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Dear Sir/Madam

Consultation – National Electricity Rules for Economic Regulation of Distribution

Ergon Energy Corporation Limited (Ergon Energy) appreciates the opportunity provided by the Ministerial Council on Energy Standing Committee of Officials (MCE SCO) to comment on the draft distribution revenue and pricing rules and the explanatory document.

The attached submission represents Ergon Energy's response to the above mentioned documents.

Ergon Energy looks forward to providing continued assistance to the MCE SCO in the development of a national regulatory framework for energy.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Tony Pfeiffer', with a horizontal line extending to the right.

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Ergon Energy Corporation Limited

**Response to the Standing Committee of Officials
of the Ministerial Council on Energy –
NATIONAL ELECTRICITY RULES
NATIONAL REGULATORY FRAMEWORK
FOR ECONOMIC REGULATION
OF ELECTRICITY DISTRIBUTION**

25 May 2007

**Response to the Standing Committee of Officials
Of the Ministerial Council on Energy
National Electricity Rules for Economic Regulation of
Distribution**

25 May 2007

This submission, which is available for publication, is made on behalf of:

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Ergon Energy

Ergon Energy Corporation Limited (Ergon Energy) welcomes the opportunity to make this submission with respect to the Explanatory Material and Exposure Draft of the National Regulatory Framework for the Economic Regulation of Electricity Distribution (Draft Rules) prepared by the Standing Committee of Officials of the Ministerial Council on Energy.

This submission is provided by Ergon Energy Corporation Limited, in its capacity as an electricity distribution network service provider in Queensland.

Ergon Energy believes that it can provide a valuable contribution to the SCO of the MCE in consideration of these and related issues and welcomes the opportunity to be involved in the ongoing development of the regulatory framework.

Summary of Key Issues

Ergon Energy's submission contains what we consider to be the following 'priority' matters for which we have proposed alternative arrangements:

- Timing and contents of Revenue Proposals, Distribution Determinations and Revenue Proposals:
 - Ergon Energy considers the Draft Rules' One-Part Revenue Proposal at 13 months is totally unworkable - instead we propose a Two-Part Revenue Proposal process that commences at 24 months;
 - Ergon Energy considers the intent of Merits Review under the 13 month arrangement (as proposed) should be preserved under our alternative Two-Part Revenue Proposal at 24 months – we therefore propose that Merits Review should be applicable to decisions of the AER at the end of each part;
 - Ergon Energy considers that the 'non-economic' rules (being dealt with separately and due for completion later in 2008) have a direct impact on Distributors' ability to prepare their Revenue Proposals – we propose that for affected Distributors (i.e. Queensland and South Australia), grandfathering or transitional arrangements need to be put in place now; and
 - Ergon Energy is concerned that there has been no recognition of the need to devise (and put into the Rules) orderly arrangements for transitioning from jurisdictional arrangements to the new national Rules – we propose that there needs to be mechanisms (such as cost pass-throughs) to ensure that Distributors are not adversely impacted upon during the transition.

- Guidelines:
 - Ergon Energy considers that the Draft Rules do not deliver consistency with the Transmission Rules (where there is no need for inconsistency) in that there is no explicit obligation on the AER to accept Distributors' proposals if they comply with the AER's Guidelines – we propose a similar obligation clause to Transmissions Section 6A.14.3 "Circumstances in which matters must be approved or accepted";
 - Ergon Energy considers that the role of Guidelines is not adequately articulated in the Draft Rules in that it states that they are not binding on the

AER, but do not explicitly provide similarly for Distributors – we suggest that Guidelines be established as ‘safe-harbour’ provisions whereby, if Distributors comply with them, the AER is obliged to approve proposals. However if Distributors propose something ‘different’ (and this should be allowed to enable innovation and continuous regulatory development), then the AER’s approval is not automatic; and

- Guidelines should not:
 - be a tool to make the AER’s life easier and simpler;
 - be a tool to enable the AER to become an unfettered rule-maker; or
 - simply re-state what is in the Rules.
- Negotiated Distribution Services:
 - Ergon Energy remains unconvinced of the need for distribution to have ‘negotiated distribution services’ in the form used for transmission – we set out the differences between transmission and distribution and explain the scope that already exists for distribution users to ‘negotiate’ about their supply arrangements; and
 - When Distributors categorise their services, they will know whether they have any ‘negotiated distribution services’ – therefore Ergon Energy proposes that a Negotiating Framework should not be required of all Distributors (as is currently drafted), but instead should only be required of those Distributors who have classified services as ‘negotiated distribution services’.
- Cost Allocation Method:
 - The Draft Rules require that the AER develop Cost Allocation Method Guidelines within 6 months of the Rules commencing, and that Distributors must lodge their Cost Allocation Method within 12 months of the Rules commencing – Ergon Energy disagrees with this approach. We believe that cost allocations are an integral part of the Revenue Proposal process, and are contingent upon, amongst other things, service categorisation, capital contribution methodologies, regulatory asset base arrangements. Therefore Ergon Energy proposes that Distributors’ Cost Allocation Methods should be proposed and approved individually as part of their Revenue Proposal process, and in the 1st-Part of that process.
- Pass-Throughs / Re-Openings:
 - Ergon Energy notes that the Draft Rules’ do not provide guidance as to what would be ‘material’ in a pass-through consideration - we propose that the materiality threshold should be set in the AER’s Distribution Determination, together with the process for applying/deciding on allowable pass-throughs, ; and
 - Ergon Energy disagrees that re-opening provisions are not needed for Distribution, whereas they are allowed for Transmission – instead we propose that limited arrangements should be drafted into the Rules.

- Side-Constraints:
 - Ergon Energy disagrees with the Draft Rules' setting of pricing side-constraints at CPI-X +2% - instead we propose that the Rules should provide guidance as to the purpose and objectives of imposing side-constraints, and then the AER should decide the maximum side-constraint percentage for individual Distributors as part of their Distribution/Revenue Determination. This allows for circumstances of the individual Distributor to be taken into account.

- Pricing Proposals:
 - The Draft Rules require that Distributors include their initial pricing proposals as part of their Revenue Proposal at 13 months – Ergon Energy considers this is possible, provided there is recognition that any changes by the AER to values proposed will mean that a (different) 'final' pricing proposal will be needed after the AER's Determination has been made. It is our suggestion that the Rules should expressly provide that a 'final' pricing proposal will be made by Distributors prior to the date that prices must be published i.e. by 31 May each year.

- Building Blocks;
 - The Draft Rules are silent as to the basis on which Capex and Opex submissions will be made – Ergon Energy agrees with this, and seeks to ensure that the AER does not become a 'rule-maker' by limiting Distributors' flexibility with regard to Capex and Opex values when making their Regulatory Proposals;
 - Ergon Energy does not agree with the inference in the Draft Rules' that the AER can make 'trade-off' decisions between Capex and Opex – instead we seek explicit clarification that the AER should not be involved in operational decisions of Distributors as to Capex and Opex trade-offs; and
 - Ergon Energy raises a raft of issues with regard to calculation of, and approach to, the Regulatory Asset Base.

- Cost of Capital (WACC):
 - Ergon Energy does not agree with the proposal in the Rules that the AER will undertake industry-wide Cost of Capital reviews on a 5-yearly basis – instead we point out the rationale and sound reasons for making Distributor-specific Cost of Capital decisions as part of the AER's Distribution/Revenue Determinations.

1. Introduction

Ergon Energy is supportive of a national regulatory regime that delivers consistency and prescriptive, rules-based distribution regulatory arrangements whilst allowing scope for innovation and evolution of regulation of monopoly entities. We are therefore pleased to support many aspects of the Draft Rules.

In general, Ergon Energy supports the alignment of the Distribution Draft Rules with the new Transmission Rules (in Chapter 6A) i.e. the move to a more prescriptive, rules-based approach. We see that efforts have been made to distinguish, as appropriate, between Transmission and Distribution arrangements. We make comment about certain differences in the sections below.

We consider that the Draft Rules present the most significant regulatory shift for Distribution entities since commencement of the National Electricity Market (NEM).

In our submission we seek to offer comment and suggestions to assist with the workability of the Draft Rules, particularly when considered in the context of all of the other legislative packages (i.e. the National Electricity Law (NEL), and the proposed future Rules and Guidelines).

2. Overarching Regulatory Framework

Ergon Energy's business is, for the most part, 'regulated'. Our 'regulator' is in the process of changing from being a Queensland Jurisdictional based regime under the Queensland Competition Authority (QCA) and the Department of Mines and Energy (DME), to a national regime under the Australian Energy Regulator (AER). Also changing is the nature and scope of the various regulators' powers.

Against this backdrop, Ergon Energy seeks to deliver its business objectives driven by what our customers' require and desire – not just against what the regulators require. It is therefore important to integrate customers' requirements and the (changing) regulatory environment.

Ergon Energy's view is that we can best understand and put forward the balance between price and services that customers require – and to make the appropriate distinctions between different customers in different locations.

For this reason Ergon Energy believes that there needs to be sufficient flexibility and timelines in the Regulatory Determination process for Distributors to propose, and the AER to properly make decisions which will properly take into account the individual circumstances of the particular Distributor, and not use a vanilla approach for all Distributors. We discuss timelines specifically in Section 3 below.

Fit-For-Purpose Model

Under the 'fit-for-purpose' model, certain matters are pre-determined and set down in the Rules, and others are left to the discretion of the AER to decide within certain parameters.

We observe that the new Rules for Transmission have a provision that supports this approach in Section 6A.14.3 "Circumstances in which matters must be approved or accepted". This section provides that the AER must approve or accept certain matters if elements of the Transmission Regulatory Proposal have met or been calculated in accordance with the Rules and Guidelines. These elements include total revenue cap, maximum allowed revenue for each year, forecast capex, forecast opex, values for performance incentive and efficiency benefit sharing schemes, length of regulatory period and negotiating framework.

There is no equivalent clause proposed for Distribution in the Draft Rules.

Ergon Energy is concerned that this creates an inconsistency (where inconsistency is not necessary) with Transmission and a void in the Distribution regime.

If Distributors' Revenue Proposals meet the Rules and Guidelines requirements, then there should be a positive obligation on the AER to approve and accept the Proposals.

Ergon Energy submits that the 'fit-for-purpose' model should be properly extended to Distribution regulation by insertion of a Distribution-equivalent clause to Transmission's Section 6A.14.3, and should accommodate the additional discretionary decisions of the AER necessary for Distribution such as:

- Form of Regulation (Service Classification)
- Control Setting Method (Building Block or Alternate)
- Form of Price Control (Revenue/Price/Hybrid Cap) and
- Cost Allocation Methodology

“Non-Economic” Rules & Transitional Arrangements

Ergon Energy notes the MCE/SCO's intention that Distribution 'non-economic' matters are being dealt with separately and in a different legislative timeframe to the current Draft Rules. We understand that these matters are expected to be settled later during 2008. It is our view that the Retail Policy Working Group/Allens Arthur Robinson process is not dealing with the full breadth of the non-economic matters.

Ergon Energy is very concerned that there is insufficient recognition of the impact of these so-called 'non-economic' matters on Distributors' Regulatory Proposals. For example, the treatment of capital contributions and ring-fencing have a direct impact on service classification, revenue requirements, asset base treatment and cost allocations.

It is not possible to prepare a Regulatory Proposal without these matters being known. Furthermore, changes to the Rules arising from the 'non-economic' package that occur after Distributors prepare their Regulatory Proposals, or after the regulatory period commences, will almost certainly have a cost or revenue impact.

Ergon Energy submits that there should be either an avenue for cost pass-through or grandfathering/transitioning of previous arrangements to ensure that Distributors are not disadvantaged by the introduction or amendment of 'non-economic' rules after Regulatory Proposals have been prepared, or after the commencement of the regulatory period.

We point out that, in order for New South Wales and Australian Capital Territory Distributors to work through their Determination process in 2009, transitional arrangements have been made which grandfather existing arrangements (that are under MCE/SCO's consultation in the 'non-economic' basket of work).

An example of a 'non-economic' problem issues is the Draft Rules Part I Section 6.17 deals with ring-fencing and obligates the AER to develop Ring-Fencing Guidelines. However there is no timeframe by which this task must be completed, nor is there an indication as to whether existing Jurisdictional Ring-Fencing Guidelines will continue to apply until:

- The end of the Jurisdictional Determination (Ergon Energy considers this imperative); and
- The AER has consulted and developed its own Ring-Fencing Guidelines.

A further example is that the Queensland Electricity Industry Code requires the QCA to review the (jurisdictional) Minimum Service Standards to apply at the beginning of each regulatory control period¹. Unless the QCA undertakes and completes this activity prior to the Queensland Distributors submitting their Regulatory Proposals, there will be a disconnect between appropriate revenue proposals and the standards which their networks must meet.

¹ Electricity Industry Code section 2.4.4 (1 July 2007 version).

Ergon Energy submits that regard must be had for the timing and impact of the 'non-economic' legislative package on the ability of Distributors to prepare Regulatory Proposals, particularly for Queensland and South Australia who must be preparing their proposals before (or in parallel with) the 'non-economic' legislative package development.

Transitional arrangements and/or grandfathering for Queensland and South Australia must be considered now to provide certainty. A cost pass-through provision should also be introduced in respect of the 'non-economic' legislative package to ensure that Distributors are not disadvantaged by any future change in this framework.

Ergon Energy expects that the matters that will require transitional arrangements include the following non-exhaustive list:

- Cost Allocation Method – need to continue under the Jurisdictionally approved method until 30 June 2010;
- Capital Contributions – need to continue under the Jurisdictionally approved method until 30 June 2010, and post-30 June 2010 if any different arrangement has not been decided by the AER, or proposed by Ergon Energy in its Regulatory Proposal;
- Ring-Fencing – need to continue under the Jurisdictionally approved method until 30 June 2010, and post-30 June 2010 if any different arrangement has not been decided by the AER before Ergon Energy needs to make its Regulatory Proposal;

AER Guidelines

Part B Section 6.2.8

We note that it is intended that the AER will make Guidelines to provide further certainty about its regulatory approach.

Taking into account that the AER is not the Rule-maker, then Guidelines need to be constrained to:

- an explanation of how the AER will interpret the Rules;
- explanations of the AER's requirements in order to exercise its powers; and
- explanations as to how the AER will evaluate Proposals.

It is Ergon Energy's view that Guidelines should not limit Distributors' allowed flexibility under the Rules for the sake of easing the AER's regulatory workload. For example, Distributors ought to be able to choose between a top-down versus bottom-up basis for developing their Capex and Opex building blocks, or to choose between separate asset bases versus a cost-allocation alternative for Regulatory Asset Base purposes.

The Rules state that once made, the Guidelines are not binding on the AER. This potentially diminishes the likelihood of the regulatory certainty intended by the MCE.

Further to our comment in this Section 2 above about the need for a Distribution-equivalent clause to Section 6A.14.3, it is Ergon Energy's view that Guidelines should provide 'safe-harbour' certainty, in that, if Distributors meet the requirements of the Guidelines, then they

should be confident that the AER will, and must, approve the categorisation, forecast, revenue etc that the Guidelines relate to. If however Distributors deviate from the Guidelines, then the AER's acceptance/approval is not automatic.

This approach to Guidelines is not a substitute for Rules. As we understand, the point of constructing the hierarchy of Law, Rules and Guidelines, is that there was recognition that Rules are difficult to change, and limit flexibility and innovation. By allowing the AER to develop Guidelines, it can publish its intended approach but still accommodate arrangements that are different. The AER can also amend its Guidelines over time as it gathers more experience and understands trends and triggers for improvements to the regulatory regime.

To give effect to this principle, Guidelines must explicitly not be binding on Distributors – otherwise they will not be able to propose their 'different' arrangements.

To give effect to the principle that Guidelines are a 'safe-harbour', and without stifling proposals for 'different' arrangements, Ergon Energy supports Section 6.2.8 - that the AER's Guidelines are not binding on itself - but only if there are 2 other supporting provisions for:

- A positive obligation on the AER to accept/approve Proposals that are compliant with its Guidelines (similarly to Transmission's Section 6A.14.3); and
- An explicit 'not binding on Distributors' clause (such that 'different' arrangements may be put forward).

There should also be an onus on the AER to make their Guidelines meaningful (i.e. they should not just re-state the Rules).

3. Timing & Contents of Regulatory Proposals

Part E Sections 6.8-6.14 and Schedule 6.1

The Draft Rules stipulate a One-Part Regulatory Proposal process at 13 months prior to the expiration of a distributor's current regulatory period. This is a high risk approach for both Distributors and the AER given:

- that the nature of the allowable Distribution Network Service Provider (DNSP) amendments (after the Draft Determination) is very limited;
- the very tight timeframe for making re-submissions;
- that it is not clear whether the AER can 'stop-the-clock' – it would appear that they can't; and
- that for the initial Determinations (NSW & ACT in 2009 and Qld and SA in 2010), integral components of the regulatory regime, such as the 'non-economic' Rules and AER Guidelines, have not yet been drafted.

Ergon Energy is exceedingly concerned about the proposed One-Part arrangement. In our view it is totally unworkable and has the potential for regulatory chaos and other unintended outcomes. Innovation and regulatory development will be stifled due to unreasonable time constraints imposed on both Distributors and the AER.

We elaborate on our concerns in the following sections.

AER Issues Papers

Part E Section 6.8.1

The Draft Rules provide that the AER may issue Regulatory Issues Papers that are relevant to a particular Distributor at least 5 months prior to the date for the Regulatory Proposal. However, where the AER chooses to issue Regulatory Issues Papers that are relevant to Distributors in general, there is no minimum timeframe stated.

Ergon Energy submits that, consistent with the arrangement for issuing Regulatory Issues Papers to a particular Distributor, there should be a 5 month minimum timeframe applicable to the issuing of Regulatory Issues Papers relevant to two or more Distributors (or Distributors in general).

The Regulatory Proposal

Part E Section 6.8.2

The Draft Rules provide that the Regulatory Proposal, to be submitted at 13 months before expiry of the current regulatory period, contain the following elements:

- Distribution Service classification proposal;
- For Standard Control Services – a Revenue Proposal and proposed regulatory mechanism;
- For Alternative Control Services – the proposed regulatory mechanism;
- For all Direct Control Services – a Pricing Proposal; and

- For Negotiated Services – the Negotiating Framework proposal.

Schedule 6.1 provides further information about the detail required in the Regulatory Proposal, and the AER may also issue Guidelines about its requirements.

Draft Rules' One-Part Regulatory Proposal

The One-Part Regulatory Proposal arrangement means that if the Revenue Proposal is deficient, then the Distributor must amend only the deficiencies and re-submit within 1 month (Section 6.9.2). It appears that there is no scope to make amendments to other parts of the Revenue Proposal that may be contingent upon the deficient components.

Ergon Energy suggests that this Section 6.9.2 be expanded to provide for consequential amendments to other parts of the Revenue Proposal that are affected by changing the deficient aspects of the Revenue Proposal.

Under the Draft Rules, the AER's decision about the Revenue Proposal would become known up to 6 months later at the Draft Determination stage (Sections 6.10.1 and 6.10.2). At this stage, the distributor has only 30 business days to submit a revised Regulatory Proposal, and these changes are limited only to those necessary to address the matters raised in the Draft Decision (Section 6.10.3).

Ergon Energy submits that Section 6.10.3 should be amended because the allowed 30 business days for re-submission is unworkable if there are significant and detailed changes necessary, and especially if it is necessary to include a further Directors' certification. Also, the nature of the revisions should be expanded to allow for any consequential changes necessary (such as changes to the Control Setting Method if the Form of Regulation [service categorisation] is rejected).

As noted above, if an element is not agreed by the AER, then the Regulatory Proposal will need to be 'unpicked' and rebuilt within 30 business days of the AER's Draft Decision.

If the disallowed element is one of the following 'cornerstone' elements:

- Form of Regulation (Service Classification);
- Control Setting Method (Building Block or Alternate); or
- Form of Price Control (Revenue/Price/Hybrid Cap)

and for the initial AER Determinations following the passing of the Rules in 2007-08:

- Cost Allocation Methodology

then the baseline core elements of the Regulatory Proposal will have been overturned.

For example, if the AER does not accept the classification of services, then the desired Control Setting Method (Building Block or Alternate) and Form of Price Control (the type of Cap) may need to change, as will the forecast values in the Building Blocks, Regulatory Asset Base, Pricing Proposal etc.

Ergon Energy reiterates that the proposed 30 business days is totally unworkable for a Regulatory Proposal re-build and re-submission to be made.

The Transmission Rules (in Chapter 6A) provide that the cornerstone elements are already known by the 13 month point in time when Transmission entities need to make their Regulatory Proposals – because the elements are already decided and set down in the Rules. Whilst Ergon Energy is certainly not advocating this approach for Distribution, we nonetheless seek to have equivalent certainty at the 13 month point in time as is afforded to Transmission entities.

Similarly, existing Jurisdictional arrangements are such that, by the time Distributors are providing data and making submissions to their regulators, the cornerstone elements have already been decided by the regulator.

For example, leading into the 2005 Queensland Determination the Queensland Competition Authority (QCA) had already:

- Consulted about and decided on the Form of Regulation – Revenue Cap (2003);
- Published a Final Decision on Service Quality Incentive Scheme (2004);
- Published Ring-Fencing Guidelines (2000);
- Published a Final Decision on Determination of Prescribed Services (2000); and
- Published Regulatory Information and Accounting Guidelines (2002).

Even with this preliminary work completed, the QCA still required around 18 months to make its Final Determination.

It is worthy of note that the Western Australian regulator (the Economic Regulation Authority) took approximately 2 years to approve Western Power's access arrangement under the propose-respond regime.

Given the interdependency of the elements of the Regulatory Proposal, it is clear that there needs to be a sequence to decision making and thence proposal lodgement. If the sequence is not followed, then all the other elements are at risk of needing to be unpicked.

It is Ergon Energy's contention that the Draft Rules' One-Part Revenue Proposal at 13 months is:

- Not consistent with the new Transmission Rules - in that at the 13 month Regulatory Proposal deadline, the cornerstone elements are not settled and known such that the regulated entity can prepare a Regulatory Proposal on a firm baseline;
- Not consistent with the transitional arrangements afforded to NSW and ACT – in that the cornerstone issues have already been decided, 14 months in advance, such that there is sufficient certainty and time available to enable Regulatory Proposals to be prepared, lodged and considered; and
- A backward step from the current Jurisdictional arrangements - in that the cornerstone elements are not known at the time the Distributor needs to provide data and lodge its proposals.

Ergon Energy Proposal for 2-Part Regulatory Proposal

Ergon Energy proposes that the Rules should provide certainty for Distributors about the cornerstone matters at a point in time that allows adequate time for the Regulatory Proposal to be developed and submitted to the AER.

It seems reasonable to provide this certainty in two ways:

- For the initial Determination by the AER, and for subsequent Determinations where the Distributor seeks to change any of the cornerstone elements – with a 24 month process – allowing for Merits Review at the end of both the 1st-Part and 2nd-Part; or
- For subsequent Determinations where the Distributor seeks to continue with its cornerstone arrangements – with an 18 month process – allowing for Merits Review at the end of the 2nd-Part.

In both situations the AER's draft decision about the cornerstone matters should be known at around 18 months thus enabling Distributors 5 months up until the 13 month lodgement deadline to prepare their Regulatory Proposals.

Ergon Energy therefore submits that the Regulatory Proposal process needs to be in two-parts, with a decision by the AER on the 1st-Part, which should comprise:

- Form of Regulation (Service Classification);
- Control Setting Method (Building Block or Alternate); and
- Form of Price Control (Revenue/Price/Hybrid Cap)

and for the initial AER Determinations, following the passing of the Rules (if not already settled), to include the

- Cost Allocation Methodology.

In the case of the initial and subsequent change situations, the AER's decision should be an irrevocable decision such that certainty is provided.

Timing for Two-Part Regulatory Proposal

For the Initial Determinations and Subsequent Determinations with changes to any of the cornerstone matters, it is Ergon Energy's submission that:

- Distributors' 1st-Part Regulatory Proposal should be made at not less than 24 months;
- AER's 1st-Part Draft Decision should be published at 19 months;
- AER's 1st-Part irrevocable Final Decision should be made at not less than 14 months;
- Distributors' 2nd-Part Regulatory Proposal should be made at not less than 13 months; and
- AER's 2nd-Part Final Decision should be made at not less than 2 months.

For Subsequent Determinations where the Distributor does not seek to change the cornerstone matters, it is Ergon Energy's submission that:

- Distributors' 1st-Part Regulatory Proposal to continue, and the current arrangements be made at not less than 18 months;
- AER's 1st-Part draft Decision (to accept the Proposal²) should be made at not less than 14 months;
- Distributors' 2nd-Part Regulatory Proposal should be made at not less than 13 months; and
- AER's 2nd-Part Final Decision should be made at not less than 2 months.

Merits Review

The Exposure Draft of the National Electricity Law (Sections 71A-Z) provides a limited form of Merits Review in certain circumstances and for certain of the AER's decisions.

Draft Rules' One-Part Regulatory Proposal Process

Ergon Energy's understanding is that the AER's Regulatory Proposal decisions are intended to be subject to Merits Review. This means that, at the end of the 13 month process, discretionary decisions of the AER when incorporated into its Final Decision and published as the Determination could be subjected to Merits Review. These discretionary decisions include decisions about the cornerstone elements:

- Form of Regulation (Service Classification);
 - Control Setting Method (Building Block or Alternate); and
 - Form of Price Control (Revenue/Price/Hybrid Cap)
- and, if not settled and approved by the AER already, the
- Cost Allocation Methodology.

Proposed Two-Part Regulatory Proposal Process

Therefore, Ergon Energy believes that if a Two-Part Regulatory Proposal process is accepted, there should be an equivalent Merits Review regime at the end of each Part, where the AER makes a decision, which is Merits Reviewable.

To allow otherwise means:

- There would be a diminishing of the currently allowed Merits Review position (where the AER decides the cornerstone matters as part of the whole Revenue Proposal); and
- There would be a risk to Distributors, whereby they would have worked their way through to the end of the Revenue Proposal process and Merits Review overturns one of the 1st-Part cornerstone matters. This would return Distributors to the unworkable situation of having to wait for, or undertake, whichever of the remedies the Tribunal decides, and inevitably meaning moving into the next regulatory period with unresolved arrangements.

² This presumes that if the AER allowed the previous arrangements, then the arrangements will be acceptable for the subsequent regulatory period, and only need to be confirmed.

Ergon Energy submits that the intended application of Merits Review should be preserved and deliver reviewability of the AER's entire Determinations – this means that if the Two-Part Revenue Proposal is accepted, there should be 'final' AER Decisions at the end of each Part, and Merits Review should be available upon those decisions being made.

We make comment below about the possibility of gaps between Distributors' Regulatory Proposals and the AER's Revenue and Distribution Determinations, and query whether elements of the AER's decisions that are not explicitly stated as required in the Rules are Merits Reviewable.

Regulatory Control Period

The Exposure Draft states that the Regulatory Control Period must not be less than 5 regulatory years. However there is not guidance as to what the principles and criteria will be for Distributors to propose, and the AER to decide, periods that are longer than 5 years.

Ergon Energy submits that, for certain Distributors, a long-term regulatory period may be necessary to deliver long-term benefits to customers. In recognition of the fact that it is the Distributors themselves who will have the best judgement as to their ability to meet customers' requirements, we propose that the AER should be required to accommodate regulatory periods that are longer than 5 years.'

Timeline

Ergon Energy has mapped out (as best we can) the milestone dates for the One-Part Regulatory Proposal process at 13 months as proposed in the Draft Rules, together with a map of our proposed Two-Part Regulatory Proposal process over 24 months – see **Attachment 1**.

Regulatory Proposals / Revenue Determinations / Distribution Determinations

The Draft Rules mandate particular elements or decisions that must be included in:

- Distributors' Regulatory Proposals;
- AER's Distribution Determinations; and
- AER's Revenue Determinations (which is a subset of the Distribution Determination).

Ergon Energy has mapped each of the matters the Draft Rules has provisions about, and tagged the elements which the Draft Rules explicitly state form part of each of the Regulatory Proposal, Distribution Determination and Revenue Determination – see **Attachment 2**.

There is not a one-to-one relationship between the matters that a Distributor must include in its Regulatory Proposal, and the matters that the AER must explicitly address in its Distribution Determination and Revenue Determination.

Attachment 2 highlights that there are some matters that a Distributor must include in its Regulatory Proposal that are not covered explicitly in the AER's Determinations. In their current form the Draft Rules would appear to say that:

- If Distributors comply with the submission elements in the Rules, then the AER cannot reject or substitute its own decisions; and
- If the AER were to make a decision outside the provisions in the Rules that relate to the Distribution Determination and Revenue Determination, then it would be overstepping its powers, which could trigger a Judicial and/or Merits Review.

4. Form of Regulation (Classification of Services)

Part B Section 6.2

Definition of 'Distribution Service'

Distributors' Regulatory Proposals, and the AER's regulatory powers, relate to 'distribution services'.

The Draft Rules Section 6.1.1 states:

The AER is responsible, in accordance with this Chapter, for the economic regulation of *distribution services* provided by means of, or in connection with, *distribution systems* that form part of the *national grid*.

Ergon Energy considers it important to draw attention to the Chapter 10 (already) defined term 'distribution service':

The services provided by a *distribution system* which are associated with the conveyance of electricity through the *distribution system*. *Distribution services* include *entry services*, *distribution use of system services* and *exit services* which are provided by part of a *distribution system*.³

We make the point that at times there seems to be an inference that the AER will be regulating a broad range of activities of Distributors – whereas the Rules explicitly limit the AER's powers only to 'distribution services' and these are 'associated with the conveyance of electricity through the *distribution system*'. Understanding this definition becomes particularly important when considering Distributed Generation and Demand Management matters – and when the AER is classifying services. It seems to Ergon Energy that some of the initiatives under consideration by MCE/SCO, such as Demand Side Response initiatives, may not unambiguously fit within the existing definitions. We would encourage consideration of this matter as part of the legislative package drafting.

Ergon Energy counsels that a clear understanding is needed by all parties (Distributors, AER, customers, generators, lobby groups) of precisely which of Distributors' activities are those services that relate to 'the conveyance of electricity through the distribution system' and that care be taken to ensure that intended initiatives (e.g. to facilitate Demand Side Response and Distributed Generation) be accommodated in an unambiguous way within the Rules and its definitions.

Rules Classification Process

The Draft Rules provide for the following sequence of decisions to be made by the AER to classify 'distribution services', bearing in mind that taking into account the definition above, it must be - that if a service is not a 'distribution service' then it is outside the AER's regulatory scope.

- Draft Rules (Section 6.2.1) provide that the AER may classify 'distribution services' as either 'direct control service' or 'negotiated distribution service' having regard to the

³ Ergon Energy's underlining for emphasis.

form of regulation factors (in the NEL), classification immediately before, consistency and 'any other factor' the AER considers relevant. Any service that is not classified in one or other category is not regulated under the Rules;

- Then the AER divides 'direct control services' into either 'standard control services' or 'alternative control services' (Section 6.2.2) for the purpose of the control setting method. It must have regard for competition, administrative costs, regulatory arrangements immediately before, consistency, and 'any other factor' the AER considers relevant; and
- Then, for 'direct control services' that are 'standard control services' the AER decides the price/revenue controls (i.e. the type of Cap) having regard to efficient tariff structures, administrative costs, regulatory arrangements before, consistency and 'any other factor' the AER considers relevant (Section 6.2.5).

We make note of the weight of the task on both Distributors (in proposing), and the AER (in deciding), when applying the 7 x Form of Regulation Factors (as outlined in the NEL). Each service must have the factors applied in order to categorise the service. Ergon Energy's experience is that most Distributors have somewhere in the order of 80-100 services to be classified. This will be a time consuming and onerous process that will require adequate time to undertake, hence our concerns in the section above about timelines and the Two-Part Regulatory Proposal process.

It is not immediately clear from the Draft Rules as to whether there should, or could, be any priority or weighting given to the different criteria the AER must consider when making its service classification decisions in Section 6.2.1(b), in particular as between sub-clauses (2) and (3). We observe that there is no explicit requirement for the AER to develop a service classification Guideline (although their proposed approach might be included in the required Submission Guideline).

Classification Proposal

The Draft Rules Part E Section 6.8.2(c)(1) provides that Distributors' Regulatory Proposal shall include a 'classification proposal'. The onus is then on the AER to decide (by accepting/rejecting the Distributors' Proposals).

This is the first, and most important, step within the cornerstone matters discussed above. Clearly deciding which services are in the AER's arena, and which category the services fall within, dictates all other preferences and decisions.

Therefore, getting this decision right, and deciding it irrevocably is the keystone decision affecting, for example, which assets are in the Regulatory Asset Base, the preferred/appropriate Control Setting Method (building block or alternate); Form of Price Control (the Cap), the Cost Allocation Methodology, Regulatory Accounts, Ring-Fencing compliance etc. Remove it, or change it and there is a consequential cascading impact on all of the other regulatory elements.

Errors or disputes about the categorisation of services risks would result in having to unpick the balance of the Regulatory Proposal. For this reason it is Ergon Energy's submission that an irrevocable decision is required about the categorisation of services up-front, in the 1st-Part of the Regulatory Proposal process – and the AER's decision should be final and subject to Merits Review at this time.

If Services Classification is Rejected

We reiterate our comment in Section 4 above, that Section 6.10.3 should be amended to enable consequential amendments to the Regulatory Proposal to be made if the proposed categorisation of services is rejected.

Classification Term

The Draft Rules Section 6.2.3 provides that once the classification forms part of the AER's Determination, then the classification cannot be changed until the next regulatory period.

This suggests that there will not be any (changed) circumstances affecting the provision of that service in its initial category – e.g.

- There will be no emergence of competition (that might move a service from 'direct control' to 'negotiate arbitrate' or from 'building block' to 'alternative control');
- There will be no new technology that may affect the service; and
- There will be no restructuring (amalgamation, divesting etc) of Distribution businesses that provide the service.

Ergon Energy submits that whilst there may be an aspiration to discourage moving services between classifications mid-period (with consequential impacts on allowable revenue etc), some scope should be provided to allow re-classification when the circumstances necessitate it.

Classification of New Services / Removal of Old Services

The Draft Rules do not provide a mechanism for the introduction of new services mid-period. It seems inevitable that as Distribution businesses adopt new technology (such as advanced metering infrastructure) and innovatively devise new ways to meet their customers' needs, that new 'distribution services' will emerge for which they should be appropriately compensated and recognised in the regulatory regime. Furthermore, introduction of services mid-period reduces the risk of Po adjustments between regulatory periods (which would occur if recognition can only occur at the next regulatory period).

Ergon Energy submits that assets, costs, prices and revenue for new 'distribution services' should be accommodated within the regulatory regime and a mechanism should be written into the Rules to cater for their introduction and classification mid-period.

5. Negotiated Distribution Services

Part D Section 6.7

The Draft Rules Part D Section 6.7 sets out a 'negotiated distribution services' arrangement similar to that applied for Transmission.

We again draw attention to the definition of a 'distribution service' that means the service must be associated with the conveyance of electricity through the distribution system.

Draft Rules' Regime

In practice, Ergon Energy believes that the opportunity for users to 'negotiate' about 'distribution services' is very different to users negotiating about 'transmission services'. Transmission users are very few in number and are very large in load/generation size, and as such have a business profile that can manage the negotiation process.

Distribution network users on the other hand are typically small individual customers/entities, who are serviced deep within the meshed distribution system. It is not possible to distinguish the supply or service to a customer at this level from his neighbour such that one customer can 'negotiate' something for himself.

Furthermore, Chapter 5 of the Rules is already very prescriptive about system standards and caters for the concept of different standards for supply in the categories of, 'automatic access standard', 'minimum access standard' and between the two, there is a 'negotiated access standard'. Distributors cannot permit their systems to operate below the stated limits, and therefore must require that users meet the 'minimum access standards' to ensure that the system remains compliant.

These access standards are readily applied to 'large' distribution users who have connection arrangements that are individually identifiable and dedicated to them. These 'large' customers already have a scope to 'negotiate' about their supply arrangements and they already get a sculpted 'regulated' individual network price to match the assets employed to supply them. These arrangements are set down in their connection agreements.

It is impossible to treat 'small' distribution users in the same way – and in any event, there are so many 'small' distribution customers that it would be unworkable to avail them all with the opportunity to 'negotiate'. Therefore small distribution users are supplied under generic (compliant) system standards that can be covered by 'generic' and usually mandated connection contracts (as are being examined by the Retail Policy Working Group).

Against this backdrop, the Draft Rules introduce the concept of 'negotiated distribution services':

- Without any limitations as to who these services might be available to;
- Without any recognition that distribution customers' mostly utilise the 'shared' distribution system, and their individual assets (usually a service wire and meters) are only a tiny segment that they individually use, such that they can 'negotiate' about it;
- Without any recognition that distribution assets built to service a single user almost always become 'shared' by other customers within the planning horizon;

- Without any recognition of the effect on the 'shared' distribution system that can be caused by a user who has connection arrangements below the minimum standards;
- Without any recognition that whilst the 1st customer may be happy with a lesser supply arrangement, small users premises change hands, and a subsequent owner of the premises may not be happy with this arrangement necessitating a re-build (and a contribution from the customer);
- With the suggestion that Distributors can offer a cheaper price if their systems do not meet Chapter 5's system standards (Section 6.7.1(4))⁴ – whereas their shared distribution systems must meet the Rules minimum system standards; and
- Without any opportunity to carve-out 'negotiated distribution services' from the Service Target Performance Incentive Scheme (in Section 6.6.2).

Ergon Energy queries the need for 'negotiated distribution services' at the distribution level, given that some users can already enter into specific connection and supply arrangements. Ergon Energy further submits that, if this category of service is to be retained, then the scope for 'negotiated distribution services' should be limited only to distribution network users who have individual connection agreements (as opposed to the generic mandated agreements) and should be contained to 'large' users who have dedicated assets that do not impact upstream on the shared distribution system.

Negotiating Framework

The Draft Rules Sections 6.7.3-6.7.6 sets down that all Distributors are required to submit a 'negotiating framework' to the AER that will form part of the AER's Determination.

As drafted, this obligation applies irrespective of whether or not the Distributor has any services classified as negotiated services. There is no scope for the AER to waive this obligation.

Individual Distributors and the AER will know from the outset of the Regulatory Proposal process whether there are any negotiated services or not. If there are none, and if, as is currently proposed, services cannot change categories mid-period, then there will not be any negotiated services until the next regulatory period. Therefore it serves no purpose that Distributors are obligated to prepare a negotiating framework for approval. This is an unnecessary administrative cost (on both Distributors and the AER) that will consume the valuable (limited) time available to prepare Regulatory Proposals.

Ergon Energy submits that the obligation to prepare a negotiating framework should be contingent upon there being a set of proposed negotiated distribution services. If there are no negotiated distribution services, then a negotiating framework should not be required.

Ergon Energy makes a drafting comment that Section 6.7.5(b)(1) requires that the Distributor's proposed negotiating framework, put up as part of its Regulatory Proposal, must

⁴ Even if a customer was prepared to accept a non-compliant system standard, a neighbouring customer has the right to require compliant standards, then because the 2 customers are indistinguishable from a system perspective, the 1st customer gets a free-ride on a compliant supply because he is paying a lesser 'negotiated' price.

comply with a Distribution Determination applying to the provider. This seems unworkable given that a Distribution Determination cannot be known nor apply until it is made by the AER (i.e. at the end of the process).

6. Cost Allocation Method

Part G Section 6.15

The Rules provide that the AER must make Cost Allocation Method Guidelines within 6 months of the Rules commencement (Section 6.15.3) and that Distributors must submit their Cost Allocation Method (CAM) within 12 months of the Rules commencement (Section 6.15.4).

Section 6.15.2(6) contains the 'Cost Allocation Principles', that is, the principles, policies and approach used to allocate costs must be consistent with the 'Distribution Ring-Fencing Guidelines'. However, the AER has not yet developed these Guidelines, and it appears will not do so for some time because they are part of the 'non-economic' package being examined by the Retail Policy Working Group and scheduled for later in 2008.

Ergon Energy queries how the Cost Allocation Guidelines and Distributors' Cost Allocation Method can be required at 6 months and 12 months after Rules commencement, potentially preceding the Ring-Fencing Guidelines (with a currently unknown timeframe for development).

The Cost Allocation Method is required of all Distributors at the stipulated point in time (12 months after Rules commencement), irrespective of whether the Distributors are under the AER's oversight. For example, Queensland Distributors' existing QCA Determination (with its own Cost Allocation Method on-foot) runs through until 30 June 2010. If the Rules commence as expected at end-2007, then the Queensland Distributors will have until end-2008 to lodge a Cost Allocation Method in compliance with the AER's Guidelines.

This is problematic because the AER's Guidelines and approved CAM cannot be applied to the previous QCA-Determination arrangements – making this exercise an administrative burden and time consuming obligation for no purpose. Furthermore, there is no point in Distributors having to maintain a current copy of the CAM on their website (as per Section 6.15.4(h)) if the CAM has no relevance to the Determination that is still running.

Ergon Energy submits that the initial Cost Allocation Methods and the associated obligation to publish it on Distributors' web pages, should not be required before, and outside of, the AER's initial Regulatory Proposal process getting underway.

Furthermore, publication of the AER-approved CAM should not be required until the commencement of the regulatory period to which it applies e.g. for Queensland Distributors, not before 31 May 2010 consistent with when network prices will need to be published.

Section 6.15.3(c)(3) requires that the AER's Guidelines may specify categories of distribution services "by reference to the nature of those services". Until Distributors' services are categorised (as part of their Regulatory Proposal), it is not possible for Distributors to prepare their CAM. For example, the AER may (or may not) accept that there are services in each of the possible categories (direct control and negotiated) – then the AER may (or may not) accept the sub-categorisation of direct control services.

Ergon Energy submits that:

- Distributors should be required to submit their Cost Allocation Method as part of the 1st-Part of their Regulatory Proposals. They should be required to re-submit CAMs at each relevant regulatory control period (even if it is to re-confirm continuation of a previous CAM) together with their service categorisation proposal. The acceptance/rejection by the AER of the CAM should be part of the AER's Determination; and
- The AER should be required to publish in their Guidelines the method and process for amending a CAM (either within-period or for the next regulatory period).

7. Pass-Throughs and Revocations/Substitutions

Determination Revocation (Section 6.13)

The Draft Rules' Section 6.13 provides that the AER may revoke and substitute a determination in certain circumstances where the error or deficiency is 'material'.

Cost Pass-Through (Section 6.6.1)

The new definitions in the Draft Rules (Section 6.1.0) include a definition for a pass-through event:

pass through event means:

- (a) a *regulatory change event*, or
- (b) a *service standard event*, or
- (c) a *tax change event*, or
- (d) a *terrorism event*, or
- (e) an event nominated in a *distribution determination* as a pass-through event for the purposes of the determination

As yet, there appears to be no supporting distribution definitions for the italicised events.

The Rules provide that a Distributor may seek approval, or the AER may require, that pass-throughs (positive or negative) be made. However there are no thresholds or parameters around the pass-throughs.

For example, the QCA in its Queensland Final Determination provides for pass-throughs (in certain circumstances) provided they pass the materiality threshold of 1% of actual annual regulated revenue per event, based on the regulated revenue in the year of the event.

Ergon Energy submits that:

- A cost pass-through materiality threshold should be proposed by individual Distributors in their Regulatory Proposals, and that the Rules should include a clear procedure that must be followed by both Distributors and the AER when seeking and approving a cost pass-throughs; and
- Pass-throughs should be capable of being re-couped/paid out outside of the side-constraint regime.

Impact of 'non-economic' Rules

Ergon Energy has made comment elsewhere in this submission about the as yet to be determined 'non-economic' Rules. We have proposed that transitional or grandfathering should be available to ensure a smooth introduction of these Rules. However, to the extent that there is a cost to Distributors, this cost should be treated as a pass-through.

Ergon Energy submits that, if the introduction of the 'non-economic' Rules imposes a cost on Distributors, then this cost should be treated as a pass-through.

The Draft Rules further provide that a pass-through application must be made within 90 business days of the relevant event. Ergon Energy considers that this is unworkable. Take for example Cyclone Larry that devastated a significant part of Ergon Energy's network in March 2006. Ergon Energy's expenditure to reinstate the network occurred both immediately after the emergency and for a considerable period thereafter over the 2005-06 and 2006-07 financial years. Post-emergency cost gathering and categorisation is a lengthy process that will only rarely be able to be finalised such that an application can be made within 90 business days.

Bearing in mind that it is Distributors who carry costs of positive change events until their applications are approved, we see no sound reason to limit the time for making the pass-through application.

Ergon Energy submits that applications by Distributors (or directions by the AER) relating to any pass-through events should not be constrained to a specific deadline after the event occurring, other than from being made within that regulatory control period.

Re-Opening Determinations

The Draft Rules do not provide for Distributors (or the AER) to re-open Determinations other than for error adjustment (Section 6.13 - as noted above). However the Transmission Rules provide for revocation and substitution of a Determination where capital expenditure was incurred as the result of an unforeseen event. The current QCA Determination for Queensland similarly provides for re-opening if there is variability in customer numbers and maximum demand growth and the trigger is 3% more than the forecast growth rate.

The concept of re-openings would mostly occur in 'extraordinary circumstances' where there is an uncontrollable unexpected event that cannot be absorbed by the Distributor and is outside of what can reasonably be treated within the pass-through regime. For example, if there is a major weather event affecting a significant portion of the Distributors' network (like multiple major cities being struck by a cyclone) or an event such as the acquisition/merging or disposal/desegregation of distribution networks under or between Distributors.

Ergon Energy disagrees that the Distribution Rules do not require re-opening provisions. We submit that Distributors should be able to apply for a limited re-opening if any of the forecasts affecting their Distribution Determination is exceeded by a trigger that is decided in their individual Distribution Determination (including Capex Forecast, Opex Forecast, and RAB if, for example, a large block of assets were acquired or disposed of). The re-opening should be limited to the matter triggering the re-opening.

8. Schemes

Service Target Performance Incentive (Section 6.6.2)

The Draft Rules Section 6.6.2 provide for the AER to prepare a “Service Target Performance Incentive Scheme” within 6 months of the Rules commencing.

Ergon Energy submits that this section should clarify that the STPIS should relate only to Standard Control Services (and not to Alternate Control Services nor Negotiated Services).

Ergon Energy has discussed elsewhere in this submission the need for appropriate timing and linkages between matters set by the Jurisdictions and the AER’s Determinations under the new Rules. This is particularly relevant to the relationship between Jurisdiction-set Minimum Service Standards (in Queensland fixed by the QCA under the Queensland Electricity Industry Code) and the STPIS devised by the AER.

Ergon Energy submits that the Rules should:

- Protect Distributors from the effects of any disconnects, including timing differences, in decisions of the Jurisdictions and the AER, with respect to the STPIS; and
- Limit the AER’s STPIS to use of only the parameters used in the Jurisdictional Minimum Service Standard schemes (e.g. SAIDI and SAIFI).

9. Distribution Pricing Rules

Part J Section 6.18 & 6.19

Pricing Proposals

The Draft Rules provide that Distributors must submit pricing proposals as part of their Regulatory Proposal (an initial pricing proposal) and each year (an annual pricing proposal). Ordinarily Distributors will know their Cap value at a time close to the start of the next regulatory year (after the regulator makes any adjustments for unders/overs, pass-throughs etc). At present, pricing proposals are approved by regulators in time for publication of prices by the deadline in the Rules of 31 May annually.

The Draft Rules require that Distributors' Regulatory Proposals (submitted at 13 months prior to commencement of the regulatory period) include a pricing proposal. The AER may reject components of Distributors' Regulatory and Revenue Proposals which will have a direct impact upon the pricing proposal submitted. There is no explicit provision that allows Distributors to re-submit pricing proposals on the basis of the AER's Final Decision.

Ergon Energy submits that a procedural provision should be inserted into the Rules that provides that Distributors can re-submit their 'final' pricing proposal up to 1 month prior to the start of the next regulatory period if the AER adjusts any aspect of the Distributors' Regulatory Proposal that affects prices.

Side-Constraints

The Draft Rules Section 6.18.6(d) provides limitations on the increases in prices to CPI-X plus 2%.

Ergon Energy submits that:

- The preferred arrangements for side-constraints is that the AER should be provided with guidance in the Rules as to the objectives for side-constraints, and then left to make decisions relevant to individual Distributors when making their Distribution Determinations. This would allow the circumstances of individual Distributors to be taken into account (including for example the length of regulatory periods).
- If the above approach is not accepted, then Ergon Energy submits that the proposed maximum percentage is unworkably low – and should be in the order of 5% (as is currently permitted by the QCA in Queensland). To do otherwise will mean that prices might remain grossly different to cost-reflective for long periods of time – at least until the next regulatory reset.

Furthermore, there should be symmetry in the application of price movement constraints. In addition to applying to price increases, there should be an equivalent side-constraint applied to any price decreases. To do otherwise would expose Distributors to unanticipated and unreasonable shortfalls in revenue.

10. Prepayments and Capital Contributions

Part L Section 6.22

Ergon Energy notes the MCE/SCO's intention that policy positions about Capital Contributions is a component of the 'non-economic' work being undertaken by the Retail Policy Working Group's work, scheduled for completion in 2008.

As noted elsewhere in this submission, it is Ergon Energy's submission that the policies about capital contributions, and their economic treatment is critical to Distributors making their Regulatory Determinations. We again reiterate our view that arrangements need to be 'firm' in order for Distributors to prepare their Revenue Proposals. Therefore transitional arrangements and grandfathering should be available to protect Distributors against Rules which change previous policies.

11. Building Blocks

Opex (Section 6.5.6) and Capex (Section 6.5.7)

The information that Distributors must include in their Revenue Proposal in relation to capital and operating expenditure is set out in Schedules 6.1.1 and 6.1.2 of the Draft Rules. These information requirements are critical because they allow Distributors to understand the minimum information that must be provided in a submission to the AER, and to tailor their work programs in order to meet those minimum requirements.

Importantly, however, the Draft Rules do not set out the basis on which the capital and operating expenditure submissions will be made, which Ergon Energy interprets to mean that this will be left to Distributors to determine as part of their submission preparation process. Ergon Energy believes that this is both necessary and appropriate. The AER should not be able to limit this discretion through the Guidelines.

Ergon Energy is aware that there are a range of options available to it, in relation to how it might propose its operating and capital expenditure submissions to the AER, including:

- Bottom up methodologies, which provide extensive detail in relation to each element of the expenditure proposal for each forecast year, and which require extensive work on the part of the AER to assess and approve;
- “Baseline and scope change” methodologies, which seek to lock in a “base year” from the current year, which can be approved as a standard for future periods, and to focus the submission on forecast additions or reductions from the standard; and
- A mixture of the two approaches, which set a “baseline” for areas of expenditure which are constant across the years and set out variances for these areas along the “baseline and scope change” approach, and a bottom up assessment for other variable areas of the DNSP’s business for which the former approach would be inappropriate.

Each of these approaches have extensive regulatory precedent in both the regulated electricity and gas distribution and transmission sectors, and both have been developed in an environment where regulated businesses were free to choose whether and for what reason they were applied.

While Ergon Energy has operated under a bottom-up approach in Queensland, we understand that the “baseline and scope change” approach has been used in Victoria for electricity distribution, and is the dominant approach in relation to gas and electricity transmission regulation. We note, however, that baseline and scope change may not be appropriate for all areas of expenditure, for all Distributors, and at all times, and each Distributor will be undertaking its own research into the applicability of different approaches as part of its Revenue Proposal process.

Accordingly, while supporting the current drafting of the Rules, Ergon Energy would reject very strongly any move by the AER to seek to constrain the choices that may be made by Distributors in relation to their Opex and Capex proposals.

While Ergon Energy accepts that this may not be the appropriate forum for this issue, we are aware that the AER is required to prepare a Distribution Submission Guideline which will set out the information that must be provided in a Regulatory Proposal.

Ergon Energy is of the view that if the AER sought to prescribe the basis by which a submission should be made in its Submission Guideline, then this would be a de-facto attempt to act as a “Rule Maker” and would be both against the principles of good regulation, and the spirit and intent of the Rules.

Relationship between Opex and Capex (Schedule 6.1.3(1))

The Draft Rules Schedule 6.1.3(1) require that Distributors’ Regulatory Proposals include an identification and explanation of any significant interactions between the forecast Opex and forecast Capex programs.

This requirement in the Draft Rules assumes that there is a mechanistic relationship (or trade-off) between Opex and Capex that can be taken into account by the AER in approving either or both of these elements of the Revenue Proposal, and that the AER could direct funds to one or the other.

Ergon Energy queries the purpose for the requirement for an identification and explanation of the relationship between Opex and Capex – and we seek explicit clarification in the Rules that the AER should not be involved in operational decisions of Distributors as to Opex and Capex trade-offs.

Opex and Capex Decisions (Sections 6.12.1 and 6.12.2)

The Draft Rules Sections 6.12.1 and 6.12.2 provide for the AER to either accept or reject elements of Distributors Regulatory Proposals, and include that for Capex and Opex, the AER may substitute its own values. However there is no guidance or ‘rules’ for how the AER might go about this. It is not clear to Ergon Energy as to how the AER will determine substitute values that equate to “benchmark Capex/Opex that would be incurred by an efficient Distribution Network Service Provider over the regulatory control period”.

Ergon Energy submits that guidance should be provided in the Rules about how the AER should go about calculating substitute values for Capex and Opex.

Regulatory Asset Base (Section 6.5.1 and Schedule 6.2)

The Draft Rules provide the mechanism for determining the Regulatory Asset Base (RAB) values in Section 6.5.1 and Schedule 6.2. The AER is required to develop and publish a ‘roll forward model’ within 6 months of commencement of the Rules.

In the first instance, Ergon Energy would like to note an error in the current drafting of Schedule 6.2 in that ‘S6.2.3’ does not exist, necessitating an amendment to the schedule to correct the numbering of clauses, including any incorrect references used within the schedule (e.g. S6.2.1(b)).

Ergon Energy draws attention to the nature of Distributors' RABs, as defined in Section 6.5.1(a). The current wording provides for the inclusion of assets in a RAB only to the extent to which they are used by a DNSP to provide 'standard control services'.

We specifically refer the MCE to Chapter 4, Section 4.4 "Shared Assets" of the QCA's 2005 Final Determination (extracted below), which allowed for the inclusion of shared assets in the RAB of a Distributor when combined with an appropriate charging mechanism relative to asset usage.

Shared Assets

Some assets (shared assets) are used by both regulated and unregulated services within Energex and Ergon. There are basically two approaches to the treatment of these assets:

- identify the shared asset portion utilised by the prescribed (regulated) distribution services and only allow that portion to be included in the regulated asset base (the remaining portion is excluded from the regulated asset base); or
- identify the shared asset portions utilised by the prescribed (regulated) distribution services and by the unregulated services. Include both portions in the regulated asset base and implement a charging mechanism to ensure that the regulated business is fully compensated for the use of these assets by unregulated users with revenue from unregulated users recognised as part of the DNSP's allowable revenue. Alternatively, the shared assets could be excluded from the regulated asset base with the regulated business then having to pay the non-regulated business for the use of its assets.

Both approaches yield the same outcome ensuring that customers of the regulated business are not subsidising the provision of unregulated services. Energex chose to adopt the first of these treatments while Ergon preferred the second.

Ergon Energy submits it is unclear how the Draft Rules provide for treatment of assets that are 'shared' for the purposes of providing both regulated ('distribution') and unregulated ('non-distribution') services. It is Ergon Energy's submission that flexibility and discretion should rest with Distributors to propose the most appropriate approach for managing shared assets.

Furthermore, it is unclear what treatment would be applied for assets which may be shared within the direct control services category. For example, where an asset is largely used for the purposes of providing standard control services but may at times be used in provision of alternative control services or even negotiated distribution services. Again, it is our proposal that flexibility and discretion to propose an appropriate methodology should rest with Distributors.

Regarding the contents of a roll forward, Ergon Energy notes that Section 6.5.1(e)(3) states that in rolling forward a RAB from the preceding regulatory control period to the beginning of first year in the next regulatory control period (i.e. the 'opening' RAB), an adjustment of the earlier RAB should be made for "outturn inflation".

Clarification (or otherwise) that this refers to an adjustment for "actual" inflation is sought. In any case, Ergon Energy submits that inflation / indexation relating to the adjustment of RAB values for a regulatory control period would be more appropriately dealt by insertion of a separate clause in subsection S6.2.1(e) of Schedule 6.2.

With regard to Schedule 6.2, and in particular S6.2.1(c) which deals with establishment of an opening RAB for specific Distributors including Ergon Energy, the RAB value of \$4,198.2M (as at 1 July 2005) for Ergon Energy aligns to the value as set out by the QCA in its 2005 Final Determination. Furthermore, S6.2.1(c)(2) provides for an adjustment to this value for any difference between actual and estimated capex that was assumed in this value.

However, there is no provision under the current Draft Rules for an adjustment to this value for any subsequent adjustments to a Distributor's RAB that are / will be made by Jurisdictional Regulators during the preceding regulatory control period.

Specifically, we refer to page 64 of Chapter 4 – Regulatory Asset Base of the QCA's 2005 Final Determination (extract below).

The data constructed by SKM has been used in this Determination. However, the Authority has not accepted that this represents an appropriate basis for calculating revenue. To address this shortcoming the Authority has required Ergon (and Ergon has agreed) to complete its asset inspection program and finalise its updated asset register as soon as practical. The Authority will then have SKM review this work and recalculate the asset base for Ergon using the updated asset information. Once this has been provided, the Authority will substitute the "correct" asset value into the workings of this Determination and adjust Ergon's revenue caps accordingly. Because the simplifying assumptions used by SKM and Ergon in producing the constructed data were conservative, it is likely that the asset base is currently under-estimated.

The outcome of this QCA-requested revaluation of Ergon Energy's RAB (as at 1 July 2005) is yet to be finalised, approved and adopted by the QCA (and Ergon Energy). However, it will result in a mid-period adjustment to Ergon Energy's RAB as at 1 July 2005 - which is not accommodated under the Draft Rules.

Ergon Energy submits that insertion of a clause S6.2.1(c)(3) is required to the effect of:

- (3) The values in the table above are to be adjusted to reflect any subsequent adjustments made to the RAB by the Jurisdictional Regulator during the previous *regulatory control period*.

Furthermore, consultation must occur between the Jurisdictional Regulator and the listed Distributors to ensure that an accurate opening RAB is derived.

Although not a specific issue for Ergon Energy, S6.2.2(d)(2) also suggests that an independent asset valuation should be undertaken in determining an opening RAB for all other Distributors (rather than that value being determined by AER).

In making further adjustments to the value of the RAB, S6.2.1(e)(2) allows for an increase to the RAB by "the amount of the estimated capital expenditure approved by the AER" where actual capital expenditure is not available (i.e. outer years of previous regulatory control period).

Ergon Energy submits the Rules are not clear in this regard. How would this approval/process be undertaken? What is required to be submitted by Distributors? What is the timeline? Is this a prudency test in another guise?

In conjunction with this, S6.2.1(e)(4) reads that any increase by actual/estimated capital expenditure can only be adjusted, to the extent that it is “properly allocated to the provision of standard control services in accordance with the CAM for the relevant DNSP”.

Any actual/forecast capital expenditure for the previous regulatory control period, must only be assessed in terms of the prevailing regulatory determination. Indeed, a CAM for a new control period cannot be applied in assessing historical numbers from a previous regulatory control period.

Ergon Energy submits that S6.2.1(e)(4) blurs the line between the new/previous regulatory control periods. We seek clarification as to the relevance of this provision.

Consistent with earlier comments on the nature of the RAB, Ergon Energy submits that S6.2.1(e)(7) (which requires the removal of assets from a RAB that are no longer used in provision of standard control services), also does not adequately deal with the treatment of those assets which may be ‘shared’ either at the distribution / non-distribution, or within the direct control services category.

Return on Capital – WACC, Nominal Risk Free Rate, Debt Risk Premium, Rate of Return Parameters (Section 6.5.2)

Section 6.5.2(a) of the Draft Rules provides that there will be a rate of return for the relevant Distributor for that regulatory period. The Return on Capital is typically the largest component of the Building Blocks.

We do not agree with the application of parameters that are determined by 5-yearly reviews because:

- Parameters determined in a 5-yearly cycle will inevitably be out of sync with some Distributors’ Determinations;
- A synchronised 5-yearly rate setting cycle for nominal risk free rate setting for all Distributors will give rise to an additional cost as well as counterparty credit risk as a result of spike in demand on the debt market caused by implementation of prudent risk management strategies by Distributors. This will also result in some Distributors having to forecast future funding requirements up to 10 years in advance;
- Section 6.5.2(c) “Meaning of nominal risk free rate” states that it is the rate determined for that regulatory control period – whereas a 5-yearly review, undertaken under Section 6.5.2(i)(1), (which includes a review of the nominal risk free rate) would be for any regulatory control period;
- The Draft Rules (Section 6.5.2(j)(3)) specifically requires values attributable to the parameters that vary according to the efficiency of the Distributor to be based on a benchmark efficient Distributor – and we do not understand how this requirement can be fulfilled by an industry-wide review, given that a ‘benchmark efficient’ Distributor is directly relevant to the circumstances of that Distributor; and
- Similarly, the Draft Rules Section 6.5.2(b) specifies the rate of return should reflect the cost of capital as measured by the return required by investors in a “commercial enterprise with similar nature and degree of non-diversifiable risk”. We do not understand how this requirement can be fulfilled by an industry-wide review.

It is Ergon Energy's submission that Return on Capital calculation should be undertaken specifically for each Distributor as a part of the AER's Determination for each Distributor.

In the event that our proposal above is not accepted, we note that Section 6.5.2(g) which requires the AER to undertake 5 yearly cost of capital reviews, does not have a period within which these reviews must be completed.

Depreciation (Section 6.5.3)

The Draft Rules Section 6.5.3(a)(1) provide for depreciation for each *regulatory year* to be calculated on the value of assets as included in the regulatory asset base, as at the beginning of that *regulatory year*. However the basis of calculation does not allow for depreciation on the value of assets brought into service during the *regulatory year* and therefore does not reflect the timing of the using up of the economic benefits of those assets.

It is Ergon Energy's submission that in calculating the depreciation for each *regulatory year* that the regulatory asset base includes half of the estimated Capex for that *regulatory year*.

Also in relation to depreciation schedules, Ergon Energy seeks clarification on the practical application of Section 6.5.3(b)(2), as we foresee difficulties in collecting and maintaining this data for long life assets.

Corporate Income Tax (Section 6.5.4)

Ergon Energy does not agree with the proposed 5 year cycle of reviews as the review is to be based on the value of the assets in the regulatory asset base for the relevant *distribution system* (Section 6.5.4(a)(2)) and the review will be out of sync with some Distributors' Determinations.

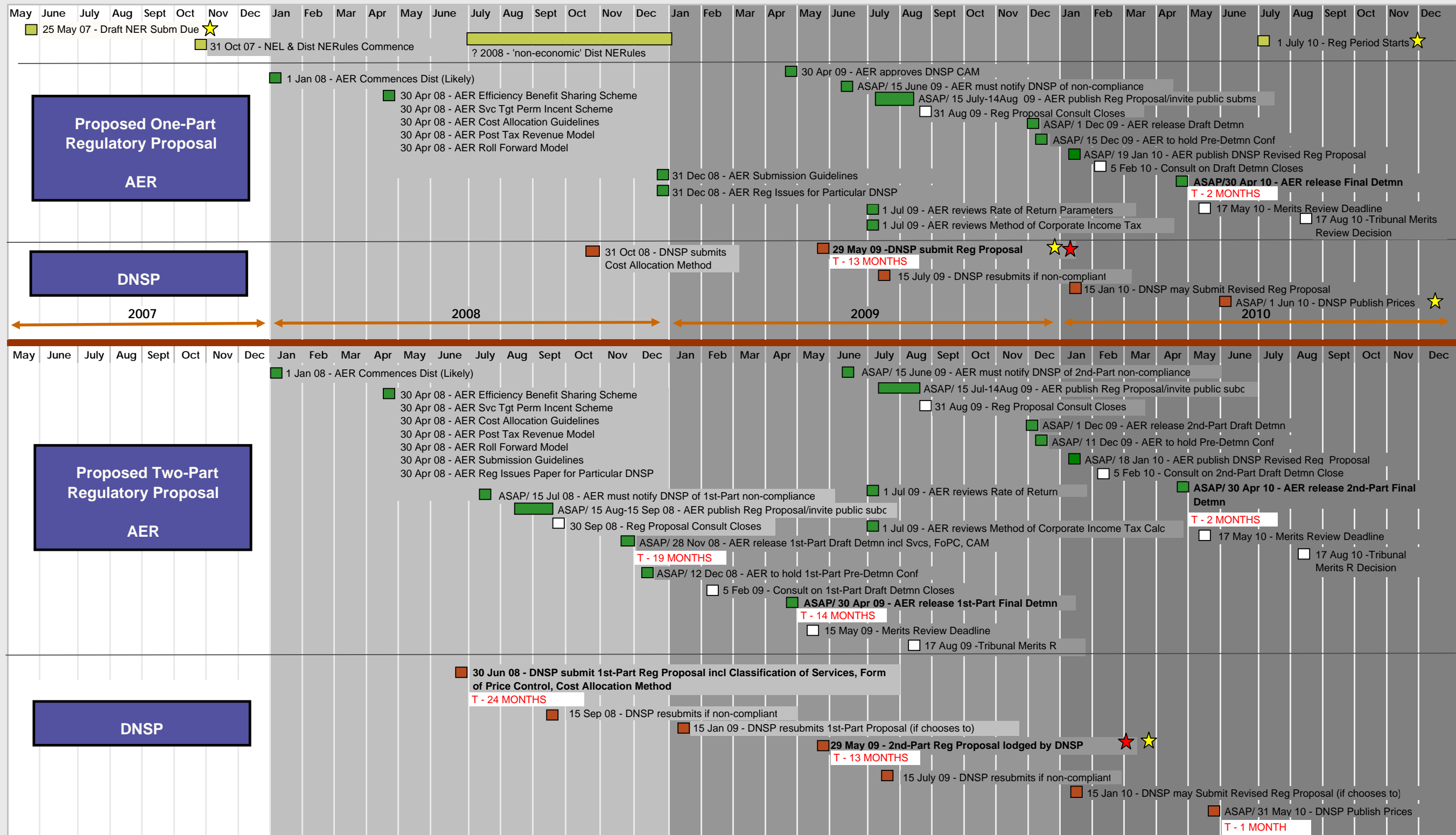
The estimated cost of corporate income tax is to be based on the taxable income and cost of debt of a benchmark efficient Distributor. This does not allow for the circumstances of the relevant Distributor.

It is Ergon Energy's submission that the calculation of taxable income and cost of debt should be made on the same basis as used elsewhere in the Draft Rules, i.e. those of a prudent operator in the circumstances of the relevant DNSP.

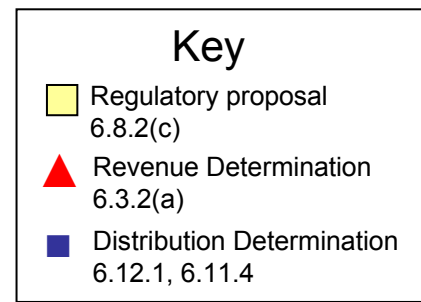
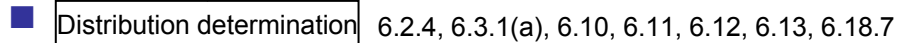
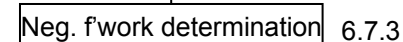
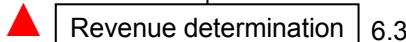
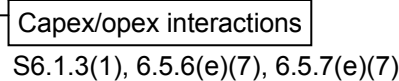
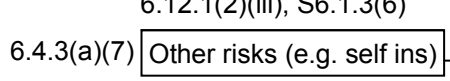
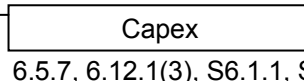
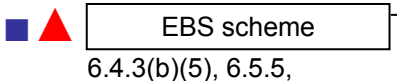
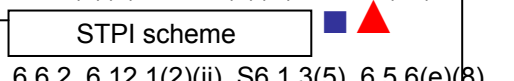
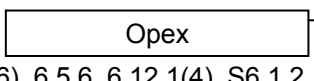
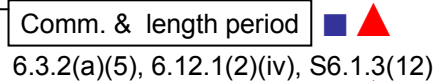
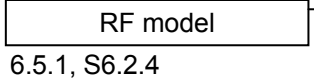
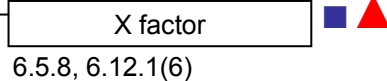
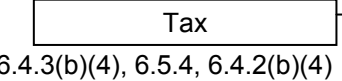
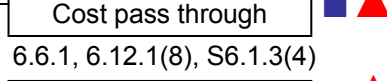
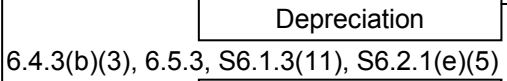
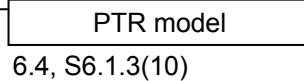
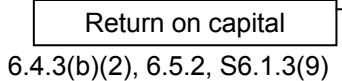
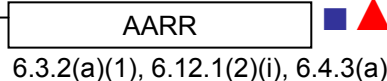
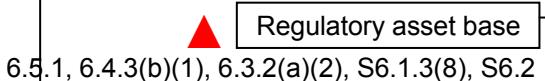
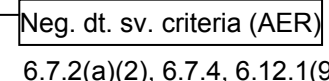
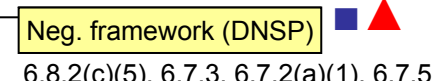
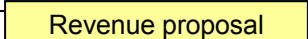
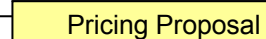
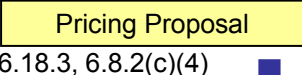
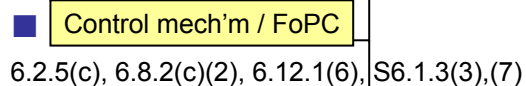
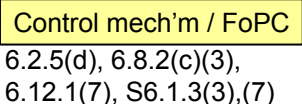
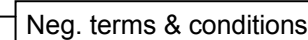
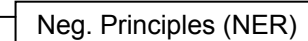
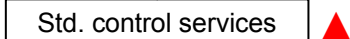
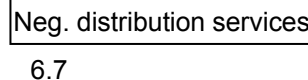
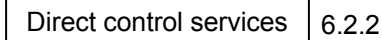
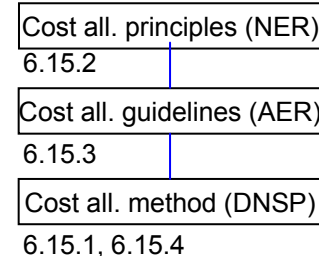
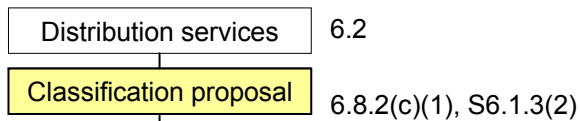
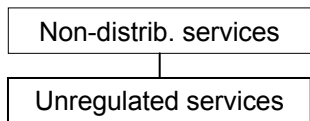
The expected statutory income tax rate is to be as determined by the AER for the *regulatory year*.

Ergon Energy proposes that statutory income tax rates should be those published by the Australian Taxation Office or under the National Tax Equivalents Regime.

National Electricity Law and Rules Timeline (for Qld)



Legislative Requirements
 AER Obligations
 DNSP Obligations
 Fixed or Known Date
 Requires ACTUALS for Capex & Opex for 2005-08 + ESTIMATES for 2008-10
 Above the Line Timeline is Current Draft NEL and NER - the "13 Month Process"
 Below the Line Timeline is the proposed 2-Part Process - the "24 Month Process"



DNSP

AER