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24 February 2005

Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4007

Dear Sir/ Madam

Submission on the Draft Determination on Regulation of Electricity Distribution

We refer to the "*Draft Determination on Regulation of Electricity*" ('the Draft Determination') issued by the Queensland Competition Authority ('QCA') for public comment. Please accept this letter and the attached document as Ergon Energy Pty Ltd's ('Ergon Energy') contribution to this aspect of the consultation process. As you are aware, Ergon Energy holds a Retail Authority with a retail area covering broadly the equivalent distribution area of Ergon Energy Corporation Limited. Further, Ergon Energy actively participates as a second tier retailer in all National Electricity Market Jurisdictions (with the sole exception of South Australia), providing us a broad exposure to the evolution of regulatory arrangements in the market.

We would welcome the opportunity to discuss our submission with you at your convenience. Should you have any queries, please feel free to contact me on (07) 3228 7536.

Yours sincerely

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ERGON ENERGY PTY LTD



**Submission on QCA's
'Draft Determination –
Regulation of Electricity Distribution'**

FEBRUARY 2005

1.0 Introduction

We refer to the draft determination on Electricity Distribution ('the Determination') released by the Queensland Competition Authority ("QCA") for public comment. Please accept this document as Ergon Energy Pty Ltd's ("Ergon Energy") contribution to the consultation process.

This submission is made by Ergon Energy from its perspective as a host Retailer of electricity in Queensland. While it may not be immediately apparent that the Determination will impact significantly on Retailers, the Determination comes at a considerable juncture in the evolution of a competitive retail market in Queensland and should be considered within that context. As an active Retailer in the National Electricity Market, we have broad exposure to the regulatory evolution of other jurisdictions, and a keen interest in ensuring that learning outcomes derived from this are applied in Queensland to ensure best practice market structure, conduct and performance in the delivery of services to customers. This submission endeavours to highlight those possible impacts and the areas of interest for Ergon Energy as a Retailer.

2.0 General Comments

This submission is made in the context of a market (ie the National Electricity Market ('NEM')) which is in the process of moving towards full retail competition for all customer classes. At this time, the Queensland timetable for full contestability remains unknown. However, there is the potential that it could be implemented within the approaching regulatory period. Within Queensland the potential for the Determination to influence the potential for competition (rather than contestability) is significant, and this issue is the primary focus of this submission.

Consequently, we believe it is important that the QCA, in determining the regulatory arrangements to apply in Queensland, fully consider the implications of its determination upon retail competition. In particular, its impact on existing contestable customer prices and service. Ergon Energy would like to highlight the following aspects of the QCA's determination that have potential implications on effective retail competition.

3.0 Price Certainty and Stability

The Delivered Cost of Energy (DCE), being the efficient retail price in a competitive market (incorporating generation, transmission, distribution and market costs), must exhibit a positive differential below the Maximum Uniform Tariff (MUT) with sufficient ongoing certainty before customers will be willing to enter the contestable market. Evidence from overseas jurisdictions suggests that customers tend to require an ongoing differential in the DCE of approximately 5% to entice their departure from the security of established MUTs. Price uncertainty associated with regulatory transitions pose a significant risk to customers considering entering the market. Without total freedom to exit the market, customers need greater certainty that they will continually financially benefit from entering the market.

3.1 Side Constraints (Clause 9.3)

"The Authority proposes to adopt side constraints on combined distribution and transmission charges by CPI plus 5% per year, to apply to all contestable customers only. The side constraints apply only to distribution price increases beyond the increases required to recover the distributor's initial revenue caps and any increases identified at the outset as being required to transition customers to cost reflective prices, as discussed below.

For contestable customers those prices are above the cost reflective level, the Authority requires that prices move to cost reflectivity by the end of the first year of the next regulatory period. For contestable customers whose prices are currently below the cost reflective level, the distributors will be required to propose price paths, which, by the end of the next regulatory period at the latest, achieve full cost reflectivity for these customers.

The side constraints will only include transmission price increases beyond those that are due to changes in the quantum of Powerlink charges at specific transmission connection points.”

Ergon Energy’s interpretation of the QCA’s determination is that existing contestable customers will not be protected from price increases associated with revenue increases arising from the transition to the next regulatory period. This could expose our contestable customers to considerable price shocks. In addition, contestable customers and potential contestable customers, for whom the benefit of being in the market is marginal, will likely see any benefit eroded due to transition associated price increases. Such a policy, would pose a threat to the ongoing competitive retail market in Queensland, as it is expected that adversely affected customers will exploit opportunities to exit¹ the contestable market, and customers considering entering will be frightened off by price uncertainty and instability.

Ergon Energy therefore recommends that appropriate side constraints apply to all contestable customer NUOS price increases to ensure that the overall delivered cost of energy does not increase by 5%, including those associated with transitioning through to the next regulatory period and the development of cost reflective prices.

3.2 Transitioning to the Next Regulatory Period (Clause 8.6)

“The authority seeks stakeholder comment on the acceptable size of any required price increases (both initial increases and annual increases), in light of the significant proposed increase in the DNSP’s revenue requirements in the next regulatory period.”

As detailed in Section 3.1, Ergon Energy believes that the success of the contestable Retail market in QLD is heavily reliant on customers having ongoing certainty that the differential between contestable and franchise electricity prices will remain of significant magnitude. Dramatic price movements arising from the transition of network revenues and hence, network prices, into the next regulatory period will inevitably contribute to customer perceptions that the regulatory risk is too great to enter the contestable market. Furthermore, experience from the outcome of other price determinations is that nominal annual price increases above between 5% and 7% result in reassessment by the customer of their Retailer relationship.

Dramatic price increases could also have a flow on effect to further undermine the contestable market. As the number of customers in the contestable markets diminishes, Retailers would be required to spread their sunk costs over less customer numbers, which has the result of driving contestable prices even higher.

¹ The Electricity Regulations 1994 stipulate that in determining the contestability of a site, only registered owners of premises (including lessees of crown land) bind future owners to contestability. Owners are not bound to stay in the market if a previous tenant of the premises took the site to market. Also, tenants are not bound to stay in the market if owners or tenants previously took the site to market. Therefore, there is the potential that a large number of sites may return to the franchise arena in response to price increases.

Given the above considerations, Ergon Energy promotes that both price stability and certainty for customers should guide the QCA's approach to price smoothing for the upcoming and subsequent regulatory periods. Whilst revenue certainty for distributors is an important imperative for them to deliver supply in accordance with good industry practice, Ergon Energy promotes that the overs and unders mechanism provides adequate protection for distributors.

Ergon Energy therefore promotes a glide path approach be applied to smoothing contestable revenues on the proviso that appropriate side constraints are implemented to protect individual contestable customer price impacts.

3.3 Within Period Adjustments to Revenue Caps (Clause 3.4)

"The Authority proposes to apply triggers to the key network cost drivers of customer numbers (3% variance) and maximum demand (5% variance) for both Energex and Ergon in the next regulatory period.

The authority proposes that the trigger mechanism be symmetrical to initiate a review if demand growth is significantly below forecast."

On this issue, Ergon Energy offers the following comments:

- In the context of a Queensland market moving towards full market competition in the future, price certainty for customers should be considered a higher priority objective than revenue certainty for distributors;
- The tolerances on customer numbers and maximum demand proposed by the QCA may create a disincentive for distributors to develop accurate forecasts;
- Maximum demands are heavily influenced by seasonal factors. In recent years, the increased utilisation of residential air conditioning has resulted in overall system maximum demands shifting from the winter night period to the summer day period. Consequently, summer ambient temperatures are now the predominant factor influencing annual maximum demands and significant variances in demand from forecast are generally associated with higher than average temperatures. Any increase in the distributor's expenditure (and hence, revenue requirement) in response to higher than forecast demand will occur in the year following the variance. However, given that it is highly unlikely that significant heat waves will occur in any two consecutive summer periods, Ergon Energy suggests that any reactive increase in the distributor's revenue requirement in response to demand variances will be inherently ineffective. To use an old expression, "there is no point shutting the gate if the horse has already bolted".

Ergon Energy suggests that the QCA give further consideration to the effectiveness of Distributors increasing their revenue requirements after a significant demand variance has occurred. We consider variances over two consecutive years would be a more appropriate trigger event for re-opening.

3.4 Cost Pass Through (Clause 3.4)

"The authority proposes to introduce a materiality threshold for consideration of cost pass through of 1% of actual annual regulated revenue per event, based on the regulated revenue in the year of the event."

Ergon Energy acknowledges the need for revenue certainty for Distributors to mitigate the impact of unforeseen events. However, as mentioned previously, Ergon Energy promotes that ensuring price certainty for customers should be considered a higher priority objective in the QCA determining the appropriate cost pass through framework.

In keeping with this principle, Ergon Energy is eager to see greater clarity in terms of what represents a cost pass through event. Under the existing guidelines, the following events could potentially be construed as cost pass through events:

- Catastrophic failure of equipment at a bulk supply substation (eg transformer explosion), or catastrophic failure of an underground gas filled cable;
- Unforeseen major network connections.

Ergon Energy recommends that the QCA develops a clear set of guidelines outlining what constitutes a cost pass through event. Furthermore, we recommend that activities relating to unforeseen network upgrades and maintenance projects be expressly excluded from consideration.

3.5 Price Approval Process (Clause 9.4)

“The Authority proposes to require each distributor to submit a Pricing Principles Statement prior to the beginning of the next regulatory period for approval by the Authority. Any amendments required during the regulatory period are to be submitted at least 60 days before prices are submitted for the coming year.

For the first year of the regulatory period the Authority requires each distributor to submit proposed prices for all customers to apply in the coming year by the later of 90 days before the beginning of the financial year or 10 working days after publication of the Final Determination. In subsequent years, proposed prices are to be submitted at least 90 days before the beginning of the financial year. In support of the proposed prices, each distributor must provide a Pricing Submission Document which demonstrates that the prices are consistent with its Pricing Principles Statement.

To comply with clause 6.14.5(a) of the Code, distributors must publish by 31 May each year, for application in the following year commencing 1 July, prices for all classes of distribution services at each voltage level, load class and pricing zone where the prices are to be the maximum prices charged. Distributors will therefore be required to publish distribution use-of-system and transmission use-of-system prices for Connection Asset Customers (excluding site specific charges) and Standard Asset Customers.¹⁷ In recognition of commercial sensitivities, prices for Individually Calculated Customers (ICC) and site specific prices for Connection Asset Customers (CAC) will not be published. However the ICC and site specific CAC prices must be provided to the Authority and the Authority will assess whether they accord with the Pricing Principles.

The Authority will endeavour to approve prices by 25 May each year. The Authority will only approve proposed prices if they comply with the approved Pricing Principles Statement. If proposed prices are not approved, the previously approved prices will continue to apply until revised prices are approved by the Authority.”

Ergon Energy’s experience as a Retailer in the Queensland Market is that customers have a growing expectation that prices shall be delivered well in advance of the next financial year to assist in their energy cost budgeting process. The current publication of prices by 31 May is inadequate to assist customers in this regard. Further, we note that distributors are required to submit prices to the QCA before 90 days prior to the next financial year, and that for the most part, these prices rarely change as part of this approval process.

Ergon Energy recommends that the QCA require distributors to publish tentative prices for CAC (excluding site specific charges) and SAC customers 90 days prior to the next financial year.

4.0 Service Delivery

The general customer expectation, as supported by Ergon Energy's extensive consultation with contestable customers in the Queensland market, is that the success of effective retail competition is correlated with improvements in energy service delivery, differentiation and product innovation. Notwithstanding the actual contractual relationship, many customers perceive the Distributor to be a service provider to the Retailer with respect to the customer's connection. Consequently, the underlying supply reliability of the network and the capacity to improve it is viewed, as being directly related to their Retailer, rather than the Network. It is likely that this expectation will be heightened under full retail competition.

Whilst, guaranteed service levels provide basic protection, the current regulatory environment has had limited success in providing for customers to negotiate anything above the minimum standard in terms of reliability and quality of supply.

Regulatory arrangements governing service delivery to contestable customers has traditionally been non-intrusive. This is attributed to the common belief that the negotiation of connection and access agreements provides adequate facility for customers to negotiate service standards on commercial terms. However, our experience is that there are several fundamental problems precluding contestable customers from negotiating better service standards. Firstly, the capping of Distributor revenue diminishes the commercial incentive to enhance supply performance, as overall, no additional revenue can be generated. Secondly, there is an inherent inequity in the negotiating power between the customer and a monopoly distributor such that the customer cannot negotiate on a fair and reasonable basis.

Ergon Energy believes an excluded services regime, if implemented appropriately, would provide a more effective framework for retailers to deliver additional services to customers on a commercially sound basis. Further, distributors are unlikely to have as much market power as the QCA's competition test suggests, as their license obligations (to connect customers to the distribution system) will limit their market influence. Under such a framework, our vision is that customers could look to a competitive market (including Retailers) to provide network services above and beyond the "standard regulated offer". This would significantly advantage customers, providing choice that will ultimately deliver the combined benefits of lower service cost and improved service delivery.

5.0 Conclusions

Ergon Energy encourages the QCA to provide appropriate consideration to the sustainability, growth and effectiveness of the competitive retail market in making its determination. In particular, consumer's opinions of retail competition, customer decisions making criteria when deciding to enter the contestable market, and the effect of supply reliability on effective retail competition. We encourage the QCA to examine its draft determination from the perspective of an end-use consumer facing retail competition and therefore ensure that the final Determination will in no way act as a barrier to competition (whether real or perceived).