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Dear Mr Pattas

## **Discussion Paper: Proposed Cost Allocation Guidelines for Electricity Distribution Network Service Providers**

Ergon Energy Corporation Limited (Ergon Energy) appreciates the opportunity provided by the Australian Energy Regulator (AER) to comment on the development of Cost Allocation Guidelines to support the transition to a nationally consistent framework for the economic regulation of electricity distribution networks.

The attached submission represents Ergon Energy response to the AER's proposed Cost Allocation Guidelines and the accompanying Discussion Paper.

Ergon Energy would welcome the opportunity to discuss this submission or provide further detail regarding the issues that it has raised should the AER require.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Tony Pfeiffer', with a large loop at the end.

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c.c.: Carmel Price, Manager Regulatory Affairs – Network Regulation

# **Ergon Energy Corporation Limited**

**Proposed Electricity Distribution Network  
Service Providers Cost Allocation Guidelines  
– Submission**

**Australian Energy Regulator  
14 May 2008**

# Proposed Electricity Distribution Network Service Providers Cost Allocation Guidelines – Submission

Australian Energy Regulator

14 May 2008

This submission, which is available for publication, is made by:

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## Overview

Ergon Energy Corporation Limited (Ergon Energy) appreciates the opportunity to provide comment to the Australian Energy Regulator (AER) on the *“Proposed electricity distribution network service providers cost allocation guidelines”* (Guidelines) and the *“Discussion Paper - electricity distribution network service providers proposed cost allocation guidelines”* (Discussion Paper). This submission is provided by Ergon Energy in its capacity as an electricity distribution network service provider (DNSP) in Queensland.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues that it has raised should the AER require.

## General Comment

As a general principle, Ergon Energy believes that all substantive provisions related to the preparation and application of a DNSP’s Cost Allocation Method (CAM) should be contained in the Guidelines. Ergon Energy is concerned that, as currently drafted, the Guidelines rely heavily on the use of regulatory information instruments to provide the level of detail that DNSPs will require to effectively develop and apply their CAMs.

This issue applies equally to all the guidelines that have been released by the AER for comment and is a matter of particular concern for those DNSPs who are currently in the process of preparing their Regulatory Proposals.

Ergon Energy believes that in the interests of transparency and regulatory certainty, all substantive issues should be addressed in the guidelines and that regulatory information instruments should only be used in circumstances where there are specific issues related to an individual DNSP, or a class of DNSPs, that are required to be addressed outside the guidelines.

Ergon Energy does not believe that the National Electricity Law (Law) or National Electricity Rules (Rules) envisage the use of regulatory information instruments for matters of general application to all DNSPs. This interpretation is supported by:

- The basis upon which the AER is permitted to issue a regulatory information instrument under Part 3, Division 4 of the Law. For example:
  - Section 28C of the Law, which provides that the AER may issue a regulatory information order to “each regulated network service provider of a specific class, or each related provider of a specified class...”; and
  - Section 28D of the Law, which provides that the AER may issue a regulatory information notice to “the regulated network service provider, or related provider, named in the notice...”;
- That the degree of transparency supporting the development of a regulatory information instrument is lower than that supporting the development of a guideline. In particular:

- Section 6.16 of the Rules requires the AER to comply with the 'distribution consultation procedures' in making, developing, or amending any guidelines, models or schemes, or in reviewing any values or method. This provides for a two-stage process of public consultation involving the release of a draft document, explanatory statement, a summary of responses to issues raised, and a final decision; and
- Section 28F of the Law permits the AER to serve a regulatory information notice or make a general regulatory information order in circumstances where it considers this reasonably necessary in the performance of its functions or powers:
  - o Section 28J of the Law only requires the impacted party to be provided with an opportunity to be heard (including provision of a draft), prior to service of a regulatory information notice; and
  - o Section 28H of the Law only provides a general requirement for public consultation, prior to making a general regulatory information order.
- The 'status' of the regulatory information instruments and the guidelines differ, impacting the degree of flexibility in their application that is afforded to both the AER and the impacted DNSP (or related party). In particular:
  - Section 6.2.8(c) of the Rules state that the guidelines are not mandatory and hence do not bind the AER or any other party; and
  - Sections 28N and 28O of the Law require a party receiving a regulatory information notice or general regulatory information order, to comply with the notice or order. As these instruments are binding in nature, they should be used with discretion.

Ergon Energy suggests that the guidelines should contain a greater level of specification than currently proposed and that the use of regulatory information instruments should be minimised.

In those circumstances where regulatory information instruments are required, these should be released by the AER as a matter of priority.

## 1 Introduction

No comment is provided.

## 2 Rule requirements

No comment is provided.

## 3 Purpose and objectives

*Q1. Are the working assumptions used to prepare this discussion paper and the proposed guidelines appropriate?*

While Ergon Energy broadly supports the working assumptions that have been applied by the AER in the preparing the Discussion Paper and Guidelines:

- Ergon Energy queries the AER's interpretation of 'regulated business', noting that that AER considers that "a single set of regulatory accounts could potentially draw from the statutory accounts of multiple entities". Ergon Energy encourages the AER to adopt a broad interpretation of 'regulated business' for the purposes of the Guideline. This is necessary to ensure that the costs and underlying transactions attributable to DNSPs' regulated services are appropriately captured, regardless of the differences that may exist between DNSPs with respect to their corporate structures or operating models; and
- Consistent with the comment in section 2, reliance on regulatory information instruments and working papers appears to undermine the working assumption that "the guidelines will be stand-alone document". Without clarification from the AER as to the content of these supplementary instruments, DNSPs cannot have confidence that "all substantive provisions used in the regulatory framework will, as far as possible, be included in the cost allocation guidelines..."

## 4 Cost allocation in the context of the regulatory framework

No comment is provided.

## 5 Differences between regulated businesses

*Q2. Is it possible to derive a single set of allocators applicable to all network service providers?*

*Q3. If yes, would it be appropriate to do so?*

Ergon Energy does not support the development of a single set of allocators for application to all DNSPs. Ergon Energy believes that there are a number of key differences between individual DNSPs, within and across jurisdictions, that influence the extent to which a single set of allocators could meaningfully be developed. In addition to the factors identified by the AER in section 5 of the Discussion Paper, the transition from varied jurisdictional to national arrangements will add to the complexity of cost

allocation arrangements for the initial regulatory control period and the difficulty in establishing a common set of allocators.

Ergon Energy supports the AER's preliminary position in the Discussion Paper that: "the provision of relevant, reliable and consistent information within an individual regulated business over time is preferable to obtaining information that is strictly comparable between different regulated businesses at any point in time".

## **6 Alternative approaches to regulating cost allocation**

No comment is provided.

## **7 Key elements of proposed cost allocation arrangements**

### ***Selection of cost allocators for shared costs***

*Q4. Should the regulated business or the AER select the allocators for shared costs?*

*Q5. Is there merit in the regulated businesses working together to produce a future industry standard for the attribution and allocation of costs?*

*Q6. Should cost allocation be allowed using the avoided cost method and, if so, under what circumstances should it be allowed?*

Ergon Energy supports a framework for cost allocation under which the regulated business is responsible for the selection of the allocators for shared costs. Each DNSP will be best placed to identify those allocators that are appropriate to its unique characteristics and the substance of the transactions supporting its service delivery.

Ergon Energy does not believe that there is merit in seeking to produce an industry standard for the attribution and allocation of costs, at this time. This is due to the significant differences that exist between the operations of individual DNSPs and the need for both the AER and DNSPs to gain practical experience in applying the requirements of Chapter 6 and the Guidelines to their service provision.

### ***Accounting principles and policies***

The role of the 'working papers' that are to be provided in support of the CAM remains unclear. In particular, Ergon Energy seeks clarification on:

- The information that is to be provided in the working papers relative to the CAM and their interaction with the CAM. Ergon Energy's preliminary interpretation of the commentary in section 7.6 of the Discussion Paper is that the CAM will describe the allocators and the method of allocation, while the working papers will describe the numeric quantity or percentage values to be applied; and
- Whether the working papers will be treated as 'confidential' between the submitting DNSP and the AER. Ergon Energy suggests that all financial information contained in the working papers should be treated as confidential and that this should be explicitly provided for in section 5.4 of the Guidelines.

Ergon Energy believes that the Guidelines should provide significantly more detail about the nature, scope and content of the working papers than is currently provided in section 5.2 of the Guidelines.



## **Regulatory audit**

While the AER's intention to issue a separate regulatory information instrument on the audit arrangements is acknowledged, Ergon Energy believes that:

- The scope of the audit should be clarified in the Guidelines. Section 5.3 of the Guidelines currently provides that:
  - The audit is to be of "financial information". This suggests an audit of forecasts although financial audits are only performed on historical actuals; and
  - The audit "must include an assessment...". This establishes the minimum requirements for the audit but leaves the actual scope of the audit (i.e. its outer parameters) undetermined;
- The audit requirements will need to be known with sufficient time and certainty to ensure that a complying audit can be performed prior to, and accompany, Ergon Energy's Regulatory Proposal (due for submission by 31 May 2009). Significantly more detail is required for this purpose than is currently provided in either the Guidelines or the Discussion Paper.

Consistent with the comment in section 2, Ergon Energy believes that the Guideline should be amended to detail the audit requirements. At a minimum, the regulatory information instrument should be released by the AER as a matter of priority.

*Q7. Is it appropriate that the scope of the regulatory audit (as it relates to cost allocation) only assesses whether the costs have been appropriately attributed or allocated, not whether the allocators themselves are most suitable?*

Ergon Energy believes that the scope of the regulatory audit, as it relates to cost allocation, should only be to assess whether:

- The allocators have been appropriately applied to the shared costs; and
- The calculation of the numeric value or percentage applied in the allocation has been appropriately determined.

Importantly, the audit should not attempt to consider whether:

- The allocators are appropriate – the allocators are proposed by the regulated business and assessed by the AER through the process of approving the CAM; or
- The forecasts of shared costs are prudent and efficient - the AER, not the auditor, determines what is prudent and efficient for this purpose.

### **Timing and transition issues**

The Rules provide for the following timeframes to apply to the preparation of Ergon Energy's Regulatory Proposal and release by the AER of its Distribution Determination:

<b>Activity</b>	<b>Date</b>
Amended Rules commence	1 January 2008
AER publishes Guideline	by 30 June 2008
Ergon Energy to submit CAM (including allocators)	by 31 December 2008
Ergon Energy to submit Regulatory Proposal (including regulatory audit)	by 29 May 2009
AER to approve CAM (including allocators)	within 6 months of receipt (i.e. by 30 June 2009)
AER to issue Distribution Determination (including final Classification of Services)	by 30 April 2010

These timeframes materially impact the development of Ergon Energy's Regulatory Proposal and CAM in the following manner:

- The Regulatory Proposal:
  - Will be prepared on the basis of expenditure that is allocated in accordance with the CAM, although Ergon Energy may be required to submit its Regulatory Proposal prior to the AER approving the CAM; and
  - Must be accompanied by an audit of the CAM, including as to whether costs have been attributed and allocated in accordance with the approved methodology. As noted above, the audit arrangements will be outlined in a regulatory information instrument that has yet to be released by the AER.

Ergon Energy appreciates the AER's recognition of these timing issues in its response to stakeholder comments on the preliminary issues paper and its stated intention to work closely with Ergon Energy to ensure their resolution. Further to the comments in section 2, Ergon Energy believes that additional information regarding the working papers and audit requirements should be released by the AER as a matter of priority to assist in mitigating the timing risks identified.

- The final Classification of Services will not be known until the Distribution Determination is issued and as a consequence, Ergon Energy will be unable to develop its CAM on the basis of the four possible service categories identified – i.e. standard control services, alternative control services, negotiated services and unregulated activities. This is due to the fact that, pursuant to section 6.12.3(b) of the Rules, the service classification in the Distribution Determination may depart from that set out in the Framework and Approach, if the AER considers that there are good reasons for departing from the classification.

Ergon Energy believes that this risk can be mitigated by a process under which Ergon Energy is permitted to:

- Prepare its CAM based on the 10 types of distribution services identified in its *“Proposal: Service Classification and Control Mechanisms”* submitted to the AER on 31 March 2008; and
- Subsequently adjust the CAM, as required, once the final classification of services is known. That is, Ergon Energy would uplift or ‘map’ the 10 types of distribution services in its CAM to the service classification in its Distribution Determination. Alternatively, Ergon Energy could seek to amend its CAM to reflect the service classification, prior to the commencement of the regulatory year 2010-11, by utilising the process for amendment outlined in section 4.2 of the Guideline.

Ergon Energy believes that these transitional arrangements for Queensland should form a specific provision in the Guidelines, similar to the explanation of the transitional arrangements for Victoria, New South Wales and the Australian Capital Territory contained in section 1.3 of the Guidelines.

## **8 Issues relating to the guidelines for Victorian DNSPs**

No specific comment is provided on the proposed Guidelines or framework for Victoria.