Ref.: TP/CP

11 August 2008

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Dear Mr Buckley

Framework and Approach Paper Application of Schemes – Energex and Ergon Energy 2010-15

Ergon Energy Corporation Limited (Ergon Energy) is pleased to make this submission to the Australian Energy Regulator (AER) in response to the AER's proposed positions released on 30 June 2008 on the application of schemes to apply to Queensland's Distribution Network Service Providers for the next regulatory control period, 2010-15.

Ergon Energy has accepted certain of the AER's proposed positions and where we have alternative views, we have set out our reasons for these views. Ergon Energy has also proposed a number of additional items that it requests the AER include in its final Framework and Approach Paper.

Ergon Energy looks forward to continuing to work with the AER in developing the regulatory arrangements that will apply to the Queensland distribution network service providers for the next regulatory control period.

Please do not hesitate to contact myself or Carmel Price, Manager Regulatory Affairs Network Regulation on (07) 41219545 should you wish to discuss this proposal in any way.

Yours sincerely

Tony Pfeiffer
General Manager Regulatory Affairs

Enc.:

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Ergon Energy Corporation Limited

Submission to the AER in response to "Preliminary Positions – Framework and Approach Paper - Applications of Schemes - ENERGEX and Ergon Energy 2010-15"

11 August 2008

Submission to the AER in response to "Preliminary Positions - Framework and Approach Paper - Application of Schemes - ENERGEX and Ergon Energy 2010-15"

11 August 2008

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

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1 Introduction

The AER has issued for public comment two preliminary Framework and Approach Papers for Ergon Energy Corporation Limited (Ergon Energy) and ENERGEX for the 2010 to 2015 regulatory control period:

- “Proposed positions: Framework and Approach Paper – Classification of Services and Control Mechanisms – ENERGEX and Ergon Energy 2010-15” (F&A Stage 1); and

- “Preliminary positions: Framework and Approach Paper – Application of Schemes – ENERGEX and Ergon Energy 2010-15” (F&A Stage 2).

Ergon Energy is pleased to make this submission to the AER in relation to F&A Stage 2. Ergon Energy made a separate submission to the AER in relation to F&A Stage 1 on 28 July 2008.

This submission is provided by Ergon Energy in its capacity as an electricity distribution network service provider (DNSP) in Queensland.

Ergon Energy would be pleased to discuss this submission with the AER and to provide further information should the AER require it.

2 Scope of the AER’s Framework and Approach Paper

Clause 6.8.1(b) of the National Electricity Rules (Rules) provides that:

> *The framework and approach paper should set out the AER’s likely approach (together with its reasons for the likely approach), in the forthcoming distribution determination, to:*
>
> *(1) the classification of distribution services in accordance with Part B;*
>
> *(2) the application to the Distribution Network Service Provider of a service target performance incentive scheme or schemes; and*
>
> *(3) the application to the Distribution Network Service Provider of an efficiency benefit sharing scheme or schemes; and*
>
> *(4) the application to the Distribution Network Service Provider (if applicable) of a demand management incentive scheme or schemes; and*
>
> *(5) any other matters on which the AER thinks fit to give an indication of its likely approach.*

The AER’s F&A Stage 1 deals with the classification of Ergon Energy’s services, and the associated control mechanisms, and so addresses clause 6.8.1(b)(1).

The AER’s F&A Stage 2 deals with the application to Ergon Energy of the service target performance incentive scheme (STPIS), the efficiency benefit sharing scheme (EBSS) and the demand management incentive scheme (DMIS) and so addresses clauses 6.8.1(b)(2) to (4).

However, the AER has not utilised clause 6.8.1(b)(5) to give an indication in either the F&A Stage 1 or F&A Stage 2 of its likely approach on any other matters. Ergon Energy believes that there are a number of other matters that it would be extremely beneficial for the AER to address in its Final Framework and Approach Paper.

Sections 3 to 5 of this submission seek clarification, and amendment, in the AER's Final Framework and Approach Paper of certain elements of the proposed STPIS, EBSS and DMIS.

Sections 6 to 16 of this submission request that the AER address the following other matters in its final Framework and Approach Paper in order to provide clarity to Ergon Energy in preparing its Regulatory Proposal:

- *Asset categories* – Ergon Energy seeks confirmation from the AER that it is acceptable for Ergon Energy to use the asset categories reported to the QCA in its regulatory accounts in the Roll Forward Model (RFM) and Post Tax Revenue Model (PTRM). Streetlights would not be included in the RFM or PTRM for standard control services if streetlighting services are classified as other than standard control services. This is addressed in section 6 of this submission;

- *Asset lives* – Ergon Energy seeks the AER's agreement to a series of specific matters regarding the treatment of asset lives. This is addressed in section 7 of this submission;

- *Regulatory asset value* – Ergon Energy seeks the AER's agreement to replace its opening asset value as at 1 July 2005 of $4,198.2 million value, as currently detailed in clause S6.2.1(c)(1) of the Rules, with a revised value of $4,232.4 million that has been approved by the QCA. This is addressed in section 8 of this submission;

- *No prudency review* - Ergon Energy seeks the AER's confirmation in its Final Framework and Approach Paper that it will not assess Ergon Energy's capital expenditure during the 2005 to 2010 regulatory control period for prudency or efficiency prior to it being allowed to be rolled into the regulatory asset base (RAB) as at 1 July 2010. This is addressed in section 9 of this submission;

- *Mount Isa – Cloncurry network* – Ergon Energy seeks the AER's in-principle agreement to the Mount Isa – Cloncurry network being regulated under Chapter 6 of the Rules, pending the Queensland Government finalising arrangements for the future regulation of these assets. This is addressed in section 10 of this submission;

- *Cost pass through for input cost increases* – Ergon Energy seeks the AER's confirmation in the Final Framework and Approach Paper that there is scope for the Queensland DNSPs to nominate significant input cost variations as pass through events, in the same way the NSW-ACT DNSPs have in their Regulatory Proposals. This is addressed in section 11 of this submission;

- *Cost pass through materiality threshold* - Ergon Energy seeks the AER's confirmation that it will apply the same materiality thresholds for cost pass through events detailed for the Queensland DNSPs as it has proposed for the NSW-ACT DNSPs. This is addressed in section 12 of this submission;

- *"Eligible Pass Through Amount", Information Requirements and Cost Pass Through Process* - Ergon Energy requests that the AER's Final Framework and Approach Paper confirm that it intends preparing a Guideline that addresses the components of eligible pass through amount(s), information requirements of the AER and detail about the process that will be followed. This is addressed in section 13 of this submission

- *Extending cost pass through events to Alternative Control Services* - Ergon Energy seeks the AER's confirmation that it will be allowed to nominate pass through events in its Regulatory Proposal for its alternative control services in the next regulatory control period. This is addressed in section 14 of this submission;

- *Meaning of "security of supply"* – Ergon Energy seeks the AER's confirmation that, although there is no codified security of supply standard in Queensland, the security of supply standard that it should "maintain" for the purposes of clauses 6.5.6(a)(3)-(4) and clauses 6.5.7(a)(3)(4) is that approved by the Queensland Government for Ergon Energy for the purposes of delivering against the EDSD Review recommendations and the associated Government Action Plan. This is addressed in section 15 of this submission; and

- *Negotiating Framework* – Ergon Energy seeks confirmation from the AER that, if it does not have any negotiated distribution services, it does not need to submit a negotiating framework as part of its Regulatory Proposal, as it would otherwise need to do under clause 6.8.2(c)(5). This is addressed in section 16 of this submission.

3 Application of a service target performance incentive scheme (STPIS)

3.1 Paper Trial for STPIS

Section 2.4.4.10 of the F&A Stage 2 outlines the AER's preliminary position that the STPIS should be applied to Ergon Energy and Energex in a form as close as possible to the national STPIS, unless the Queensland DNSPs raise relevant reasons why this should not be the case.

Ergon Energy disagrees with this preliminary position and believes that implementing the STPIS by way of a paper trial is the most appropriate approach for the 2010-15 regulatory control period.

In particular, Ergon Energy does not agree with the AER's view that Ergon Energy's service standard reporting to the QCA in the current regulatory period could be considered to have been a paper trial for the STPIS. This is because there have not been any penalty and reward parameters set and tested so that there has not been any 'practice run' of a scheme. As a result, Ergon Energy has not been able to learn what business modifications are necessary in order to operate effectively under a STPIS, as would otherwise be evident under a paper trial.

Ergon Energy's modelling to date of a scheme that complies with the AER's national STPIS indicates that it may result in potentially unintended pricing outcomes. In particular, Ergon Energy believes that the intent of the scheme is undermined where the DNSP's performance data is highly variable between years (even after normalisation for major events). The data variance masks not only the DNSP's true underlying performance, but the impacts of any actions taken to specifically address underlying performance. Rewards/penalties under the scheme are hence incurred based on the year-on-year data variability and not the performance improvement/degradations over which a DNSP has control. Ergon Energy does not believe that the s-bank mechanism resolves this issue.

Furthermore, Ergon Energy understands that the NSW DNSPs operated under a full paper trial in the current regulatory control period, 2004-09, and the AER has permitted them to continue the paper trial for their next regulatory control period. ActewAGL is also permitted to have a paper trial for its next regulatory control period.

Given that Ergon Energy has never operated under any form of STPIS, the potential unintended pricing outcomes and the AER's decision to continue to apply a paper trial to the NSW-ACT DNSPs, Ergon Energy believes that the AER must have full regard to Queensland transitional arrangement specified in clause 11.16.5 of the Rules. That is, *to consider applying the STPIS through a low-powered scheme or paper trial for the 2010-15 regulatory control period.*

In the interest of consistency and fairness, Ergon Energy strongly believes that the AER should allow a paper trial to be applied to the Queensland DNSPs for the next regulatory control period.

3.2 Full alignment of reliability exclusions not achieved

Ergon Energy notes that there is not full alignment between the exclusion events listed in section 6.7.4 of the AER's explanatory statement for the STPIS and the exclusion events listed in the Queensland Electricity Industry Code (EIC).

In particular, Ergon Energy considers that the AER should add the following other exclusion events that are part of the EIC to the national STPIS or, alternatively, the STPIS that applies just to Ergon Energy:

- An interruption caused by a customer's electrical installation or failure of that electrical installation; and

- A direction of a police officer or another authorised person exercising powers in relation to public safety.

The AER stated in its Final decision - Electricity Distribution Network Service Providers Service Target Performance Incentive Scheme (June 2008) that interruption events as a result of the direction of police and other authorised emergency personnel:

> *…do not occur often and will generally have a minor impact on performance, which will in any case be reflected in the historical data used to set targets under the reliability parameters in the STPIS.*

Ergon Energy agrees that such events generally do not occur frequently and tend to have only a minor impact on reliability performance. Consequently, Ergon Energy sees no reason why such events cannot be exclusion events under the STPIS, as the impact on Ergon Energy's performance under the STPIS would generally be negligible. The key benefit for Ergon Energy doing this is that it would be able to maintain one set of reliability data, rather than two sets that would otherwise be required if a distinction was maintained between the exclusion events under the EIC and the STPIS.

The AER also stated in its Final decision - Electricity Distribution Network Service Providers Service Target Performance Incentive Scheme (June 2008) that interruption events as a result of a customer's electrical installation:

> *…have also not been specifically included in the final STPIS on the basis that it is often difficult to determine whether a customer's installation has caused a service interruption or whether the interruption is due to a distribution network protection system not responding appropriately to a customer fault. Also, outages due to a customer's electrical installation are unlikely to be material to the performance measured under the reliability parameters in the STPIS.*

Ergon Energy recognises the difficulty in determining whether or not a customer's installation has caused a service interruption and agrees that such events will generally tend to have only a minor impact on reliability performance. Again, given the minor contribution of such outages to overall network performance, Ergon Energy sees no reason why such events cannot be exclusion events under the STPIS, as the impact on Ergon Energy's performance under the STPIS would generally be negligible. Again, this would enable Ergon Energy to maintain one set of reliability data for the purposes of the EIC and STPIS.

Not allowing these to be STPIS exclusion events would impose additional reporting burden and administrative costs on Ergon Energy for no material benefit to users or the AER. The additional costs to Ergon Energy arise from having to modify existing reporting systems to accommodate jurisdictional and national reporting requirements.

In addition, Ergon Energy's reliability performance will be publicly reported by both the QCA and the AER. Differing reporting requirements between the QCA and the AER will result in apparently 'inconsistent' results in the public domain. This is a highly undesirable outcome. Ergon Energy therefore considers that streamlining and aligning performance reporting requirements is imperative wherever possible.

For each of the reasons stated above, Ergon Energy requests that the AER include the following exclusion events in the STPIS through the final Framework and Approach paper for Ergon Energy:

- An interruption caused by a customer's electrical installation or failure of that electrical installation; and
- A direction of a police officer or another authorised person exercising powers in relation to public safety.

3.3 Telephone Answering Parameter

Ergon Energy reports the number of customer calls to the Loss of Supply and Emergency numbers to the QCA and the Queensland Department of Mines and Energy. Ergon Energy seeks clarification in the Final Framework and Approach Paper about whether calls to both numbers should be included (i.e. combined) when reporting against the Telephone Answering parameter, or whether Loss of Supply and Emergency performance should be considered as separate customer service parameters.

Ergon Energy notes from Appendix A of the STPIS Guidelines that the units for the Telephone Answering parameter are “The Percentage of Total Calls”. Clarification is sought on the precise definition of “Total Calls” in the context of the STPIS.

Ergon Energy’s Interactive Voice Response (IVR) system handles all incoming calls relating to customer service, faults and emergencies. A customer may opt to speak to a human operator if their query cannot be addressed by the IVR system alone.

Ergon Energy seeks confirmation in the AER’s Final Framework and Approach Paper that the 30 second answering time for the Telephone Answering Parameter relates to the time between the customer opting to talk to a human operator (and hence leaving the IVR system) and the time the call is answered by a human operator, excluding calls abandoned before a human operator answers.

Ergon Energy seeks confirmation in the AER’s Final Framework and Approach Paper:

- Whether calls to both Loss of Supply and Emergency numbers should be included in reporting against the Telephone Answering parameter;
- Definition of “Total Calls” in the context of the STPIS; and
- That the 30 second answering time relates to the time between customer opting to talk to a human operator and the time the call is answered by a human operator, excluding calls abandoned before a human operator answers.

3.4 Entry to STPIS

In its Final Decision - Electricity Distribution Network Service Providers Service Target Performance Incentive Scheme (June 2008), the AER stated that:

> When *performance targets* are set at the start of a *regulatory control period*, the term ($Tar_{t-2} – Act_{t-2}$) shall be adjusted for the first *regulatory year* of the *regulatory control period* as follows:
>
> (1) Where the *parameter* has not previously applied to a DNSP, the ($Tar_{t-2} – Act_{t-2}$) term shall be set to zero.
>
> (2) Where targets are adjusted (i.e. in accordance with clauses 3.3.1 or 5.3.1), the ($Tar_{t-2} – Act_{t-2}$) term shall be replaced with ($Tar_{t-1} – Act_{t-2}$).

For year 2 (and for every year thereafter) the STPIS is driven by a “difference of differences” mechanism as given by the equation below (except when transitioning between regulatory control periods, in which case point (2) holds):

$$Gap_t = [(\text{Target}_{t-1} - Actual_{t-1}) - (\text{Target}_{t-2} - Actual_{t-2})]$$

Under this mechanism (and with constant targets during the regulatory control period), a DNSP is <u>rewarded if the current year’s performance is better than the previous year</u>, and <u>penalised if the current year’s performance is worse than the previous year</u>.

However for year 1 (the first time the parameter applies to a DNSP), in accordance with point (1) above, the STPIS is driven by a different mechanism, whereby a DNSP is <u>rewarded for performance that is better than the target</u>, and <u>penalised for performance</u>

that is worse than the target. The value of the target is critical. The equation below expresses this mathematically.

$$Gap_t = \left[\left(\mathrm{Target}_{t\text{-}1} - Actual_{t-1}\right)\right]$$

The mechanism for calculating the "Gap" in year 1 is inconsistent with the mechanism in place for year 2 onwards. From year 2 onwards, a DNSP can be performing above target, but as long as the performance improves compared to the previous year, the DNSP will be rewarded. In year one, the same situation would result in a penalty, even though performance had improved compared to the previous year. In the context of the STPIS, this is not a fair or consistent outcome.

Also, given that the AER has indicated that it will take into account the previous five years' average performance, the MSS targets and the expected impact of planned reliability works in setting performance targets, it is likely that the actual performance in 2010-11 will be higher than the targets, notwithstanding weather and other uncontrollable events. This therefore means a higher likelihood of a penalty in year 1 if point (1) above is adopted.

Ergon Energy is of the view that a fair and consistent approach would be to apply point (2) for the first year the parameter applies to a DNSP. This would ensure that the "difference of differences" mechanism discussed above is preserved and applied consistently from the beginning.

For Ergon Energy in 2010-11 (the first year operating under the STPIS), the Gap would be calculated as follows:

$$Gap_{2010-11} = \left[\left(\mathrm{Target}_{2009-10} - Actual_{2009-10}\right) - \left(\mathrm{Target}_{2009-10} - Actual_{2008-09}\right)\right]$$

In this instance, $\mathrm{Target}_{2009-10} = \mathrm{Target}_{2010-11}$ as no targets exist for 2009-10.

For 2011-12, the Gap would be calculated as follows:

$$Gap_{2011-12} = \left[\left(\mathrm{Target}_{2010-11} - Actual_{2010-11}\right) - \left(\mathrm{Target}_{2010-11} - Actual_{2009-10}\right)\right]$$

For the remainder of the regulatory control period, the Gap would be calculated as follows, using 2012-13 as an example:

$$Gap_{2012-13} = \left[\left(\mathrm{Target}_{2011-12} - Actual_{2011-12}\right) - \left(\mathrm{Target}_{2010-11} - Actual_{2010-11}\right)\right]$$

Where with flat targets:

$$\mathrm{Target}_{2010-11} = \mathrm{Target}_{2011-12} = \mathrm{Target}_{2012-13} = \mathrm{Target}_{2013-14} = \mathrm{Target}_{2014-15}$$

For 2016-17 (the year affected by the transition between regulatory control periods), the Gap would be calculated as follows:

$$Gap_{2016-17} = \left[\left(\mathrm{Target}_{2015-16} - Actual_{2015-16}\right) - \left(\mathrm{Target}_{2015-16} - Actual_{2014-15}\right)\right]$$

Ergon Energy therefore requests that, for the purpose of entering any STPIS, the AER adopt this method for calculation as detailed above.

3.5 Other STPIS-related matters

Ergon Energy has identified a number of other issues which, although not mentioned in the F&A Stage 2, should be clarified as part of the Final Framework and Approach Paper. These are detailed below.

Ergon Energy seeks clarification in the Final Framework and Approach Paper on how the s-factor will be incorporated into the control mechanism. In particular, it would be helpful if:

- Equation (2) of Appendix C of the STPIS Guidelines demonstrated how the s-factor rewards or penalties are retained during the regulatory control period; and
- More detail could be provided on how the s-bank mechanism operates.

Ergon Energy seeks confirmation in the Final Framework and Approach Paper that performance targets under the STPIS will be a constant target throughout the regulatory control period. Ergon Energy understands that the target will be set at the beginning of the regulatory control period and at that time will be adjusted to take into account of planned reliability works and the Minimum Service Standards (MSS).

Ergon Energy also seeks clarification in the Final Framework and Approach Paper on how the AER intends to:

- Take into account both the MSS as well as historical 5 year performance in setting STPIS performance targets;
- Adjust the STPIS performance targets for planned reliability improvements; and
- Calculate the T_{MED} threshold for the 2.5 Beta Method (i.e. Will it be recalculated annually or set once at the beginning of the regulatory control period? In either case, the AER will require DNSP specific data sets to perform the calculation.) To ensure accuracy and consistency with the EIC, Ergon Energy requests that the T_{MED} threshold continue to be calculated annually (and not once at the beginning of the regulatory control period).

Ergon Energy also seeks clarification on what the AER considers to be an appropriate form of network segmentation for performance reporting in the STPIS.

Ergon Energy seeks confirmation in the Final Framework and Approach Paper that, should the +/- 3% cap on Maximum Revenue at Risk apply, the value of $(1+S'_t)$ must lie between 0.97 and 1.03 inclusive (i.e. reflective of the +/- 3% cap), and that this condition does not apply to the value of $((1+CPI) \times (1+S'_t))$.

Ergon Energy seeks confirmation in the Framework and Approach that it can propose its own Value of Customer Reliability (VCR) for Urban, Short Rural and Long Rural feeder performance, provided that sufficient supporting evidence is provided to justify the alternative values.

4 Application of an Efficiency Benefit Sharing Scheme

Ergon Energy generally accepts the AER's preliminary position on the application of an EBSS to the Queensland DNSPs.

Ergon Energy's only comment in relation to the EBSS relates to the potential to suspend the scheme by agreement between the AER and the DNSP.

Currently, the EBSS does not include any provisions to suspend the scheme in any circumstances. This contrasts with the STPIS which makes provision in clause 2.7 for the AER to suspend the STPIS at any time and for a DNSP to propose the suspension of the scheme.

Ergon Energy also notes that EnergyAustralia's Regulatory Proposal proposes that its EBSS be capable of being suspended by agreement with the AER by having all of the carry over amounts set to zero (refer page 158 of EnergyAustralia's Regulatory Proposal).

Ergon Energy agrees with EnergyAustralia that there may be future situations, many of which may presently be unforeseeable, where it is appropriate to suspend the EBSS in order to avoid perverse or unintended outcomes.

Ergon Energy therefore requests that the AER include in its Final Framework and Approach Paper equivalent provisions for the EBSS as those included in clause 2.7 for the STPIS.

5 Application of a Demand Management Incentive Scheme

Ergon Energy generally accepts the AER's preliminary position on the application of a DMIS to the Queensland DNSPs.

However Ergon Energy has two concerns being that:

- The amount of the Demand Management Innovation Allowance (DMIA) is so limited that, in the event that additional eligible initiatives are identified within the regulatory control period, they will not be funded; and
- The cost involved with undertaking the ex-post review arrangements may be disproportionate to the allowable DMIA.

Ergon Energy therefore requests that the AER consider accommodating the potential problematic issues of insufficient DMIA and limiting the costs of ex-post reviews to be proportionate with the DMIA in its Final Framework and Approach Paper.

6 Asset categories

Ergon Energy seeks the AER's confirmation in its Final Framework and Approach Paper that:

- It is acceptable for Ergon Energy to use in the RFM and the PTRM the asset categories that it currently reports to the QCA in its regulatory accounts. Ergon Energy seeks this confirmation because the asset classes used in the regulatory accounts are different to those that the QCA used in its 2005 Final Determination; and

- The streetlight asset category will not be included in the RFM or PTRM for standard control services if streetlighting services are classified as other than standard control services. It is noted that Ergon Energy has proposed in its submission to the F&A Stage 1 that street lighting services be unregulated.

7 Asset lives

At present, there is no particular method outlined by the AER for deriving remaining useful life of assets. This information is necessary for input to the Post Tax Revenue Model and the Roll-Forward Model and has a material impact on the depreciation calculations, and hence the RAB.

The QCA did not use asset classes as the basis for its 2005 Distribution Determination, however it is understood that the QCA did use a methodology incorporating asset classes in its decision[1]. In addition, tax asset lives were not used by the QCA in the 2005 Final Determination.

This means that, Ergon Energy needs to devise a method for determining the remaining asset lives values. Ergon Energy proposes, and is seeking the AER's agreement to the method set out below and requests this method be confirmed in the AER's Final Framework and Approach Paper.

[1] The QCA did not release its model to Ergon Energy.

Ergon Energy seeks the AER's approval in the Framework and Approach for the following approach to the treatment of asset lives:

- Asset standard lives for each asset class should be provided by Ergon Energy in its Regulatory Proposal consistent with the asset classes currently reported annually to the QCA;
- Tax standard lives for each asset class should be provided by Ergon Energy in its Regulatory Proposal in accordance with current Australian Taxation Office determinations;
- Asset remaining lives for each asset class, correct as of 1 July 2005, should be provided by Ergon Energy in its Regulatory Proposal, based on the asset lives in its asset register, adjusted to reflect the asset classes in the 2005-06 regulatory accounts;
- Asset remaining lives for each asset class, correct as of 1 July 2010, should be calculated by Ergon Energy based on the forecast mix of assets as of that date. The methodology to perform the calculation should be detailed in Ergon Energy's Regulatory Proposal;
- Tax remaining lives for each asset class, correct as of 1 July 2005, should be calculated based on the tax lives in Ergon Energy's tax book. This should be detailed in Ergon Energy's Regulatory Proposal; and
- Tax remaining lives for each asset class, correct as of 1 July 2010, should be calculated by Ergon Energy based on the forecast mix of assets as of that date. The methodology to perform the calculation should be detailed in Ergon Energy's Regulatory Proposal.

8 Regulatory asset value

The table in clause S6.2.1(c)(1) of the Rules states that Ergon Energy's RAB is $4,198.2 million as at 1 July 2005 unless "the Queensland Competition Authority nominates a different amount in writing to the AER".

Ergon Energy wrote to the AER on 8 July 2008 attaching a letter from the QCA to Ergon Energy dated 23 March 2006. The 23 March 2006 letter stated in Attachment 1 that "The Authority has recalculated Ergon Energy's revised opening asset value at 1 July 2005 to be $4,232.4 million, $34.2 million higher than the 2005 Final Determination forecast of $4,198.2".

Ergon Energy's letter of 8 July 2008:

- Was copied to the QCA so that they were aware that Ergon Energy had provided the revised opening asset value to the AER on the QCA's behalf; and
- Sought the AER's advice as to whether the two letters jointly satisfied the requirements of the Rules so that the $4,232.4 million value could be used as the starting point for Ergon Energy's roll forward model for the next regulatory control period.

Ergon Energy has not yet received a response from the AER to its letter of 8 July 2008.

Ergon Energy now requests that the AER confirm in its Final Framework and Approach Paper that it agrees to replace the $4,198.2 value in clause S6.2.1(c)(1) of the Rules with the $4,232.4 million value approved by the QCA. By confirming this in its Framework and Approach Paper, the AER will make Ergon Energy's revised opening asset value as at 1 July 2005 clear to all of its stakeholders.

Ergon Energy proposes to adjust the $4,232.4 million value by $39.014 million which was included by the QCA as a working capital allowance. Given that the Post Tax Revenue Model now has this inherent in its calculations, inventory is no longer required as part of the opening 2005-06 regulatory asset base. The adjusted opening 2005-06 regulatory asset base is therefore proposed to be $4,193.39 million.

9 No prudency review

The Rules make no reference to the AER conducting a prudency assessment of a DNSP's, such as Ergon Energy's, capital expenditure for the purposes of determining its RAB.

Ergon Energy interprets this to mean that the AER cannot undertake a prudency review of Ergon Energy's capital expenditure for the purposes of its Distribution Determination for the next regulatory control period. Ergon Energy has previously discussed this with officers of the AER, who have indicated that they agree with this view.

Ergon Energy seeks the AER's confirmation in its Final Framework and Approach Paper that it will not assess Ergon Energy's capital expenditure during the 2005-10 regulatory control period for prudency or efficiency prior to it being allowed to be rolled into the RAB as at 1 July 2010. Rather, Ergon Energy will be allowed to include the actual capital expenditure that it has incurred during the current regulatory control period in its RAB on the basis of the RFM by applying the relevant provisions of Chapters 6 and 11 of the Rules.

10 Mount Isa – Cloncurry network

Ergon Energy owns and operates the Mount Isa - Cloncurry network, which services approximately 10,000 customers (or about 1.6% of Ergon Energy's customer base) in the north west of Queensland. This network is isolated from the coastal network that interconnects to the eastern Australian States and, as such, operates outside of the National Electricity Market (NEM).

Section 89 of the Queensland Electricity Act 1994 (the Electricity Act) provides that, with respect to the Mount Isa – Cloncurry network, the Minister may either:

- Decide, in the way that the Minister considers appropriate, the prices, or a methodology to fix the prices that may be charged for the provision of customer connection services; or

- Direct the QCA to regulate the pricing of these services under the Rules, as if the supply network were part of the national grid.

The Minister has previously exercised the power of direction under section 89B(2) of the Electricity Act and directed the QCA to regulate the Mount Isa – Cloncurry network. As a consequence, the QCA's Final Determination for the current regulatory control period includes a determination in relation to the Mount Isa – Cloncurry network.

If no action is otherwise taken, Ergon Energy will no longer have a single regulator responsible for the regulation of both its grid connected network and its Mount Isa – Cloncurry network.

However, Ergon Energy understands that the Queensland Government is currently evaluating options for the future regulation of the Mount Isa – Cloncurry network now that it has been determined that responsibility for the economic regulation of the national grid will transfer from the QCA to the AER. Ergon Energy understands that one option the Government is considering is to transfer the power of direction under section 89B(2) of the Electricity Act to regulate the Mount Isa – Cloncurry network from the QCA to the AER.

The Government may not finalise arrangements on this matter until after Ergon Energy submits its Regulatory Proposal to the AER. However, it is expected that this matter will be clarified by the time the AER is required to issue its Distribution Determination for Ergon Energy.

Given this current uncertainty, Ergon Energy seeks the AER's in-principle agreement in its Final Framework and Approach Paper to the following treatment of the Mount Isa – Cloncurry network for the purposes of the next regulatory control period:

- Ergon Energy to include the Mount Isa – Cloncurry network in its Regulatory Proposal;

- The AER to assess Ergon Energy's Regulatory Proposal, inclusive of the Mount Isa – Cloncurry network, in accordance with Chapter 6 of the Rules; and

- The AER's Distribution Determination either to include, or exclude, provision for the Mount Isa – Cloncurry network once the Queensland Government's decision on the future regulatory treatment of this matter is known.

This approach is considered necessary because it avoids the potential for the AER having future responsibility for regulating the Mount Isa – Cloncurry network but Ergon Energy not having included the relevant information in its Regulatory Proposal to enable the AER to assess its requirements.

11 Cost pass through for input cost increases

Clause S6.1.3(2) of the Rules requires that a DNSP's building block proposal must contain "a proposed pass through clause with a proposal as to the events that should be defined as pass through events". Clause 6.12.1(14) states that a distribution determination must include "a decision on the additional pass through events that are to apply for the regulatory control period".

Section 5.2.2 of the AER's February 2008 "Efficiency benefit sharing scheme for the ACT and NSW 2009 distribution determinations" states that:

> *…the AER also notes that there may be scope to nominate significant input cost variations as pass through events. If significant input cost changes are treated as pass through events then they will not influence carryover amounts since pass through events are excluded from the operation of the EBSS.*

The NSW-ACT DNSPs nominated the following pass through events in their Regulatory Proposals, which appear to rely on the AER's February 2008 EBSS decision:

- "EnergyAustralia proposes that the variance in actual cost movements or demand for the regulatory control period from cost movements or demand forecasts used in the capital and operating expenditure forecasts for that period should be included as a pass through event" (page 163 of EnergyAustralia's Regulatory Proposal);

- "Country Energy agrees with the AER that there may be scope to nominate significant input cost variations as pass through events. Consequently, input cost changes treated as pass through events would not influence carryover amounts for the operator of the EBSS" (page 170 of Country Energy's Regulatory Proposal); and

- "ActewAGL Distribution proposes that the 2009-14 determination should include an additional pass through event to apply when input prices vary and result in a material variation in actual capital and operating expenditure incurred in the 2009-14 regulatory period" (page 275 of ActewAGL's Regulatory Proposal).

Ergon Energy seeks confirmation in the Final Framework and Approach Paper that similar scope exists for the Queensland DNSPs to nominate significant input cost variations as pass through events in their Regulatory Proposals.

12 Cost pass through materiality threshold

Clause 6.2.8(a)(4) of the Rules provides that the AER may publish a guideline in relation to its “likely approach to determining materiality in the context of possible pass through events”. The AER has not yet published such a guideline for the Queensland DNSPs.

However, the AER has released various position papers and issues papers for the purposes of the NSW-ACT regulatory resets, and indicates on its website that it proposes to publish, “in the near future”, a “Guideline on the AER's approach to determining materiality thresholds for possible pass through events”.

The AER’s December 2007 Preliminary Positions Paper[2] for the NSW-ACT DNSPs contains two materiality thresholds for cost pass through events:

- “The AER proposes that if the change in revenue from the event exceeds 1 per cent in any one of the remaining years of the regulatory period, the threshold will be met”; and
- “If the change in total capex attributable to the event exceeds 5 per cent of the AARR, the event will be deemed material”.

The Queensland DNSPs have the same need as the NSW-ACT DNSPs to understand the materiality thresholds that will apply to cost pass through events in the next regulatory control period.

Consequently, Ergon Energy seeks confirmation in the Final Framework and Approach Paper that the AER will apply the same two materiality thresholds for cost pass through events detailed above for the Queensland DNSPs as has been proposed for the NSW-ACT DNSPs and incorporate these into a Guideline.

13 “Eligible pass through amount”, information requirements and cost pass through process

As noted in section 12, the AER’s December 2007 Preliminary Positions Paper[3] for the NSW-ACT DNSPs included the AER’s preliminary view that cost pass through amounts should be calculated on the basis of revenue and two thresholds have been proposed.

In addition to understanding the materiality threshold, DNSPs need clarity about:

- What is included in the *eligible pass through amount* which is defined in the Rules Chapter 10 (for distribution) to be:

  > In respect of a *positive change event* for a *Distribution Network Service Provider*, the increase in costs in the provision of *direct control services* that the *Distribution Network Service Provider* has incurred and is likely

[2] AER, “Matters relevant to distribution determinations for ACT and NSW DNSPs for 2009-14, Preliminary Positions Paper, December 2007, page 49

[3] Ibid

to incur until the end of the *regulatory control period* as a result of that *positive change event* (as opposed to the revenue impact of that event);

- The information requirements of the AER when assessing a cost pass through application; and

- Details of how in a practical sense the AER will apply the process set out in the Rules clause 6.6.1.

Ergon Energy requests that the AER's Final Framework and Approach Paper confirm that it intends preparing a Guideline that addresses the components of *eligible pass through amount*(s), information requirements of the AER and detail about the process that will be followed.

14 Extending cost pass through events to Alternative Control Services

As noted, clause S6.1.3(2) of the Rules requires that a DNSP's building block proposal must contain "a proposed pass through clause with a proposal as to the events that should be defined as pass through events". By virtue of being included in a building block proposal these pass through events only relate to standard control services.

However the definition of *eligible pass through amount* set out in section 13 relates to the broader grouping of direct control services and not just the sub-group of standard control services. This means that the Rules clearly contemplate that pass through events can apply to alternative control services, and not just be limited to standard control services.

Ergon Energy therefore seeks the AER's agreement to apply the Rules section 6.6.1 cost pass through provisions as part of the control mechanism for alternative control services. This is in accordance with the Rules section 6.2.6(c).

Ergon Energy notes that ActewAGL sought the AER's approval for inclusion of pass through amounts for alternative control services in its Regulatory Proposal (refer section 16.2 on page 265).

Ergon Energy seeks the AER's confirmation in the Final Framework and Approach Paper that the AER will allow Ergon Energy to nominate cost pass through events in its Regulatory Proposal that can apply to alternative control services in the next regulatory control period. Ergon Energy proposes that the same requirements that would otherwise apply to pass through events for alternative control services as apply to standard control services under the Chapter 6 of the Rules.

15 Meaning of "security of supply" standards

Clauses 6.5.6(a) and 6.5.7(a) of the Rules require that a DNSP's operating and capital expenditure forecasts for the relevant regulatory control period must:

> *(3) maintain the quality, reliability and security of supply of standard control services; and*
>
> *(4) maintain the reliability, safety, and security of the distribution system through the supply of standard control services.*

The Electricity Distribution Service Delivery Review (EDSD Review) addressed the issue of Ergon Energy's security of supply in its July 2004 report. The EDSD Review recommended to the Queensland Government that:

> *Ergon Energy be required (unless otherwise agreed with major customers) to maintain "N-1" on all bulk supply sub-stations and large zone supply sub-stations (5MVA and above) and sub-transmission feeders. Critical high voltage feeders should also meet "N-1" with the exception of those where Ergon Energy can provide satisfactory evidence that this does not put significant numbers of customers at risk*

The Queensland Government issued a response to the EDSD Review in August 2004, entitled "An Action Plan for Queensland Electricity Distribution" (Action Plan). This Action Plan adopted the recommendations of the EDSD Review and, amongst other things, required that:

> *More conservative planning criteria – ENERGEX and Ergon Energy will adopt more conservative planning assumptions, so that if assets fail across their systems they will have sufficient backup capacity to ensure customers don't lose supply. ENERGEX and Ergon Energy will aim to achieve best practice security of supply for their systems by 2009/10.*

Given that the EDSD Review's recommendation and the Government's Action Plan was expressed at a very high level, Ergon Energy developed a new network security standard in order to give them practical effect. This revised standard was more stringent than the standard that had previously been applied by Ergon Energy in the lead up to the EDSD Review. The revised standard was endorsed by the Queensland Government.

The application of the revised standard resulted in Ergon Energy needing to significantly increase its capital and operating expenditure for the current regulatory control period beyond previous levels. The need for this increase is reflected in:

- Ergon Energy's key planning documents, including its Network Management Plan; and

- The QCA's 2005 Final Determination, which approved the increased capital and operating expenditure forecast over the current regulatory control period.

Indeed, Ergon Energy has been over-expending its approved capital expenditure building blocks during the current regulatory control period.

Ergon Energy is currently in discussion with the Queensland Government regarding a further revision to the security of supply standards which will continue to be consistent with both the EDSD Review recommendations and the associated Government Action Plan.

Ergon Energy intends treating its existing or any new security of supply standards that may be approved by the Queensland Government as:

- That which it needs to "maintain" for the purposes of clauses 6.5.6(a)(3)-(4) and clauses 6.5.7(a)(3)-(4) of the Rules; and

- The basis for its network planning, and capital and operating expenditure forecasting, for the next regulatory control period. This will then be reflected into its Regulatory Proposal to the AER.

On this basis, Ergon Energy requests that the AER recognise in its Final Framework and Approach Paper that, although there is no codified security of supply standard in Queensland, the security of supply standard that Ergon Energy should "maintain" for the purposes of clauses 6.5.6(a)(3)-(4) and clauses 6.5.7(a)(3)(4) is that approved by the Queensland Government for Ergon Energy for the purposes of delivering against:

- The EDSD Review recommendations; and

- The associated Government Action Plan.

16 Negotiating framework

Clause 6.8.2(c)(5) of the Rules requires that a Regulatory Proposal must include "for services classified under the proposal as negotiated distribution services – the proposed negotiating framework".

The AER's F&A Stage 1 proposes that Ergon Energy will not have any negotiated distribution services in the next regulatory control period. Ergon Energy supports this view and does not intend proposing to the AER in its Regulatory Proposal that any of its services be classified as negotiated distribution services.

Given that a negotiating framework only relates to negotiated distribution services, there would be no benefit served by Ergon Energy including a negotiating framework in its Regulatory Proposal for the next regulatory control period.

Ergon Energy therefore seeks the AER's confirmation in its Final Framework and Approach Paper that it does not need to include a negotiating framework as part of its Regulatory Proposal if it does not propose to have any negotiated distribution services, as would otherwise be required under clause 6.8.2(c)(5) of the Rules.