

3 May 2018



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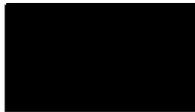
Dear Mr Pattas

PRELIMINARY FRAMEWORK AND APPROACH

Ergon Energy Corporation Limited (Ergon Energy) and Energex Limited (Energex) appreciate the opportunity to provide the attached submission on the AER's preliminary framework and approach (F&A) paper, for Ergon Energy and Energex, for the regulatory control period commencing 1 July 2020.

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact me on [REDACTED].

Yours sincerely



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Preliminary framework and approach Energex and Ergon Energy Regulatory control period commencing 1 July 2020

Joint submission to the Australian
Energy Regulator

3 May 2018



Part of the Energy Queensland Group



CONTENTS

1.	INTRODUCTION.....	1
2.	CLASSIFICATION OF SERVICES.....	2
3.	FORMS OF CONTROL.....	3
4.	INCENTIVE SCHEMES	4
5.	EXPENDITURE FORECAST ASSESSMENT GUIDELINE	7
6.	DEPRECIATION	7

1. INTRODUCTION

Ergon Energy Corporation Limited (Ergon Energy) and Energex Limited (Energex) appreciate the opportunity to provide feedback on the AER's preliminary framework and approach (F&A) paper, for Ergon Energy and Energex, for the regulatory control period commencing 1 July 2020.

The F&A, which precedes the submission of regulatory proposals, is a key step in the distribution determination process that guides regulated businesses in formulating their regulatory proposals by outlining the AER's likely approach to:

- Classification of services
- Forms of control and formulae
- Application of incentive schemes
- Application of the expenditure forecasting assessment guideline
- Calculation of depreciation for rolling forward the regulatory asset bases
- Pricing of dual function assets

For the most part, Ergon Energy and Energex are supportive of the AER's preliminary F&A as it considerably reflects a continuation of current regulatory arrangements apart from amendments prompted by recent developments in the regulatory environment.

In October 2017, Ergon Energy and Energex formally requested that the AER make a new F&A, given that it was worth revisiting dated aspects of the current F&A which was published in 2014. Notably, Ergon Energy and Energex considered that changes to the current classification of services were necessary following the development and publication of the AER's ring-fencing guideline. In addition, the development of a new demand management incentive scheme and innovation allowance mechanism and expected amendments to the service target performance incentive scheme meant the current F&A required updating.

Notwithstanding that Ergon Energy and Energex are generally comfortable with the AER's preliminary F&A, we have concerns with certain aspects of the AER's preliminary F&A particularly the proposal to increase the STPIS revenue at risk from ± 2 per cent to ± 5 per cent, which we do not support.

2. CLASSIFICATION OF SERVICES

Ergon Energy and Energex generally support the AER's preliminary service classification positions and the proposed 2020-25 Queensland service classification table.

Service classification determines which distribution services the AER will regulate and how distributors recover the costs of providing regulated services. It is one of the fundamental decisions that the AER makes in the distribution determination and it has flow on impacts on a range of other decisions including forecast operating expenditure, forecast capital expenditure, regulated asset base etc.

Proposed service reclassifications

The AER's service classification decisions now define ring-fencing obligations that we must comply with during a regulatory control period. As previously mentioned, changes to some of Ergon Energy and Energex's current service classification are necessary following the introduction of the AER's ring-fencing guideline for electricity distributors which requires, amongst other things, functional separation for unclassified distribution services and legal separation for non-distribution services.

In our July 2017 ring-fencing waiver applications, we signalled our intention to seek reclassification for a number of services in the 2020-25 regulatory control period. In this context, Ergon Energy and Energex agree with the AER's preliminary position to reclassify:

- Emergency recoverable works as standard control services (SCS).
- High load escorts as alternative control services (ACS)
- Security (Watchman) lights as ACS
- Provision of training to third parties for network related access as ACS
- Network related property services as ACS

Notwithstanding this, we request some minor amendments to the AER's service classification table. In particular, Ergon Energy and Energex are also seeking the reclassification of the 'sale of inventory' service as an ACS and its inclusion in the service classification table. This service relates to the sale of inventory to developers and suppliers of developers where these items are eventually gifted to the distributor as part of a network connection. Ergon Energy and Energex currently have a ring-fencing waiver for this service and have previously advised the AER of the intention to seek reclassification as an alternative control service.

Changes to the service classification table

Ergon Energy and Energex note and support that the AER has made a significant effort to harmonise service groupings and descriptions, as far as practicable, across all distributors. While the AER's proposed 2020-25 Queensland service classification table differs to that from the current 2015-20 regulatory control period, harmonisation across distributors promotes transparency and consistency of the AER's service classification decisions.

Further, Ergon Energy and Energex consider that the general approach of classifying distribution services in clusters is appropriate. The prior approach of attempting to define every individual service in the service classification table is inflexible, especially where new services are required during the regulatory period. The AER's proposed approach enables distributors to incorporate new services and the pricing approach in the annual pricing proposal.

Finally, Ergon Energy and Energex note that the AER is required to develop and publish a service classification guideline by 30 September 2018. Given that the service classification guideline is published after the finalisation of the F&A for Ergon Energy and Energex, in July 2018, Ergon Energy and Energex anticipate that the AER is working concurrently on both processes to avoid significant changes to the final F&A.

Metering services

Ergon Energy and Energex note that the AER's preliminary F&A states that as a result of the commencement of the Power of Choice, Queensland distributors are no longer permitted to install or replace existing meters with type 5 and 6 meters. While this is true in Energex's distribution area, we wish to reiterate that the Mount Isa-Cloncurry Network in Ergon Energy's distribution area is exempt from Chapter 7 of the NER and therefore is not subject to Power of Choice. Consequently, Ergon Energy will continue to install type 6 meters in this area.

3. FORMS OF CONTROL

Ergon Energy and Energex support the AER's preliminary decision to apply the following forms of control in the 2020-25 regulatory control period i.e.:

- Revenue cap for SCS
- Caps on the prices of individual services for ACS.

The application of the above forms of control is in keeping with previous regulatory arrangements in Queensland. Moreover, we note that the AER has made a concerted effort to transition all distributors to revenue caps for SCS.

Ergon Energy and Energex are also comfortable with the continuation of the application of current control formulae, noting that the formulae for standard control services will potentially change following the completion of the AER's review of its STPIS.

4. INCENTIVE SCHEMES

Ergon Energy and Energex support the AER's preliminary position to continue to apply the following incentive schemes in the 2020-25 regulatory control period:

- Service target performance incentive scheme (STPIS)
- Efficiency benefit sharing scheme (EBSS)
- Capital expenditure sharing scheme (CESS)
- Demand management innovation allowance mechanism (DMIA).

Further, Ergon Energy and Energex support the application of the AER's recently developed demand management incentive scheme (DMIS).

The application of the incentive schemes, set out above, complements the incentive based regulatory regime administered by the AER where network revenues are set for a regulatory control period and distributors are incentivised to outperform the revenues; the incentive schemes provide distributors with additional incentives to improve efficiency and service performance.

While Ergon Energy and Energex are generally supportive of the application of the incentive schemes, we have a few reservations regarding the AER's proposed approach on the STPIS and CESS as outlined below.

STPIS

Ergon Energy and Energex note that the AER is proposing to continue to apply the STPIS in a broadly similar manner to the current application of the scheme, with the following exceptions: the revenue at risk cap will increase to ± 5 per cent (from ± 2 per cent) and amended STPIS will likely apply in the 2020-25 regulatory control period. We have concerns in relation to the proposed changes.

Revenue at risk

The AER's preliminary F&A states that:

Our proposed approach is to apply the scheme standard level of revenue at risk for Qld distributors at ± 5 per cent as we do not consider that a lower than scheme standard level would fully achieve the intended outcomes of the STPIS.¹

Ergon Energy and Energex strongly disagree with this view. Since the inception of the STPIS in Queensland, in 2010, Ergon Energy and Energex have outperformed STPIS targets and delivered improved reliability and customer service outcomes for Queensland customers with a lower than scheme standard level revenue at risk. For this reason, we do not consider that a high-powered STPIS is necessary.

Moreover, we note that the objective of the STPIS is to provide incentives for distributors to maintain and improve service performance. Thus, to the extent that Ergon Energy and Energex have managed to achieve this objective with a lower revenue at risk, it is not clear what additional outcomes, if any, are achieved by a higher revenue at risk.

Perhaps more importantly, Ergon Energy and Energex believe that affordability is the primary concern for our customers, rather than our current reliability and customer service performance levels. Results from the most recent Queensland Household Energy Survey conducted by Ergon Energy, Energex and Powerlink, in November 2017, showed a significant increase in household energy bill concern across all demographics and regions compared to the previous year, reaffirming our view that affordability is the primary concern for customers.

A higher powered STPIS also increases the risk of within-period revenue volatility which potentially exacerbates affordability issues. Sharper increases in network charges driven in part by higher-powered STPIS outcomes are not in the interests of our customers.

Amended STPIS

Ergon Energy and Energex were generally supportive of the AER's draft amended STPIS published on 14 December 2017. However, we had some concerns with the AER's proposed changes to the scheme which we outlined in our submission. At a high level, Ergon Energy and Energex wish to reiterate that:

¹ AER, Preliminary framework and approach, Energex and Ergon Energy, Regulatory period commencing 1 July 2020, March 2018, p55

- We do not support the proposed changes to the ratio of system average interruption duration index (SAIDI) and system average interruption frequency index (SAIFI) incentives to 60:40 from 50:50. We strongly believe that the AER's view that customer average interruption duration index (CAIDI) was declining, therefore, necessitating an adjustment to the ratio of incentives, was based on limited observations, in particular, the AER considered a trend over four years. Given the variability of reliability performance on a yearly basis, Ergon Energy and Energex believe that significantly more data is required before the AER can justify such an amendment to the scheme.
- The amended STPIS must not set out the incorporation of the s-factor into the control formulae for standard control services. Instead, that is appropriately set out in the distribution determination.
- The AER's proposed methodology for adjusting performance targets where reward or penalties exceed the revenue at risk caps is confusing and difficult to apply. We support adopting the methodology that was set out in Energex's 2015-20 regulatory proposal which was accepted by the AER.
- We continue to support the AEMC's recommendation to remove catastrophic days before the calculation of the major event day threshold. The AER's decision in rejecting the AEMC's proposal was not based on sound reasoning. While we agree that there is no perfect method to identify catastrophic events in a manner that applies consistently to all distributors, we believe that the modified 4.15 beta threshold is at least an improvement over the current approach of not even attempting to identify catastrophic events. The exclusion of catastrophic events is of particular importance to Ergon Energy and Energex, which operate in an area characterised by frequent extreme weather events.

Lastly, Ergon Energy and Energex are concerned about the STPIS review timeframes. We note that the review commenced in January 2017 and initial indicative timeframes suggested that the review would be completed by October/November 2017. However, the final decision is now not due until June 2018. Given that we expect the amended STPIS to apply during the next regulatory period, we require clarity regarding the AER's final amendments to the scheme before we can commence preparing our regulatory proposals.

CESS

Ergon Energy and Energex are generally comfortable with the AER's proposed application of the CESS. However, the issue of adjusting rewards for capital expenditure deferrals is of concern.

Setting aside the debate about whether such adjustments are appropriate in the first place, it is unclear how the AER will make the adjustments. In particular, it is not clear to us how the AER will identify the deferred projects noting that the AER states that it does not determine which projects and programs a distributor should or should not undertake during a regulatory determination.²

5. EXPENDITURE FORECAST ASSESSMENT GUIDELINE

Ergon Energy and Energex note the AER's intention to apply its expenditure forecast assessment (EFA) guideline in assessing Ergon Energy and Energex's proposed expenditure forecasts. The EFA guideline includes a suite of assessment/analytical tools and techniques that the AER can use to assess our expenditure proposals including benchmarking, replacement and augmentation models etc.

While Ergon Energy and Energex acknowledge that the AER has discretion in the application of various tools outlined in the EFA guideline, we consider that the AER should provide sufficient detail in the F&A in relation to the application to the tools to our capital and operating expenditure proposals. In particular, the AER should provide the indicative weights that it proposes to apply to specific tools. Currently, it is unclear how the AER will apply benchmarking going forward, noting that the AER's excessive reliance on its benchmarking methodology in setting operating expenditure allowances in the previous round of regulatory reviews was successfully challenged by the New South Wales and Australian Capital Territory distributors.

6. DEPRECIATION

Ergon Energy and Energex support the AER's preliminary position to use forecast depreciation to roll forward the RABs to the commencement of the 2025-30 regulatory control period. Ergon Energy and Energex agree that the use of forecast depreciation in conjunction with the CESS provides sufficient incentives to pursue capex efficiency gains over the 2020-25 regulatory period.

² AER, Preliminary framework and approach, Energex and Ergon Energy, Regulatory period commencing 1 July 2020, March 2018, p61