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23 November 2012

Mr Philip Weickhardt and Ms Wendy Craik
The Productivity Commission
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Canberra City ACT 2601

Email: electricity@pc.gov.au

Dear Commissioners

Productivity Commission's Draft Report – Electricity Network Regulatory Frameworks

Ergon Energy Corporation Limited ((Ergon Energy) appreciates the opportunity provided by the Productivity Commission (the Commission) to provide comments on the *Draft Report – Electricity Network Regulatory Frameworks*. This submission is provided by Ergon Energy in its capacity as a Distribution Network Service Provider in Queensland.

Ergon Energy looks forward to providing continued assistance to the Commission in reviewing electricity network frameworks, with a focus on benchmarking arrangements and the effectiveness of the current regulatory regime.

Yours sincerelv

Jenny Doyle
Group Manager Regulatory Affairs

Ergon Energy Corporation Limited

Submission on the

Draft Report – Electricity Network Regulatory Frameworks

Productivity Commission

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1. INTRODUCTION

Ergon Energy Corporation Limited (Ergon Energy) welcomes the opportunity to provide comment to the Productivity Commission (the Commission) on its Draft Report – Electricity Network Regulatory Frameworks (the Draft Report). This submission is provided by Ergon Energy, in its capacity as a Distribution Network Service Provider (DNSP) in Queensland. Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the Commission require.

2. GENERAL COMMENTS

Ergon Energy is broadly supportive of the Commission's draft recommendations. Ergon Energy has provided some high level comments on the rate of return and the benchmark cost of debt allowance. These comments are reiterations of earlier comments made by Ergon Energy to the Australian Energy Market Commission's (AEMC) Network Regulation Rule Change consultations. Section 3 provides Ergon Energy's responses to particular draft recommendations made by the Commission.

2.1. Rate of Return (WACC)

Ergon Energy generally supports the AEMC new common rate of return framework for electricity and gas service providers arising from its Draft Determination[1] and considers the changes proposed are a significant improvement on the current approach and should lead to improved estimates of the weighted average cost of capital (WACC) used in the regulatory process. However, there are a number of elements within this framework which raise concerns for Ergon Energy, particularly in relation to the allowed rate of return objective and the Australian Energy Regulator's (AER) non-binding Rate of Return Guidelines. Ergon Energy refers the Commission to our submission[2] to the AEMC dated 7 October 2012 for further detail regarding these concerns.

2.2. Benchmark Cost of Debt

Ergon Energy agrees that incentives for cost minimisation could be strengthened by improving the estimates of the weighted average cost of capital used in the regulatory process, and in particular in relation to the benchmark cost of debt allowance. Ergon Energy recommends that the Commission review our submission to the AEMC[3] for more detail on our view on the cost of debt.

Ergon Energy considers that the inclusion of an historical trailing average approach to estimate the debt risk premium and the risk free rate in the National Electricity Rules (Rules) is a positive outcome for network service providers (NSPs) with large debt portfolios. NSPs with large debt portfolios are currently unable to align their actual debt costs with the return on debt allowance under the current approach (i.e. WACC fixed for five years over a short time interval every five years).

Ergon Energy further considers that no explicit adjustments to the allowed return on equity are required if NSPs are able to align their actual debt costs with the return on debt allowance via one of the three return on debt approaches listed in the draft Rules (i.e. prevailing cost of funds approach, historical trailing average approach, or some combination of these two approaches). Ergon Energy acknowledges that Queensland Treasury Corporation (QTC) has made a detailed submission[4] to the AEMC on their Draft

[1] http://www.aemc.gov.au/Media/docs/12-18737-Draft-determination---FINAL-version-for-publication---23-August-2012---ERC0134-ERC0135-GRC0011-ba365497-9d8d-4cfc-9d81-cce6f1438066-0.pdf

[2] http://www.aemc.gov.au/Media/docs/Ergon-Energy-Corportation-Limited---received-8-October-2012-f728883c-3d50-46a9-8fb9-90f40f57fdc4-0.PDF

[3] ibid

[4] http://www.aemc.gov.au/Media/docs/Queensland-Treasury-Corporation-123dcf49-ca7f-4c88-906d-bd84d1ab9002-0.PDF

Determination pertaining to the rate of return framework, including the return on debt and return on equity, and therefore refers the Commission to QTC's submission, which Ergon Energy supports. Ergon Energy also confirms its continued support for QTC's proposal for the benchmark return on debt to equal a ten-year moving average of the ten-year total corporate cost of debt and agrees with Strategic Finance Group Consulting's view that QTC's proposed moving average approach is one way of avoiding the potential for investment distortions on new borrowings.

Ergon Energy does not consider that the AER is in the best position to determine the most suitable approach to estimating the return on debt, as the AER is not experienced in issuing debt and/or managing interest rate risk. On this basis, Ergon Energy considers that NSPs who are actually responsible for implementing interest rate risk management strategies are in the best position to determine the debt management approach that is most appropriate for their business.

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

Ergon Energy also considers that the current 40 day maximum averaging period should be increased to a minimum period of at least six months due to the significant increase in debt balances held by some NSPs since the WACC parameter review was completed by the AER in 2008-09. Ergon Energy further considers that it may be appropriate for the averaging period to be extended to between 6 and 12 months for the next regulatory reset for NSPs who are transitioning to a different return on debt approach such as a long-term trailing average of the total return on debt.

A longer averaging period would enable NSPs with large debt portfolios to align their actual financing costs with the return on debt allowance, which would be of benefit to service providers and consumers over the longer term. Ergon Energy has further proposed a single averaging period in relation to the return on debt and for the timing and length of the single averaging period to be discussed and agreed between the regulator and the service provider during the AER's Framework and Approach process.

Ergon Energy also supports consideration of the interdependency of WACC parameters in both the determination and the appeals process to ensure high quality WACC estimate outcomes. Ergon Energy further supports specification of the interdependent nature of the parameters used to estimate the WACC in the Rules in accordance with the Commission's draft recommendation, although considers there may be some practical difficulties with this approach.

3. TABLE OF DETAILED COMMENTS

Draft Recommendation	Ergon Energy Response to Recommendations
Draft Recommendation 8.1 - The AER should regularly undertake aggregate benchmarking of the performance of network businesses, including of their: • multifactor productivity — the output of services for given inputs; and • separate productivity of capital, labour and intermediate inputs. The results should control, to the best extent available, any significant variations in the operating environments of the businesses, including customer density, line type and length, reliability requirements, and the capital vintage of relevant assets.	Ergon Energy generally supports the Commission's draft recommendation. Ergon Energy notes that attempts by the AER to derive efficient levels of capital or operating expenditure for a DNSP through benchmarking techniques would be difficult and open to challenge.
Draft Recommendation 10.1 - Distribution businesses should implement the roll-out of advanced metering infrastructure — so called smart meters — on a region-by-region basis within their network. • Before any roll-out, the AER, drawing on the proposal and supporting evidence from the distribution business, should assess the net present value of costs and benefits, and be required to consider demand management options that do not rely on smart meters. • When the AER determines the optimal start date of the roll-out, the relevant distributor must submit a costing to the Regulator for approval and agree to an appropriate timeline for implementation. • Mandatory time-based network charges to retailers (Draft Recommendation 11.3) should be implemented once smart meters are installed, appropriate customer consultation and education has taken place, and retail price regulation is removed (Draft Recommendation 12.3).	From a high level perspective Ergon Energy supports a framework that enshrines meter ownership and maintenance sitting within a dedicated asset management regime. The cost of servicing difficult and remote sites should be considered – contestability could leave a DNSP with all the high cost to serve sites. The roll-out of smart meters should only occur based on a positive business case that includes all costs.
Draft Recommendation 11.1 – The Standing Council on Energy Reform (SCER) should be tasked with overseeing the progressive implementation of cost-reflective, time-based pricing for electricity distribution network	Ergon Energy believes that DNSPs should have discretion to determine their own network tariff structures and choose which signals should be sent to customers in managing demand and recovering their allowable revenues on an efficient basis. Ergon Energy is

services, predicated on the long run marginal costs of meeting peak demand. Amongst other things, the SCER should:
• following consultation with key stakeholders, set timelines for the various steps in the development and implementation process, having regard to:
  o the Commission's specific proposals in relation to this process (Draft Recommendations 11.2 to 11.7); and
  o progress in making necessary changes elsewhere in the system;
• monitor compliance with those timelines;
• address any areas where greater engagement between key stakeholders (distribution businesses, retailers, state and territory governments, the AER and customer representatives) would assist the expeditious implementation of the new pricing regime, and
if and as necessary, take specific steps to address implementation delays.
	currently undertaking a review of its Network Tariff Strategy. As part of this Strategy, Ergon Energy will investigate innovative network tariffs (e.g. critical peak demand charges, capacity-based charging, coincident demand pricing, and Time-of-Use tariffs).
	
	We note that the Commission has indicated that network businesses should have responsibility for formulating detailed tariff structures, and iterations in them over time.[5] Ergon Energy supports this position.
	
	Ergon Energy does not believe specific timeframes should be introduced. Rather, the implementation and timing of cost-reflective, time-based pricing should be at the DNSP's discretion.

<u>Draft Recommendation 11.3</u>
When the process of implementing cost-reflective, time-based prices for distribution network services is sufficiently advanced to reasonably allow for a tightening of relevant clauses in the Rules:
• clause 6.18.5(b)(1) should be amended so as to ensure that time-based tariffs are determined by (rather than 'take into account') a reasonable estimate of the long run marginal cost for the service concerned; and
• clause 6.18.3(d)(1) should be amended so as:
  o to ensure that the grouping of customers for the purposes of setting time-based tariffs is based on economic efficiency (rather than 'having regard to' it); and
  o to make it explicit that significant differences in the long run marginal cost of meeting peak demand between locations and across customer groups should be
	Ergon Energy considers that economic efficiency is an important factor when grouping customers for the purposes of setting time-based tariffs. However, Ergon Energy notes that there are a number of other factors which should not be excluded, for example administrative simplicity and ensuring the tariff structures are customer-friendly / easy to understand.
	
	Ergon Energy seeks clarification from the Commission on what would be regarded as "significant differences" in meeting peak demand between locations. Some direction should be provided. It should be observed that if there is too much differentiation by location, this could result in a large number of different network tariffs, which may result in costs increases and complex tariff structures.

[5] Refer to pp 388-9 of the Draft Report

reflected in network pricing structures.	
<u>Draft Recommendation 11.4</u> When the process of implementing cost-reflective, time-based prices for distribution network services is suitably advanced, the requirements governing assessments by the AER of pricing proposals by DNSPs should be amended such that the Regulator: • can only approve a distribution business's peak demand forecasts if they include reasonable forward estimates of the likely demand response to time-based pricing; and • subject to the above condition, must approve any reasonable estimate by a distribution business of the long run marginal costs of meeting peak demand. To support these changes, the AER should develop a capacity to model demand responsiveness to time-based pricing.	Ergon Energy believes that it will be difficult to quantify the likely demand response to time-based pricing. In particular, Ergon Energy queries how this would be measured if retailers do not pass through a DNSP's price signals in their product offerings? Ergon Energy also notes that at some point, the desired demand response will be achieved. This means we would be unable to provide forward estimates. If this approach is adopted, the AER: • Will need sufficiently skilled resources (e.g. people with engineering and economic backgrounds) to model demand responsiveness; and • Should consult with DNSPs on their proposed model, particularly given that DNSPs would have more specialised knowledge of their networks.
<u>Draft Recommendation 11.5</u> Clause 6.2.8(a)(3) of the Rules should be amended to: • require the AER to publish guidelines on the methodology or methodologies that are appropriate for estimating the long-run marginal costs of meeting peak demand, and the factors that should be encompassed in those estimates; and • give the AER the authority to publish binding guidelines about efficient, time-based tariff structures, including definitions of 'peak' pricing events. These guidelines should be developed in consultation with the relevant stakeholders and should be improved over time as the implementation of time-based pricing progresses.	If Draft Recommendation 11.3 is adopted, Ergon Energy agrees that the AER should publish guidelines on the methodology or methodologies that are appropriate for estimating the long run marginal costs of meeting peak demand. The distribution consultation procedures outlined under Chapter 6 of the Rules should be followed. Ergon Energy does not support providing the AER the authority to publish binding guidelines about efficient, time-based tariff structures. As discussed above, the time-based tariff structures should be introduced at the DNSP's discretion, and in accordance with their network needs.
<u>Draft Recommendation 11.7</u> The AER should require: • distribution network businesses to demonstrate that they have actively engaged with retailers very early in the development of new time-based pricing structures, including on ways to incorporate those charges in retail prices to clearly signal to customers the costs of meeting peak network demand; and	Ergon Energy agrees that DNSPs should consult with consumer groups and retailers on their proposed tariff structures and intends to do so when making changes to our network tariff structures. This will ensure that customers, retailers and interested parties are involved in the development of new tariffs and are cognisant of changes likely to affect them. We note that any consultation process will need to work into our current Pricing Proposal process.

• distributors and retailers to demonstrate that they have engaged with, and educated, customers prior to the introduction of smart meters, and again prior to the introduction of new time-based customer tariffs. Such engagement should occur sufficiently early to ensure that customers have the knowledge and time to respond appropriately to time-based pricing (including of the various means to manage their peak demand); are aware of the implications for their electricity bills; understand the way in which advance warning of critical peak pricing events will be communicated; and are aware of the support mechanisms in the event that the new pricing regime creates financial difficulties for them.	In terms of educating customers about the introduction of smart meters, Ergon Energy considers that the Commonwealth government and/or the state or territory governments should also have a role.
Draft Recommendation 12.1 - Coinciding with the gradual roll-out of smart meters to allow more cost-reflective network pricing, revenues from all distribution network 'standard control services' should be subject to regulated weighted average price (not revenue) caps. This should not apply to transmission businesses, which, given the complexities and lower net-benefits, should continue to be subject to revenue caps.	Ergon Energy does not support a prescriptive framework that imposes a particular form of price control on DNSPs. Ergon Energy does not consider that sufficient investigation has occurred to fully explore the merits of this draft recommendation.
Draft Recommendation 12.2 - The AER should review the operation of, and the incentives provided by, the Demand Management and Embedded Generation Connection Incentive Scheme. In doing so, the AER should ensure that distribution companies' incentives are appropriately aligned with the objective of achieving efficient demand management. The innovation allowance component of this scheme should also be increased.	Ergon Energy indicated to the AEMC our support of recommendations made by the AEMC in their Power of Choice Stage 3 Demand Side Participation Review[6]. In particular Ergon Energy confirmed our support for the AER reviewing the current Demand Management and Embedded Generation Connection Scheme to ensure that DNSPs are appropriately incentivised and rewarded to engage in Demand Side Participation activities[7]. However, we would recommend that there is a thorough investigation prior to any decision being made to ensure that any administrative and transaction costs imposed on DNSPs to meet any amended regulatory framework are considered.
Draft Recommendation 13.1 - Governments should, as soon as practicable, discontinue subsidies for rooftop photovoltaic units and other forms of distributed generation delivered via feed-in tariffs, and the small-scale component of the Renewable Energy Target scheme. State and territory governments should change the way small-scale distributed generators are reimbursed for exporting power into the grid. This would involve:	Ergon Energy recommends that the Commission should closely investigate the overall net customer benefit in balancing distributed generation in areas where the network would require augmentation to meet that distributed generator's export requirements. Networks have not been designed to handle large export power flows at the distribution level and this should be considered. In Ergon Energy's experience, high penetration levels of distributed generation have resulted in additional network augmentation costs. Ergon Energy also refers the Commission to the Queensland Competition Authority's

[6] http://www.aemc.gov.au/Market-Reviews/Open/stage-3-demand-side-participation-review-facilitating-consumer-choices-and-energy-efficiency.html
[7] http://www.aemc.gov.au/Media/docs/Ergon-Energy---received-19-October-2012-60add825-3d5d-4137-85e6-962c4c7fb69f-0.pdf

• feed in tariffs that approximate the wholesale price of electricity at times of peak and non-peak demand; and • arrangements that provide for direct payments from distribution businesses to distributed generation providers, which reflect the network value of their distributed generation capacity and output. To provide a transition to the new arrangements, current feed-in tariff schemes should continue for existing customers until the end of their contract period or until those schemes expire (whichever is earlier), but be closed to new entrants one year from the governments' formal acceptance of this recommendation. Prior to that date, state and territory governments should develop replacement feed-in schemes with tariffs that approximate the wholesale price of electricity.	Issues Paper – *Estimating a Fair and Reasonable Feed-in Tariff for Queensland* and our response to this Issues Paper[8]. The QCA is investigating the establishment of a fair a reasonable feed-in tariff for electricity generated from small scale solar photovoltaic generators and exported to the Queensland Electricity Grid.
Draft Recommendation 21.4 – The National Electricity Law should be amended to expedite the making of Rules arising from any appropriately conducted independent review relevant to the National Electricity Market and that are agreed by the SCER. This should be achieved by giving the: • AEMC the power to expedite Rule requests; and • South Australian Minister a broader power to make Rules.	Ergon Energy does not support this draft recommendation. This draft recommendation in effect will not give stakeholders who may be directly impacted by a final decision made by, for example an independent review body, a reasonable and fair opportunity to advocate their positions. This proposal is inconsistent with promoting stable and predictable development of the energy rules framework over time. In particular, it appears that these proposals are at variance with the well-functioning separation of roles which is identified as good practice by the Commission itself, with SCER exercising policy-making functions, AEMC being responsible for rule-making and the AER executing regulatory functions. Ergon Energy considers that the current rule making process is reasonable and more importantly, it works well be providing a predictable, consistent and centralised approach to rule change assessments. We think that the current rule making framework is transparent and each body has clearly defined roles and this should not be departed from.

[8] http://www.qca.org.au/electricity-retail/Review_Of_Solar_Feed/IssuesPaper.php