



Our Reference: TRO-09855

Treasury

17 MAR 2005

Mr E J Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001


Dear Mr Hall

Government's Response to the Electricity Distribution Draft Determination

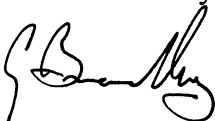
I refer to the Queensland Competition Authority's (QCA) invitation to provide comments on the *Draft Determination on the Regulation of Electricity Distribution* (the Draft Determination).

The Government has examined the issues raised in the report and has a number of comments which it encourages the QCA to take into consideration when preparing its final determination. These issues are outlined in the attached submission.

As future economic growth and prosperity will need to be underwritten by new investment, it is important the regulatory arrangements in place encourage infrastructure development. In this context, the Government believes the State economy would benefit considerably from the promotion and preservation of incentives in the regulatory framework, and enhanced transparency in regulatory outcomes.

If you have any further queries, or require additional information, please contact Mr Steve Williams on telephone (07) 3234 1277.

Yours sincerely

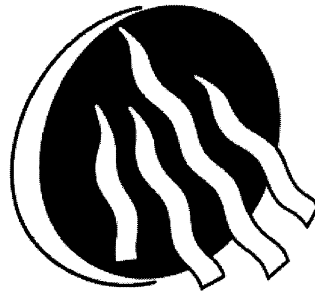


Gerard Bradley
Under Treasurer

Encl.

Queensland Government Submission

**Queensland Competition Authority
Draft Determination
Regulation of Electricity Distribution**



**Queensland
Government**

February 2005

1.0 INTRODUCTION

The Queensland Government (the Government) welcomes the opportunity to provide comments to the Queensland Competition Authority (QCA) in relation to its *Draft Determination on the Regulation of Electricity Distribution* (the Draft Determination).

The Government has examined the complex issues raised in the report and has a number of comments which it encourages the QCA to take into consideration as part of its deliberations on the final regulatory arrangements.

The electricity distribution system is one of the most critical elements of the Queensland economy's economic and social infrastructure. Energex and Ergon Energy's (the DNSPs') regulated networks provide services which enhance the welfare of the population and promote the national and international competitiveness of state-based industries.

As future economic growth and prosperity will need to be underwritten by new investment, it is important the regulatory arrangements in place encourage infrastructure development. In this context, the Government believes the State economy would benefit considerably from the promotion and preservation of incentives in the regulatory framework, and transparency in regulatory outcomes.

2.0 CAPITAL AND OPERATING EXPENDITURE

The electricity industry is characterised by elements of uncertainty, particularly in regard to the levels of demand growth and the size of the future capital expenditure programmes energy providers, including DNSPs, will need to undertake. Decisions taken by these businesses will have considerable ramifications for the Queensland economy.

The Draft Determination provides a flexible framework with which to accommodate this uncertainty. The Government supports this approach.

2.1 Implications of the EDSR Review

The recent Electricity Distribution and Service Delivery (EDSD) Review assessed the performance of Queensland's electricity distribution networks, identifying a number of shortcomings in regard to the DNSPs' service standards and expenditure programmes. In this context, the Review set out a number of recommendations to alleviate these problems so as to ensure the future reliability of supply to Queensland customers in an environment of high growth in maximum energy demand. In doing so, it foreshadowed the need for levels of capital (capex) and operating and maintenance (opex) expenditure significantly above previous regulatory allowances.

The DNSPs' initial opex and capex forecasts for the new regulatory period, considered by the QCA in making its Draft Determination, were submitted prior to the release of the EDSR Report. The businesses have now had an opportunity to review their future network plans in

light of the EDSD recommendations. Accordingly, both DNSPs have re-submitted revised forecasts to the QCA for its consideration.

The Government is strongly of the view that the regulatory framework should provide the DNSPs with sufficient opex and capex allowances to meet all of their EDSD obligations.

The QCA previously commissioned consultants Burns and Roe Worley (BRW) to review the DNSPs' proposed capex and opex expenditures. BRW assessed a significant reduction in Energex's capex. In addition, it discounted the assessed efficient level of capex by 20 percent on the basis of Energex's past expenditure performance and its inability to provide a more detailed resource plan.

The Government believes this allowance should be revised upwards where the revised expenditure forecasts are efficient and at the time Energex is able to reasonably demonstrate it has the planning and resourcing capability in place to efficiently deliver the proposed programmes. Customers should not be expected to pay for a level of services which are unable to be provided.

The Government notes that since the BRW assessment, the planning framework for Queensland's DNSPs has been substantially improved through, for example:

- the introduction of minimum service standards; and
- a requirement for both Energex and Ergon Energy to prepare annual network management plans.

In addition, as part of the implementation of the EDSD recommendations, the DNSPs have put in place joint training initiatives, while Energex has increased its planning staff numbers.

2.2 Transparency in review arrangements

Flexibility in the regulatory framework is accommodated by review mechanisms such as demand triggers and a number of capex pass-through arrangements. The Government supports the QCA's position in this regard in order to minimise the adverse impacts associated with unexpected demand growth within the regulatory period and to provide the DNSPs with an element of investment certainty.

However, the Government believes that the QCA should confirm that, at the time of any such review, it will not seek to review other elements of the regulatory framework such as the WACC parameters.

2.3 Maximising flexibility within the regulatory framework

Given the significant difference between Energex's initial capex forecasts and the level of expenditure assessed as necessary by BRW for the forthcoming regulatory period, the QCA has implemented a cost pass-through mechanism to accommodate this variance being rolled into the capex allowance if found to be necessary.

In light of the uncertainty surrounding future demand growth in particular, the Government believes this initiative has merit. However, it considers the QCA should neither seek to set a timeframe nor place an upper limit on the amount of additional capex that can be passed through in this process. If circumstances dictate there are clear technical and efficiency grounds for a revision of Energex's capex above \$3.376 billion, this should be permitted.

In addition, the Government is of the view that Ergon should be provided with the same opportunity to pass-through additional capex beyond the level of its allowance.

3.0 WEIGHTED AVERAGE COST OF CAPITAL

The allowed rate of return or Weighted Average Cost of Capital (WACC) represents a reward to regulated entities for the risk of undertaking investment in essential infrastructure, and as a result it is a key incentive within the regulatory framework. Where this incentive is found to be inadequate, investment levels will most likely be similarly deficient, and network development and the continuing availability of services be adversely impacted, particularly over the long-term.

Accordingly, the regulatory regime will provide the greatest benefit to the State's energy consumers if it is able to encourage and sustain efficient levels of investment in electricity assets. In this context, WACC should be set such that regulated firms are able to earn a return that not only adequately compensates owners but also attracts investment in regulated infrastructure in Queensland.

The Government believes it important that, where possible, regulators adopt a consistent approach to setting WACC parameters. This uniformity would establish greater transparency in decision-making processes and enhance the level of certainty associated with regulatory outcomes. In turn, such an approach could be expected to promote a more stable investment climate.

In this respect, it notes recent regulatory decisions in the Australian energy sector tend to suggest that regulators are reaching a consensus on many WACC parameter estimates. These positions are generally supported by the ACCC which has published benchmarks to be used in calculating WACCs to apply in the forthcoming round of regulatory determinations for electricity transmission entities.¹ However, there still appears to be considerable disagreement as to what is an appropriate value for the equity beta.

In its Draft Determination, the QCA has set an equity beta for Energex and Ergon Energy of 0.90, which is less than:

- the benchmark of 1.00 adopted by the ACCC; and
- 0.95, the overall average of recent regulatory decisions in the Australian energy sector.

¹ ACCC (2004), Decision: Statement of Principles for the Regulation Electricity Transmission Revenues, December.

The QCA's consultants, the Allen Consulting Group (ACG), indicated that, for the average regulated electricity distributor with a gearing level of 60%, an equity beta of 1.00 was justified on the basis of:

- the desirability of maintaining stability of regulatory decisions across time; and
- consistency in regulatory decisions across companies.

However, ACG identified a number of unique distinguishing factors in the Queensland regime which lowered the level of systematic risk facing Energex and Ergon Energy, and accordingly recommended a lower equity beta be adopted by the QCA.

The Government has reservations about whether 0.90 is an appropriate equity beta for the DNSPs. It notes equity betas adopted in recent Australian energy sector regulatory decisions have fallen in a range between 0.71-1.20. This suggests there remains a considerable degree of uncertainty in the estimation of the variable.

The ACCC acknowledges this uncertainty. It notes that, using current market data, statistical estimation techniques tend to produce varying confidence intervals (and sample average) estimates. On this basis, it has continued to adopt an equity beta of 1.00. The United Kingdom gas and electricity regulator, the Office of Gas and Electricity Markets (Ofgem), has also adopted a value of 1.00 in light of this statistical uncertainty.

In the past, regulators have recognised the uncertainty associated with obtaining point estimates for WACC parameters and set values at the upper end of the reasonable range as compensation. This philosophy, supported by the Productivity Commission and the QCA's WACC consultant Dr Lally, recognises the social costs of under-investment are far greater than the alternative.

In previous submissions to the QCA regarding WACC matters, the Government has recommended where there is no clear consensus on the point estimate for a parameter, its preferred approach is to err on the side of higher rather than lower rates of return. This is particularly important in a state experiencing strong economic growth, such as Queensland, with a consequent need to encourage investment in essential infrastructure.

Accordingly, consistent with the position taken by the ACCC, the Government considers that the QCA should adopt a value of 1.00 for Energex and Ergon Energy's equity beta.

4.0 RECOGNITION OF EFFICIENCIES

The Government notes the 2001 Final Determination put forward the view that any out-performance of opex efficiency targets in the current regulatory period should be carried forward in accordance with some form of gains maintenance approach for a period of five years beyond the year in which the gains were achieved. In October 2004, the QCA conducted a public consultation process, seeking comment on matters relating to the design and implementation of an efficiency carry-over mechanism (ECM). It is yet to finalise details of this framework.

The Government supports effective incentive regulation whereby the regulatory framework provides incentives for regulated businesses to create operational efficiencies with these benefits being eventually passed on to customers. This principle should remain a central element of the regulatory framework.

However, the Draft Determination proposes to deduct an amount of \$104.7 million from Energex on the basis that this amount was under-spent by the DNSP during the current regulatory period. In addition, it does not consider allowing the carry-forward of any efficiencies, while at the same time noting the distributors probably did make some real efficiency gains over the regulatory period.

In the spirit of an incentive regulatory framework, and in the interests of transparency, the Government is of the view that, prior to settling this matter for the Final Determination, the QCA should make a formal assessment of the DNSPs' efficiency performances, including identifying whether Energex's underspend can be attributed to real efficiency gains over the period.

In coming to a final position on this matter, the Government believes that the QCA should balance:

- the continued operation of an incentive regulatory framework; with
- the principle that DNSPs should not be rewarded for 'efficiencies' achieved at the expense of a deterioration in service quality.

The onus should be placed on the DNSPs themselves to provide a reasonable substantiation of any claims for efficiency gains.

5.0 SMOOTHING

The Government considers a number of key guiding principles should assist in determining the most appropriate approach with which to smooth the aggregate annual revenue requirements (AARRs). These principles include that, where possible:

- over the regulatory period, DNSPs should be permitted to recover the net present value (NPV) of their unadjusted revenue series;
- price volatility for customers should be minimised; and
- the transition to the subsequent regulatory period should be smooth.

Given the contrasting profiles of the unadjusted revenue paths facing the two businesses, the Government believes different smoothing approaches would best accommodate these principles. It suggests:

- for Energex, an NPV-smoothing process could be applied, while ensuring that the Government's other objectives are met; and
- for Ergon Energy, the significant initial increase in its AARR would most likely result in unacceptable price shocks for customers or transitional problems into the next regulatory period if NPV smoothing was adopted. Therefore a departure from NPV smoothing should be considered for Ergon Energy. Since changes in DUOS prices will not impact on retail prices paid by franchise customers, the focus of this departure should be on the contestable component of the AARR series. In this context, a greater regard could be given to establishing an acceptable price path for contestable customers.

While the Ergon Energy approach is likely to result in a revenue stream with a lower NPV than the unadjusted series, the Government considers this outcome represents an effective compromise between the conflicting objectives of revenue recovery and customer price stability. The Government notes that, under this approach, Ergon Energy's contestable customers will be provided with an implicit subsidy for the term of the regulatory period, after which DUOS prices should be at a cost-reflective level.

The Government encourages the QCA to explore alternatives to mitigate the revenue loss to the DNSP while, at the same time, ensuring existing contestable customers are transitioned towards cost-reflectivity without unnecessary price shocks. For example, this may involve setting a maximum annual DUOS price increase for currently contestable customers while at the same time capping the contestable component of the AARR at the cost-reflective level. In this context, however, the Government considers it is important that the approach adopted should not increase the franchise component of Ergon Energy's AARR beyond its cost-reflective level.