2. The Scope of Distribution Price Regulation

Ergon Energy disagrees with the position outlined in the Consultation Paper that:

...the same activities should either be included or excluded from regulation regardless of jurisdiction.

Rather, Ergon Energy believes that it is critical that regulation recognises the significant commercial and operational differences between Network Service Providers (NSPs) and as such, is only applied where there is a demonstrated need. Therefore, the Rules should set out a process where NSPs can test the continued application of regulation to assets or services. As such, network service providers should be given the opportunity to propose to the AER elements of their business that should be excluded and to have those proposals subject to an explicit test applied by the AER. The AER's decisions would be reviewable. The basis for such exclusion would include those factors currently identified within the Rules and also circumstances where the NSP could justify to the AER the basis for the exclusion.

Further, Ergon Energy believes that the Rules should establish the principles used to guide the AER in determining whether the NSPs' proposals for excluded services should be accepted or rejected, including the threshold test to be applied. These principles should be consistent with the coverage criteria underpinning the national access regime and be subject to merits review.

With respect to isolated (non-interconnected) distribution networks, Ergon Energy believes that that they should remain outside the AER's regulatory jurisdiction. However there should be flexibility retained within the Rules to allow the AER to regulate particular isolated distribution networks at the request of the relevant Jurisdiction. This might arise in circumstances where there are clear efficiency benefits for such an arrangement. For example, Ergon Energy is responsible for the isolated Mount Isa distribution network in North West Queensland, however, this network only accounts for some 2% of Ergon Energy's regulated revenue and as such the benefits of Jurisdictionally-based regulation are unlikely to be sufficient to justify a separate stand alone regulatory exercise. The current arrangement is that Queensland legislation provides for the *Jurisdictional Regulator* (the Queensland Competition Authority) to regulate this isolated network in the same way, and in conjunction with, the regulation of the interconnected distribution network.

Section 3. Price Cap Regulation for Distribution Services

Ergon Energy believes that the Rules should specify the form of regulation and that the form should be limited to a building block based revenue cap, price cap or hybrid (consistent with the current regulation of DNSPs). The NSP should be able to propose the form of control (from within the suite of controls outlined in the Rules), that they believe best addresses their particular circumstances. This is consistent with a propose/respond model. This approach also supports the possibility of applying a lighter handed form of control (such as price monitoring) to those services excluded from the main regulatory control but where it is considered that some form of regulation is still required.

Ergon Energy agrees with the Consultation Paper that consideration of other alternative forms of regulation such as indexation using productivity indices should be held over for more substantial discussion and analysis possibly under the auspices of the AEMC. Ergon Energy considers that such alternatives have a number of difficulties associated with the need to reflect the significant differences in commercial and operating factors faced by different NSPs.

With respect to transitional issues, Ergon Energy supports allowing existing regulatory decisions to run their course with the AER to undertake a regulatory review and reset upon expiry of the current determinations.

Section 4. Regulatory Requirements in Relation to Tariff Setting

Ergon Energy broadly supports the recommended approach to tariff setting outlined in the Consultation Paper. That is, that high level pricing principles should be set out in the Rules.

Ergon Energy considers that NSPs should propose a detailed pricing methodology and associated prices as well as any proposed side constraints on price movements as part of a detailed regulatory proposal to be submitted to the AER. The pricing methodology should be consistent with the high level pricing principles included in the Rules.

A key issue is that the principles need to be sufficiently flexible to allow the development of innovative price/service offerings.

Section 5. Service Performance Targets

Ergon Energy believes that it is critical for the Rules to require the adoption of an incentive based regulatory framework. Further, for an incentive regulation arrangement to be successful Ergon Energy believes it needs to be as broad based as possible reflecting the inter-relationship between service quality, capital expenditure, operating expenditure and associated performance measures. However, the limited role of NSPs in terms of activities such as system operations etc means that many factors will be beyond their control and therefore should not be included in the incentive regime. That is, incentives should be limited to those elements over which NSPs have principal control.

As such, Ergon Energy believes that the Rules should include a requirement for the adoption of an incentive based regulatory framework incorporating a minimum suite of incentive arrangements applying to:

- operating costs;
- capital expenditure;
- service quality; and
- asset utilisation.

Such incentive arrangements would need to be supported by standard performance measures. NSPs should in turn be encouraged to propose incentive arrangements exceeding the minimum mandated together with proposing (and justifying) the magnitude of associated incentives. Such justification would include analysis of customer willingness to pay for improved service quality, a factor that goes to the heart of the NEM objective.

To the extent that service guarantees are incorporated into economic regulation, Ergon Energy believes that due recognition must be given to the fact that a service that incorporates such a component is materially different to a service that provides no such guarantee. As such, it is critical that NSPs are appropriately compensated for any risk that they become exposed to as a result of offering higher value services to customers.

Ergon Energy notes that the experience to date with incentive and penalty based structures has seen significant detrimental financial consequences arising for the NSPs. When assessing proposals put forward by NSPs, the AER should be obliged to ensure that the expected impact on the business from the application of the incentives and penalties leaves the business no worse off than if no such arrangements applied.

Ergon Energy considers that the Rules should outline NSPs property rights with respect to efficiency improvements attributable to their actions. Ergon Energy believes that NSPs should be able to retain the benefits of any expenditure reductions below target levels into the next regulatory period by way of efficiency carry over arrangement. Further, in order to provide better incentives, the carry over period should be extended to ensure the network service provider retains at least 50% of the net benefit from the improved performance in NPV terms (assuming an 8% WACC this would require around a 9 or 10 year carry over).

The critical design issue is to ensure that perverse incentives are not created by incentives in one area that impact on another area – for example, in the absence of balanced incentives, operating cost incentives could drive significant increases in capital expenditure beyond a level that could be justified on efficient investment grounds. The exact balance between these factors is likely to vary between different NSPs and as such, individual NSPs should be given the opportunity to propose and justify their preferred arrangements.

Section 6. Process for Regulation for Price Capped Services

Ergon Energy supports the adoption of a modified propose/respond model. The key elements of the framework should be for NSPs to develop a proposal for submission to the AER based on the guiding principles outlined in the Rules (for example, with respect to the form and scope of regulation). The AER would in turn consult and issue a draft decision and subsequently a final decision which might be in a form that is implementable. A critical final step is access to suitable dispute resolution processes. The Consultation Paper notes that dispute processes are outside the scope of the paper, however, Ergon Energy believes that proper consideration of the regulatory framework cannot occur without due consideration of dispute resolution arrangements. Specifically, adopting Ergon Energy's preferred model based on high level principles contained within the Rules requires that the AER be given significant discretion in assessing proposals submitted by NSPs. Associated with that discretion is the need for enhanced accountability which will require access to merits review.

Section 7. Information Disclosure

Ergon Energy considers that the Rules should require the development of guidelines for information disclosure arrangements and should provide for NSPs to propose a reporting framework consistent with the guidelines. This should ensure a reasonable level of national consistency is achieved while allowing NSPs to develop reporting frameworks consistent with their own individual circumstances and systems. The presence of national guidelines will reduce the likelihood of unexpected information requirements and therefore make the NSPs reporting task simpler.

Ergon Energy considers that information disclosure has three key roles:

- Providing evidence that an NSP is operating within its revenue or price control;
- Underpinning efficiency and service quality incentive schemes; and
- Supporting ring-fencing controls.

With respect to the last of these, Ergon Energy considers that the core issue with ring-fencing is being able to show that:

- confidential information is only being used for the purposes for which it was provided;
- there is no preferential self dealing; and
- there is no internal cross subsidy between contestable and non-contestable business elements.

Ergon Energy considers that the current Rules already provide sufficient powers to ensure that the AER can access the level of information required to complete its task. Further, the AER should be subject to a reasonableness test in relation to its information requirements. This includes the ability of the AER to establish ring-fencing guidelines and supporting regulatory accounts.

Ergon Energy considers that the ring-fencing requirements in the Rules will need to be high level and flexible in order to provide the AER with sufficient discretion to address the differing commercial and operational characteristics of NSPs. That is, a rural based DNSP such as Ergon Energy will face a different suite of operational issues than an urban DNSP. For example, the need to service both the

network and the retail interface in low population density areas is likely to require sharing of resources between the network and retail businesses which might be in conflict with standardised ring-fencing arrangements. As such, the AER would need to be able to assess the DNSPs ring-fencing proposal in light of its commercial and operating environment rather than imposing a one size fits all solution.

Section 8. Connection and Capital Contributions Requirements

Ergon Energy considers that NSPs should be able to propose how capital contributions are to be treated and the approach to be taken to up front contributions for new connections.

Ergon Energy is concerned that the Consultation Paper fails to recognise the significant differences faced by NSPs across the broad geographic spread of the NEM and therefore the need to ensure sufficient flexibility in the application of regulation to ensure that particular NSPs are not disadvantaged.

Ergon Energy considers that the critical issue with respect to connection management is the ability to send price signals to customers, for example, the ability to charge customers (including small customers) a capital contribution reflective of the cost of the connection. As such, a blanket exemption for small customers from paying capital contributions would not be desirable and would particularly impact on Ergon Energy given the unique nature of its network.

Section 9. Distribution Network Expansion Rules

Ergon Energy considers that the Rules should establish high level principles governing network expansion and that NSPs should be able to propose arrangements for assessing requests for connection or expansion of the network consistent with the overarching principles.

Similarly to connections discussed above, Ergon Energy considers that the critical issue is to be able to signal inefficient network expansion.

Part C: Consumer Protection

Section 2. Distributor Obligation to Provide Connection Services

Ergon Energy considers that a continuation of the current direct relationship between DNSPs and end-customers is the preferred approach.

Ergon Energy is concerned to ensure that the move to a national regulatory framework does not result in dual regulation due to overlapping residual obligations at a state level.

Section 3. Distributor Disconnections and Reconnections of Small End Customers

Ergon Energy supports the development of simple and transparent obligations aimed at ensuring small end-customers are treated fairly.

Ergon Energy is concerned to ensure that the move to the national regulatory framework does not result in dual regulation of disconnection and reconnection obligations.

Current state based legislation contains a wide range of circumstances for connection/disconnection (including for safety related reasons). Ergon Energy considers that the NEL and NER should be sufficiently flexible to enable jurisdictional variations in requirements to be catered for providing they are consistent with overarching principles.

Section 4. Distributor Small End Customer Dispute Resolution

Ergon Energy supports the use of alternative dispute resolution schemes for small customers but is concerned to ensure that such schemes do not allow for forum shopping between state based and nationally based dispute resolution schemes. As such, it is critical that a clear delineation is established as to what dispute resolution arrangements a customer can access and also what matters are able to be raised for dispute resolution.

Ergon Energy considers that a suitable cut off for small end-customers would be a threshold of either 0.1 or possibly 0.2 GWH per annum.

Section 5. Retailer Obligation to Supply to Small End Customers

Ergon Energy is concerned to ensure that retailer of last resort obligations are sufficiently clearly and comprehensively addressed so as to ensure that under no circumstances are DNSP's left with responsibility to act as a retailer. In addition, it is important that retailer and distributor obligations with respect to small end-customers are aligned.

Section 6. Retailer Small End Customer Market Contract

As this is primarily a retailer issue, Ergon Energy has no comment to make.

Section 7. Small End Customer Marketing

As this is primarily a retailer issue, Ergon Energy has no comment to make.

Section 8. Small End Customer Dispute Resolution

As this is primarily a retailer issue, Ergon Energy has no comment to make.

Part D: Other Distribution and Non-Price Retail Regulation

Section 2. Business Authorisation

Ergon Energy considers that business authorisations should be limited to issues of technical capability and should continue to be undertaken at a jurisdictional level. It is important that business authorisations do not result in a dual level of economic or service quality regulation.

Section 3. Distributor Interface with Retailers

Ergon Energy has not, to date, required use of system agreements and is concerned to ensure that an unnecessarily prescriptive approach is not adopted in the development and implementation of such instruments.

Ergon Energy considers that a more appropriate approach would be to provide principles within the Rules to guide the development of the distributor/retailer interface with access to suitable dispute resolution where required.

Section 3. Distributor Interface with Embedded Generators

Ergon Energy considers that the regulatory framework needs to remain sufficiently flexible to deal with the ongoing evolution of energy supply alternatives such as embedded generation. That is, excessive prescription in the Rules may limit the ability of DNSPs with specific operating environment issues to develop innovative alternative solutions. However, it is critical that the Rules provide guidance to all parties (including the AER) as to the treatment of interface issues such as the treatment of avoided TUoS. Further, it is critical that embedded generation connections are in accordance with the technical provisions contained within the current Rules.

Section 5. Balancing Regime and Settlements, Effecting Customer Transfer in Balancing and Settlements System

Ergon Energy considers that continuation of the current arrangements is appropriate.

Section 6. Metering

Ergon Energy is concerned to ensure that metering is not subject to dual regulation at both a national and state level and as such supports the adoption of a national approach subject to the removal of existing state obligations.

Section 7. Load Shedding and Curtailment

Ergon Energy considers that it is essential that clear Rules are established guiding load shedding and curtailment and that DNSPs are provided with appropriate statutory immunity in undertaking this role.

Section 8. Retailer Failure Arrangements

Ergon Energy is concerned to ensure that retailer failure does not result in DNSPs, by default, becoming retailer of last resort and is also concerned to ensure that any costs incurred by the DNSP as a result of retailer failure are able to be recovered.

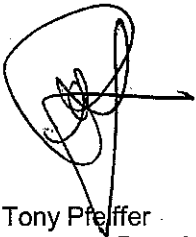
Section 9. Jurisdictional Directions

Ergon Energy considers that the approach to allowing limited jurisdictional directions outlined in the Consultation Paper is appropriate.

Ergon Energy believes that appropriate use of jurisdictional directions which the AER is required to recognise will allow the incorporation of local issues in a transparent manner while ensuring that DNSPs are not financially disadvantaged.

If you have any questions on this and related matters, please contact our Manager Regulation Networks, Tony Pfeiffer (07 3228 7711).

Yours faithfully

A handwritten signature in black ink, appearing to be 'Tony Pfeiffer', written over a faint circular stamp or watermark.

Tony Pfeiffer
Manager Regulation, Networks

Cc: Mr Alan Millis
Deputy Director General
Department of Energy
P O Box 15216
City East Qld 4002