



19 February 2001

Mr Gary Henry  
Director – Electricity  
Queensland Competition Authority  
GPO Box 2257  
Brisbane QLD 4000

Our Ref: R-01-033

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Dear Mr Henry,

#### **DRAFT DETERMINATION ON REGULATION OF ELECTRICITY DISTRIBUTION**

We refer to the draft determination released by the Queensland Competition Authority for public comment. Please accept this letter and the attached document as Ergon Energy Pty Ltd's ('Ergon Energy') contribution to this aspect 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).

We would be pleased to discuss our comments with you at your convenience. Please feel free to call me on (07) 3228 8116 if you would like to discuss any of the above issues.

Yours sincerely

**Darren Barlow**  
**Manager Regulation**  
**Strategic Business Development Group**

ERGON ENERGY PTY LTD



SUBMISSION ON THE DRAFT  
DETERMINATION ON REGULATION OF  
ELECTRICITY DISTRIBUTION

## 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 will in fact have serious consequences for Retailers in general, and in particular on the process of moving towards a fully competitive retail electricity market. This submission endeavours to highlight those possible impacts and the areas of concern for Ergon Energy as a Retailer.

## 2.0 GENERAL COMMENT

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 contestability ('FRC'). On 1 January 2001, a further tranche of the New South Wales and Victorian electricity markets became contestable, with the current goal of those jurisdictions to have FRC fully implemented by approximately 1 January 2002. While the Queensland timetable for full contestability remains undecided, Ergon Energy expects that further tranches of the Queensland market will be opened to contestability over time. The introduction of FRC throughout the NEM represents a significant policy initiative of the respective NEM jurisdictions. Within Queensland the potential for the Determination to influence the prospects for competition (rather than contestability) is significant, and it is the impact on this prospect that forms the focus of this submission.

The Determination should not be examined in isolation from its impact on existing and proposed market developments. Further to this, Ergon Energy believes that it is important for the QCA, in considering the Revenue Cap to be applied, to link the Determination with the existing determination of the Department of Mines and Energy in its role as Regulator prior to December 2000. Equally, the impact of revenue requirements on reliability of supply requires consideration in the context of retail competition.

We believe it important that the QCA consider the following issues:

- Under FRC, residential customers will generally only wish to contract with their Retailer who in turn will make all necessary arrangements with the Local Network Service Provider ('LNSP') on the customer's behalf (this is often referred to as a 'straight-line' relationship). In this context, a use of systems agreement between Retailers and LNSPs will be required and in formulating these agreements, it will be necessary for the LNSP to offer all Retailers service and supply reliability of a standard expected by customers. A failure to do so may result in adverse public perceptions towards Retailers and reduce the efficacy of FRC.
- The pricing for Distribution services (that is the conversion of the Revenue Cap into Network tariffs), should not create a barrier to customers entering the contestable market and hence a barrier to competition. In this context, the impact on retail competition of the uncertainty created by the Network charges to be developed reflecting an estimate of the glide path proposed in the Determination and the potential for price shocks arising from the suggested tax treatment require examination.

- Prescribed services should be reviewed to ensure that the likely changes to the requirements of Retailers and customers resulting from an increase in the level of competition can be adequately dealt with within the terms of the Determination.

These issues are considered further below in the context of the Determination.

### **3.0 SIDE CONSTRAINTS**

#### **3.1 Differential Side Constraints**

The Determination recommends a side constraint on the annual movement in individual Network tariffs of CPI plus 5 percent for existing contestable customers and CPI plus 2 percent for residential customers.

We recognise the merits of side constraints to supplement the fixed Revenue Cap. However, we find the recommendation that different percentages be applied to contestable and non-contestable customers an unacceptable barrier to customers migrating from non-contestable to contestable status.

Designating different side constraints for contestable and non-contestable customers creates the potential for different price shocks by customer class and accordingly, may create either a barrier to customer switching (ie a barrier to competition) or change the relativity between an individual customer's delivered cost of energy to the Maximum Uniform Tariff<sup>1</sup> ('MUT') and therefore stifle competition. Evidence from overseas jurisdictions indicates that customers tend to require a reduction in the delivered cost of energy (DCE) of approximately 10% to entice their departure from the security of established MUTs. Allowing differing rates of change for side constraints based upon the customer's status as contestable or non-contestable presumes that the non-contestable side constraint variation (whether up or down) is passed through to end-use consumers. This is not the case due to the manner in which the MUT is set and thus no price signal is provided to the customer. The true effect will be the creation of a variation in the Community Service Obligations ('CSO') of Queensland Treasury and a potentially adverse impact upon the cash flow of host Retailers by effectively (and we presume inadvertently) transferring the risk of this variation (and the extent to which it is captured by the CSO) to the host Retailer. The cash flow impact of this risk could reduce the competitiveness of host Retailers and thus prove detrimental to the spread of competition.

#### **3.2 Definitional Issues**

Differential side constraint variation rates (ie 5% for existing contestable customers and 2% for residential customers) also raise definitional issues that require resolution. For example, does "*existing contestable customers*" mean:

- Tranche 1– 3 customers who are eligible for contestability (as at what date);
- Tranche 1– 3 customers who have entered the contestable market (as at what date);
- On a rolling basis, any customer in Queensland who is or becomes eligible for contestability (in this instance the issue is one of determining the rate applied to customers who migrate part way through the period);

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<sup>1</sup> The Maximum Uniform Tariff is approved by the Minister for Mines and energy under section 90 of the Electricity Act 1994.

- On a rolling basis, any customer in Queensland who enters the contestable market (in this instance the issue is one of determining the rate applied to customers who migrate part way through the period); or
- Some other variation on the above definitions.

Similar issues arise with respect to the definition of “*residential customer*” in the instance where Queensland proceeds with FRC during the term of the Determination.

A subsidiary definitional issue is that depending upon the definitions of these two classes of customer it is possible that some classes may be subject to no side-constraint rule at all. For example, under what definition do non-contestable business customers lie? How does one assess for the purposes of the side-constraint rule whether a rural/farming customer is a business customer or residential?

### 3.3 Impact on Customer Movement

A further fundamental issue is raised by differential side-constraint rates. This situation arises depending upon the definition adopted. If we assume that the 5% rate applies to the contestable market whereas the 2% rate applies to the non-contestable market then the relativity of these rates will stifle customer movement from the franchise to contestable markets. Why? Given that the MUT is generally below the DCE for customers within the Ergon Energy Retail Area and the differential between DCE and MUT drives the customer’s decision to enter the contestable market (usually by a savings margin of approximately 10%) the application of a differential side-constraint rate (even assuming that the residential rate will be capable of being passed through to customers – which is not at present possible) will see MUT rising at a lower rate than contestable tariffs. All things being equal (which they are not, as explained earlier), an economically rational consumer would generally be disadvantaged by entering the contestable market.

We ask the QCA to reconsider the issue of side-constraints generally and specifically:

- The application of differential side-constraint rates (irrespective of the mechanism);
- The effect of Retailer inability to pass through changes to Network charges to non-contestable customers as a result of side-constraints and its impact upon a customer’s decision regarding contestability; and
- The impact of an inability to pass through non-contestable charges on the ability of Host Retailers to compete effectively in the contestable market.
- Uncertainty for customers regarding the Network tariffs underlying the glide-path and the impact volatility in Network charges year on year may have upon any decision by ‘marginal’ customers of entering the contestable market. We suggest that the preferred solution would be for the AARR to be “front-ended”. That is, for the glide path to be loaded in the years prior to the introduction of FRC. The effect of this glide-path structure is to ensure that prior to FRC occurring all Network tariff volatility (aside from that generated naturally as a result of the side-constraints) is transparent to the customer. As a result any customer migration into contestability should not result in subsequent “regret syndrome” due to network tariff increases. Alternatively (ie if the glide-path remains as presently predicted) transparency in long term decision making process could be enhanced by the QCA requiring the Networks to publish indicative tariffs for the full glide-path to provide greater transparency and allow customers an

opportunity to fully assess the impact of the annual increase on any decision to enter the contestable market.

Ergon Energy is very concerned that the significant ambiguity/uncertainty surrounding both the definition and application of the side-constraint rules may in its current form inadvertently discourage retail competition in Queensland by effectively providing a positive disincentive to a customer when assessing the benefits to be received on entering the contestable market. The likelihood of competition in further tranches in Queensland is therefore potentially significantly reduced.

#### **4.0 PRICE SHOCKS ARISING FROM TAX TREATMENT**

We are concerned that calculating the weighted average cost of capital ('WACC') using actual cash tax payments will result in significant price shocks for end-use consumers which may lead to adverse outcomes with respect to the advancement of migration from the MUT to contestable markets in Queensland.

We understand that for the Queensland Distribution Networks, tax depreciation has typically exceeded accounting depreciation as a result of the utilisation of the accelerated depreciation rates. This has traditionally resulted in the actual tax payable being lower than that calculated on the accounting profit. In relation to this, we comment that:

- As part of the recent Ralph Reforms, the accelerated depreciation rates are being removed and accounting depreciation rates and tax depreciation rates are likely to merge in the future. As a result, the depreciation timing differences traditionally experienced will substantially reduce.
- As noted above, the use of accelerated depreciation rates usually results in an effective tax rate lower than the statutory rate. Once all the available accelerated tax depreciation has been claimed, this situation will reverse and the effective rate will rise above the statutory rate. The effective rate will remain higher than the statutory rate until all assets that received accelerated depreciation have been fully depreciated for both accounting and tax purposes. At that time the two rates will equalise. In the interim, actual tax rates (and tax payments) are likely to shift upwards sharply and to a significant extent. Our concern is that this rise, once incorporated into the revenue cap, will result in significant price shocks to consumers.

Price shocks are undesirable to the general community for obvious reasons. One of these is the effect such a price shock could have upon contestability dynamics. As mentioned above the decision to become contestable usually requires savings in DCE of 10% over the relevant MUT. Of its nature, a move to the contestable market involves a loss of protection for the customer from price volatility. Part of this 'loss' involves an increased exposure to volatility in Network charges. Any subsequent increase in costs that either reduce savings or transform the customer into a 'loser' from the move to contestability will damage both customer and community perceptions of competition and deregulation. It is highly likely that price shocks in Network charges resulting from the change to tax treatment will raise these issues.

There is also the possibility that these price shocks will occur in close proximity to the date for implementing FRC in Queensland. If that were the case, the price shocks would inevitably (though incorrectly) be linked to the introduction of FRC. Such a result could be very damaging to the whole FRC process which already risks public disapproval based on preconceptions of the impact of deregulation within many sections of the community. We believe it extremely important to the success of FRC that customers are provided with the maximum degree of

certainty in any transition to a contestable market. Wherever possible, it should be ensured that external factors do not artificially cloud perceptions of the deregulation process.

We strongly support an approach to the formulation of the Revenue Cap that will limit the possibility of price shocks arising from the change in tax treatment and the potential impact they may have on the assessment by the community of the success and benefits of FRC.

## 5.0 SERVICE STANDARDS AND RELIABILITY ISSUES

We support in principle the proposal to develop a service quality regime for Networks. We believe that in developing the regime the following issues should be considered:

- It is our belief that for customers in rural and regional Queensland, reliability of supply is a more important consideration than the price of energy (on a delivered basis). Accordingly, we suggest that it would be appropriate for the QCA to ensure that in determining the adjusted annual rate of return ('AARR'), this is recognised and LNSPs adequately funded to provide the level of reliability of supply expected by the community. The QCA should not limit the AARR at the risk of compromising reliability of supply.

We encourage the QCA's promotion of competition in Queensland by ensuring that LNSPs are able to achieve the level of supply reliability and service demanded by retail customers. If ensuring this would require additional capital expenditure or the provision of additional prescribed services, then we encourage the QCA to incorporate these requirements in the Determination – particularly given the lead times required for an improvement in Network reliability.

Further, it is important for the success of FRC that at a minimum, reliability of supply remains at its current level, and preferably improves to meet rising customer expectations. Any reliability problems are likely to be linked (by customers) to the introduction of competition in the retail electricity market and accordingly, may act as an incentive for customers to remain on franchise tariffs (materially impacting on the CSO) or to believe incorrectly that deregulation has led to a reduction in reliability standards.

- Under FRC, it is anticipated that the majority of contestable customers will enter into a form of standard service contract ('SSC') with their Retailer under which a 'straight-line' relationship will exist between the customer, the Retailer and the LNSP. That is, the customer will contract directly with the Retailer, and the Retailer will arrange the customer's connection and supply with the LNSP. As a result of the movement towards this form of legal relationship between parties, it will be vital for the service standards of the Networks to be robust and continually improving. Further, it will be vital to incentivise the Networks to improve their service standards. In developing the service quality regime, it is necessary to recognise that in many instances it will be Retailers (rather than end-use customers) who will effectively be the 'customers' of the LNSP. The service quality regime will need to reflect this reality and ensure that:
  - The service quality regime accounts for Retailers' commitments under their SSCs; and
  - LNSPs are accountable to Retailers for meeting the service level requirements.

The Determination as it currently stands does not address these issues.

## 6.0 CONCLUSION

We make the following summary comments in conclusion:

1. It does not appear that consideration has been given to the FRC process or the implications of the Determination upon community perceptions of FRC, deregulation, customer decision making criteria when deciding to enter contestable markets, or the effect of supply reliability on FRC. We encourage the QCA to examine the 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).

We are concerned that in its present form, scope exists for the Determination to act as a barrier to retail competition where:

- Customers are treated differently based solely upon whether or not they are contestable.
- The setting of the AARR impacts on the services (and the standards) provided by LNSPs, including reliability of supply. As noted earlier, customers are likely to relate any service or supply problems with their Retailer and deregulation.

Regulation of the Network results in price shocks, which are likely to be seen as a consequence of FRC, regardless of whether that is the case. These price shocks are exacerbated by the absence of transparency for customers of the implied Network charges inherent in the glide-path adopted in the Determination, and the impact this may have for 'marginal' customers.

2. With a view to ensuring no barriers will exist to retail competition, we submit that the Determination should specifically more fully consider:
  - any distinctions in respect of service or price for the supply of electricity to contestable versus non-contestable customers, including the current proposal that different side-constraints apply to contestable and non-contestable customers;
  - that reliability of supply is guaranteed at increasingly high levels to meet rising customer expectations as a result of the introduction of competition; and
  - the method for calculating WACC, and in particular the use of effective tax rates in determining WACC, will not result in price shocks in future periods.
3. The Determination's requirements with respect to service levels should be reconsidered taking account of the straight-line relationship that will exist between customers, Retailers and LNSPs. Consideration must be given to the need to ensure that LNSPs will meet the obligations Retailers will have to their customers under the SSCs.

We thank you for the opportunity to comment on the Determination and would welcome an opportunity to discuss our views with you in greater detail.