Ref: JD/RC

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Mr Richard Khoe
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Dear Mr Khoe

SUBMISSION ON THE ECONOMIC REGULATION OF NETWORK SERVICE PROVIDERS DIRECTIONS PAPER

Ergon Energy Corporation Limited, in its capacity as a Distribution Network Service Provider in Queensland, welcomes the opportunity to provide a submission to the Australian Energy Market Commission on its *Economic Regulation of Network Service Providers Directions Paper.*

Should you require additional information or wish to discuss any aspect of this submission, please do not hesitate to contact me on (07) 4092 9813.

Yours sincerely

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Encl: Ergon Energy's submission.

Ergon Energy Corporation Limited

Submission on the *Economic Regulation of Network Service Providers*

Directions Paper

Australian Energy Market Commission

16 April 2012

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

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1. INTRODUCTION

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider (DNSP) in Queensland, welcomes the opportunity to provide comment to the Australian Energy Market Commission (AEMC) on its *Economic Regulation of Network Service Providers (NSPs) Directions Paper* (Directions Paper).

Ergon Energy generally supports the initial positions set out in the Directions Paper. In particular, we appreciate the AEMC's views that:

- Benchmarking should take into account the circumstances of the NSP;
- Capital expenditure (capex) incentives in the National Electricity Rules (the Rules) do not create an incentive for an NSP to spend more than its allowance;
- The Australian Energy Regulator's (AER) proposed 60/40 sharing mechanism on expenditure above a NSP's allowance is not feasible, and other options to address the identified problem should be explored;
- The rate of return framework should be subject to merits review; and
- Government-owned NSPs should not be treated differently to privately-owned NSPs in determining the cost of debt.[1]

Ergon Energy is a member of the Energy Networks Association (ENA), the peak national body for Australia's energy networks. The ENA has prepared a comprehensive submission addressing each of the questions posed by the AEMC in its Directions Paper. Ergon Energy is fully supportive of the arguments contained in their submission However, Ergon Energy considers there are merits in exploring the adoption of a trailing average approach for the Weighted Average Cost of Capital (WACC) debt parameters (both debt risk premium (DRP) and risk free rate). Both the ENA and Queensland Treasury Corporation (QTC) have explored alternative options in their submissions which deserve further and appropriate consideration. Taking account of the complexity and material impact of the matter, Ergon Energy supports the ENA's proposition for a separate review process. In addition to the issues raised by the ENA, Ergon Energy provides comments on the consultation questions posed by the AEMC.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AEMC require.

[1] Refer to pages 29, 40, 43, 80 and 119 of the Directions Paper.

2. TABLE OF DETAILED COMMENTS

Question(s)	Ergon Energy Response
Chapter 2: Assessment Framework	
1. Is the Commission's assessment approach, as set out in Chapter 2 and Appendix B, appropriate? Are there other factors that should be taken into account in assessing the rule change requests?	Ergon Energy believes that the successful development and implementation of proposals in some areas of the Directions Paper (e.g. cost of debt) will require further substantive consideration of the issues raised. Therefore, Ergon Energy believes that the AEMC should consider the establishment of separate review processes to take forward the detail of the issues in recognition of the significant risks and costs to the long-term interests of consumers arising from a contracted process of assessment and design.
Chapter 3: Capex and Opex Allowances	
2. The Commission seeks further evidence on the drivers for increases in network costs, and in particular on the link between capex and opex allowances under the NER and such increases in network costs.	The ENA commissioned NERA Economic Consulting (NERA) to undertake analysis of factors causing price / revenue increases for each NSP. A copy of this analysis has been provided with the ENA submission. For Ergon Energy, this analysis shows that the largest contributor to our price / revenue increases has been changes in the WACC. The primary reason for the WACC increase between the regulatory periods has been a higher DRP as a result of changing market conditions (i.e. the global financial crisis). As noted by NERA, the benchmark adopted by the AER (BBB+, 10 year) is the same as that adopted by the Queensland Competition Authority (QCA) in the previous regulatory control period. This implies that, ceteris paribus, the DRP would have been the same. As such, any change in the DRP does not reflect deficiencies in the Rules. The next largest contributor to price / revenue increases is 'other factors'. The 'other factors' impacting Ergon Energy include: • In the 2005–10 regulatory control period, Ergon Energy overspent it capex allowance to address, among others, customer and demand growth on our network. This contributed to a higher opening Regulatory Asset Base (RAB) for the 2010–15 regulatory control period; • The tax allowance component under the QCA's building block was based on actual tax paid. This is much lower than the assumed tax for a 0.5 gamma; • A carry forward amount of $10.7 million ($2009–10) for accelerated depreciation due to Cyclone Larry increased the allowed revenue in the first year of the current

	regulatory control period; and • The starting point of the 2009–10 revenue included a net over-recovery adjustment of approximately $9.3 million for revenue over-recovery, a cost pass through for Cyclone Larry and the exclusion of excluded distribution services revenue. Finally, operating expenditure (opex) and capex factors resulted in the remaining increase. The key drivers for this include augmentation to meet peak demand, asset renewal/replacement, real wages growth, increased legislative obligations, and reliability standards. For example, Ergon Energy has invested significantly in pursuing the N-1 reliability standards arising from the 2004 Electricity Distribution and Service Delivery Review. It should be noted that the AER and its consultants have recognised these as legitimate drivers.
3. Would it be appropriate for the wording of the NER to be clarified to better reflect the policy intent?	In the context of asking the question, the AEMC has noted that in its view, the policy intent of Chapter 6A appears to remain appropriate and applicable. Therefore, the underlying issue is whether the AER has applied the Rules in a way that is consistent with this policy intent. Ergon Energy believes there is nothing in the AER's behaviour to date that can be seen to be inconsistent with the AEMC's policy intent. Therefore, there is no reason to alter the wording of the Rules.
4. What circumstances of the NSP should the AER be required to take into account when benchmarking?	It is a fundamental requirement that benchmarking take account of differences in the business environment facing NSPs. Ergon Energy considers the differences that should be taken into account should include: • Input costs (e.g. labour rates and local taxes); • Operating environments (e.g. weather, topography, soil properties, population densities and the urban / rural nature of certain areas); • Network sizes. For example, Ergon Energy's network area covers more than one million square kilometres, which is over six times the size of Victoria. This network characteristic would impact on our performance against reliability standard targets due to accessibility issues and distance to travel to faults; • Network types. For example, Ergon Energy has a large sub-transmission system as well as Single Wire Earth Return systems (SWER); • Reliability targets; • Asset characteristics (e.g. long, old, radial and sparsely populated distribution and sub-transmission lines);

	• Customer bases (e.g. a larger percentage of industrial customers, such as mines, would impact on load and forecasting as they consume large amounts of energy despite representing only a small percentage of total customers); • Procurement policies (i.e. purchase versus lease policies for property, fleet and IT etc. would affect the mix of capex and opex); and • Historical jurisdictional requirements (e.g. capitalisation, cost allocation and accounting practices).
5. Would it be appropriate for the capex objectives to be clarified to better reflect jurisdictional reliability standards?	Ergon Energy believes it would be appropriate to amend the capex objectives to clarify that capex forecasts should seek to target mandated service and reliability standards. Where these standards have been amended, the current reference to the goal of "maintaining" existing levels of performance has the potential to cause a lack of clarity.
6. What factors or features of the approaches of other regulators should be taken into account when reviewing other regimes to confirm the best practice approach to economic regulation?	Ergon Energy believes the current regime reflects regulatory best practice. To confirm this position, we suggest the AEMC explore the approach other regulators have adopted with respect to: • Using the regulatory proposal / submission as the starting point in the regulatory determination process; • Using other information sources or assessment techniques, and the weight placed on them; and • The decision criteria for rejecting or accepting a regulatory proposal / submission. Ergon Energy refers the AEMC to the ENA's submission and associated expert report on this issue.
Chapter 4: Capex incentives (and related issues)	
7. In what circumstances would an NSP need to spend more than its allowance under the NER?	An NSP may need to overspend its forecast expenditure due to: • Regulatory error (e.g. incorrect or low forecasts adopted by the AER); • A change in circumstances from when the forecasts were set. This may be the result of unexpected customer growth, growth in peak demand, higher real input costs (e.g. labour and material costs), new policy initiatives, new or revised regulatory obligations relating to reliability, service (including customer connection timeframes), electrical safety and environmental requirements; and

	• Incentive schemes. Achieving positive outcomes under these schemes may result in some expenditure in excess of the forecast amounts. However, it should be noted that real world constraints such as cash flow and limited available capital, ensure that spending in excess of amounts determined through a regulatory determination is subject to signficiant checks and balances. Further, current incentives penalise an NSP for expenditure that is in excess of forecasts over the regulatory period. Ergon Energy is concerned that there is an implication that expenditure above forecast is inefficient. However, there are circumstances where the efficient level of expenditure is materially different from forecasts. Rule changes designed to encourage NSPs to spend only the approved forecast would most likely encourage inefficient behaviour.
8. What is the best option for dealing with the capex incentive issues identified in this paper?	Ergon Energy supports the introduction of a capex incentive scheme via the Efficiency Benefit Sharing Scheme (EBSS). Such a scheme would: • Provide a continuous incentive for NSPs to reduce capex over the regulatory control period (i.e. it will not provide an incentive to defer capex to later in the period); • Allow for a balance of incentives between capex and opex to ensure that an efficient choice between the two is chosen (i.e. when they are substitutable); • Provide symmetric incentives so that it applies to all capex within an NSP's allowance, not just the capex in excess of the regulatory allowance; and • Negate a need for any ex-post assessment as the incentives will encourage NSPs to behave in an efficient manner. Ergon Energy believes this scheme should be developed in consultation with industry, be cognisant of the differences between transmission and distribution networks, and focus on what is valuable to customer (i.e. not just lowering the cost). Due to the complex nature of the EBSS, Ergon Energy recommends that it should be addressed through the development of AER guidelines. Ergon Energy does not support optimising the RAB,[2] the 60/40 sharing mechanism proposed by the AER,[3] or ex-post prudence tests. Ex-post prudence tests are difficult to design and apply, increasing the risk for NSPs that otherwise prudent expenditure is not rolled into the

[2] Refer to EECL (2012), *Submission on the Optimisation of Regulatory Asset Base and Use of Fully Depreciated Assets*, 20 January 2012.
[3] Refer to EECL (2011), *Submission on the Economic Regulation of NSPs Consultation Paper*, 8 December 2011.

	RAB.
9. How does using actual or forecast depreciation to determine the RAB affect a NSP's behaviour?	Ergon Energy agrees that the use of actual depreciation is likely to lead to a bias against short lived assets, with a greater potential reliance on network solutions with a long asset life. This is because the penalty from spending more on assets with shorter economic life is large compared to longer lived assets. This disincentive may affect investments in innovative technologies, such as smart meters and smart grids.
10. The Commission notes the comments by the ERAA on the need for a rigorous approach to assessing capex reopeners and contingent projects. The Commission seeks submissions from retailers on any other options for minimising the impact of capex reopeners and contingent projects on retailers.	Nil comment.
11. More extensive use of the uncertainty regime means regulatory arrangements more closely resemble commercial contracts. Is this appropriate?	It is not clear how the use of the uncertainty regime would more closely resemble commercial contracts. The costs that are affected by uncertainty measures, in most cases, relate to projects over which NSPs have limited discretion and the prices and conditions for providing the services are regulated. Therefore, the flexibility for NSPs, which would otherwise be accommodated in a commercial contract through price or conditions, is not available.
12. To what extent would stronger capex incentives, through an EBSS for example, deal with incentives for a NSP to inefficiently change its capitalisation policy during a regulatory control period?	Ergon Energy notes that the current EBSS provides a provision that removes the potential for NSPs to inefficiently change their capitalisation policy during a regulatory control period. Under the AER guidelines,[4] a DNSP must: • Adjust the forecast opex used to calculate the carryover amounts so that the forecast opex is consistent with the capitalisation changes; and • Provide a detailed description of the changes in the capitalisation policies and a calculation of the impact of those changes on forecast and actual opex. The AER has discretion to adjust the forecast opex if they believe the changes will adversely impact the operation of the EBSS. Ergon Energy considers that any capex EBSS incentive scheme should adhere to the aforementioned requirements.
13. How, and to what extent, does the incentive for a NSP to overspend or underspend vary depending on whether it uses	Nil comment.

[4] AER (2008), *Electricity DNSPs: EBSS*, June 2008.

a related party or not having regard to the other incentives for efficient capex, including the scope for the AER to determine efficient capex at the regulatory determination?	
14. To what degree would a parent company of a NSP be better off if related party margins, that are higher than those allowed for by the AER in the regulatory determination, are due to genuine higher costs?	Nil comment.
15. Should the AER be given the power to develop and implement pilot or test incentive schemes within a controlled environment?	Ergon Energy agrees with the AEMC's comments that "*there is a risk that new incentive schemes could be introduced that lead to unexpected and perhaps unwelcome outcomes*".[5] As such, we do not support giving the AER power to introduce new incentive schemes. However, Ergon Energy recognises that there is some merit in developing and implementing pilot or test incentive schemes within a controlled environment. Any proven pilot or test scheme(s) should then be introduced via the usual Rule change process. This will ensure adequate consultation and provide the AER with guidance in their implementation and application of the scheme.
16. What limits should be placed on the extent of these schemes?	Ergon Energy considers the following factors should be taken into account: • Limiting the revenue at risk to a small amount or using a 'paper trial' approach; • Involving NSPs in the design of the scheme; • Voluntary participation by the NSP in the pilot or scheme; • Creating limitations on the scope of the scheme (e.g. to a certain location or customer class).
17. Should the concept of compensation for consumers for use of shared assets be applied to transmission, as well as distribution?	Nil comment.
18. Stakeholders have suggested use of assets for alternative control services should be excluded from the uses for which consumers should receive compensation. Are there any other examples of such uses?	To the extent that assets included in the RAB are used to deliver Alternative Control Services (and the users of the Alternative Control Services are charged for use of these assets) it is appropriate that that network customers should receive some compensation. Under the transitional arrangements for Queensland, a small proportion of assets in the RAB are used to provide Alternative Control Services and a revenue adjustment is recognised in the building block for Standard Control Services for Ergon Energy.

[5] Directions Paper, p62.

19. What are the appropriate guiding principles allocating compensation arising from sharing assets between regulated and unregulated services?	Ergon Energy believes that the Rules should provide incentives for NSPs to use assets for delivery of other services which earn additional revenue; this supports the National Electricity Objective (NEO). The ENA also believes that electricity customers should share in benefits associated with distribution system assets, since the NEO promotes the long term interests of customers (which the ENA considers should preclude shareholders capturing all the benefits). The sharing of benefits arising from multiple uses of electricity network assets between electricity customers and NSPs should be consistent with the following principles: • NSPs should be incentivised to pursue alternative use network services by being permitted to retain a share of benefits from these services; • Benefits should be defined as incremental revenue from alternative uses net of all incremental costs including avoidable costs, tax, the cost of risk, and a reasonable margin associated with the non-regulated alternative use service; and • Arrangements for implementing benefits sharing should: o Recognise legacy arrangements and the maturity of the market for alternative uses; o Be administratively simple; and o Be proportionate to the benefits.
Chapter 5: Rate of Return Frameworks	
20. Are some WACC parameter values more stable than others, and sufficiently stable to be fixed with a high degree of confidence for a number of years into the future? Would it be practical for periodic WACC reviews to cover only some parameters that are considered relatively stable in value, and require others to be determined at the time of each regulatory determination?	Ergon Energy believes that that there is no individual WACC parameter that does not rely on market based evidence for reaching decisions on an appropriate value. Given the experience of the last few years, it is clear that no WACC parameter value is sufficiently stable for it to be fixed with a high degree of confidence for a number of years into the future. Ergon Energy supports the current approach of periodic WACC reviews for all WACC parameters (via the Statement of Regulatory Intent) but agrees there should be sufficient flexibility in the Rules to allow WACC parameters to be reconsidered at the time of each regulatory determination due to changing market circumstances, the availability of better data or estimation techniques, developments in finance theory and practice, and to incorporate outcomes from merits review processes. However, reconsideration of parameters should be subject to the persuasive evidence threshold. Ergon Energy concurs with SFG Consulting's recommendation that consideration should be given to allowing a merits review of WACC parameter values (resulting from the SOCC and

	periodic WACC reviews) for all NSPs and gas service providers on the basis that more scrutiny of WACC parameter values are likely to produce higher-quality WACC estimates. Ergon Energy recommends that the AER adopt a consultative approach when developing new methodologies and values for certain WACC parameters and allow sufficient time for stakeholders to respond during the consultation process.
21. Would it be useful if the AER periodically published guidelines on its proposed methodologies on certain WACC parameters as opposed to undertaking periodic WACC reviews that locks in parameter values for future revenue/pricing determinations?	Ergon Energy supports the AER periodically publishing guidelines on its proposed methodologies on certain WACC parameters outside of and in addition to the periodic WACC reviews. In doing so, the AER should adopt a consultative approach. Ideally, it would be beneficial for the AER to consult on changes to WACC parameter methodologies and values prior to periodic WACC reviews and prior to the release of Draft Determinations for NSPs. Ergon Energy notes that the Rules currently allow the AER to undertake periodic WACC reviews more frequently than every five years.[6] However, the AER has not exercised this discretion. Although not explicitly provided for, there is no apparent reason why the AER could not instigate publication of a guideline under the Rules.
22. Given the uncertainty in estimating certain parameters, should the AER be required to produce the best possible values for all parameters or adopt a range from which it can choose a preferred estimate? Which WACC parameters are inter-related and should the rules recognise the inter-relationships of these WACC parameters?	The AER should be required to produce the best possible values for all parameters in order to achieve a high-quality estimate of WACC. Ergon Energy has some concerns with allowing the AER to choose a preferred estimate from a range. In particular, Ergon Energy is concerned that the AER may choose the lowest value in the range for each parameter. Alternatively, the AER may choose to offset certain parameters to achieve a preferred outcome. In both scenarios, it is unlikely the highest quality estimate of WACC would be achieved. In certain circumstances the final estimate may be below the efficient financing costs that a DNSP requires. As the AEMC noted in its Directions Paper,[7] small changes in WACC parameter values can have a significant impact on the required revenues for the regulated assets of DNSPs: "*…the return on capital component of their regulated revenues can account for anywhere between approximately 50 to 70 per cent of their annual aggregate revenue requirements… Therefore, relatively small changes to the value of the overall rate of return can have a significant impact on the total revenue requirements of NSPs and gas service providers, and ultimately, consumer prices.*"

[6] Clause 6.5.4(b).
[7] p70.

	In addition, changes in certain WACC parameters have a greater impact on the regulated revenues than other WACC parameters. As the AER's sensitivity modelling results illustrated, changes in the risk free rate and the DRP are extremely sensitive and have much greater impact on the revenues than changes in other WACC parameters. Therefore, allowing the AER to choose a preferred estimate from a range with respect to these particular WACC parameters raises significant concerns for Ergon Energy. With respect to the inter-relationship of certain WACC parameters, Ergon Energy acknowledges that the QTC has prepared a detailed submission on this topic and, in this regard, Ergon Energy refers the AEMC to the QTC submission.
23. How do the outcomes with the persuasive evidence test applying at the time of the regulatory determinations in Chapter 6 of the NER differ from the NGR rate of return framework? Does the persuasive evidence test make it less likely that values of WACC parameters will be updated as quickly as under the NGR framework, or vice versa?	Ergon Energy notes that the persuasive evidence threshold has not prevented WACC parameters from being updated in the light of new evidence (e.g. during the 2009 WACC review and the following appeal to the Tribunal). It is difficult to assess the gas framework in comparative terms to electricity because in practice they have influenced each other.
24. How has the rate of return framework under the NGR worked alongside the NER frameworks?	Nil comment.
25. Are there any concerns about the lack of guidance in the NGR on how the AER and ERA will approach the rate of return decision? To what extent is the rate of return framework under the NGR influenced by the WACC approach adopted for the electricity sector by these regulators?	Nil comment.
26. Are there reasons to adopt a WACC definition other than the vanilla post-tax nominal definition that is used under the NER? Alternative proposals should explain why that alternative is likely to result in a better WACC estimate.	Ergon Energy supports the use of the vanilla post-tax nominal definition currently prescribed in the Rules.
27. Should the AER/ERA be given discretion to consider models other than the CAPM when estimating the required return on equity under the NGR? What prescription or principles could the rules contain to guide the way in which information from other models might be used to produce a better WACC estimate?	Nil comment.
28. Are there any reasons why an appropriate WACC	Ergon Energy supports a common WACC framework and cannot formulate any compelling

estimate cannot be provided to NSPs and gas service providers from a common WACC framework, without necessarily requiring the same parameter values to be adopted across the electricity transmission, electricity distribution and gas sectors?	reasons as to why an appropriate WACC estimate could not be provided to NSPs and gas service providers under this framework. Ergon Energy further supports SFG Consulting's views that a common WACC framework can apply without necessarily requiring the same WACC parameter values to be adopted across the electricity transmission, electricity distribution and gas sectors. The businesses are different and therefore the equity betas may differ for the electricity sector in comparison to the gas sector.
29. Which rate of return framework would best meet the key attributes identified? Are there any other attributes that should be considered?	The rate of return framework for DNSPs would best meet the key attributes identified as the Chapter 6 framework provides a mechanism for the WACC parameter values to evolve and change over time, whereas the Chapter 6A framework does not. Chapter 6 is a more flexible framework and provides greater scope to react to changes in evidence and data about parameter values at the time of a regulatory determination. Ergon Energy therefore supports the AEMC's views that *"the current rules in electricity transmission for determining the rate of return are not satisfactory"* due to the rigidity of the rules in Chapter 6A and the discrepancies that can arise following the outcomes of merits review appeals.[8]
Chapter 6: Cost of Debt	
30. Is the benchmark DRP approach likely to overstate the prevailing cost of debt, having regard to the suggestion that the overstatement may be a reflection of shorter maturity debt leading to a higher refinancing risk for NSPs? What weight should be placed on the views of market analysts on the ability of stock market listed NSPs to out-perform their cost of debt allowances?	The current approach of setting the regulated cost of debt allowance for all NSPs based on a risk free interest rate and DRP that corresponds to a ten year term does not overstate the prevailing cost of debt. To the extent there is a perceived overstatement, this is a reflection of the increased reliance on shorter-term debt since the start of the global financial crisis and reflects appropriate compensation for the increased refinancing risk faced by equity providers. Limited or little weight should be placed on the views of market analysts regarding the ability of stock market listed NSPs to out-perform their regulated cost of debt allowances.
31. What are the pros and cons of the recent approaches taken by IPART and the ERA in estimating the DRP?	Ergon Energy supports the current use of a ten year risk-free interest rate and DRP for the purpose of calculating the regulated cost of debt for all NSPs. Ergon Energy further supports the use of a broader sample of data for estimating the DRP. Ergon Energy does not support the recent approaches taken by the Independent Pricing & Regulatory Tribunal (IPART) and the Economic Regulation Authority of Western Australia (ERA) in revising the benchmark to estimate the DRP (or the risk free interest rate) to a five-tear term to maturity. The re-specification of the benchmark appears to be on the basis that

[8] Directions Paper, pv.

	there is greater data availability at this tenor rather than a change in the optimal or benchmark funding practices of NSPs. IPART's methodology: • Does not take into account the actual financing decisions of businesses investing in long lived assets; • Applied an arbitrary approach to selecting the sample of bonds; and • Did not provide guidance on how the value was selected from the range.
32. What evidence is there that the DRP benchmark in the NER may have changed? Would it be appropriate for the regulator to specify the DRP benchmark in any periodic reviews or would it be more appropriate to specify it at the time of the determinations?	There is no evidence that the DRP benchmark in the Rules with respect to term to maturity has changed. The increased issuance of shorter-term debt since the global financial crisis is due to market conditions, rather than a change in the benchmark or optimal funding practices of NSPs. The regulated cost of debt allowance for all NSPs should continue to include compensation for a ten year risk-free interest rate and a ten year DRP. The Rules should provide some guidance as to how the DRP is to be estimated, rather than give complete discretion to the AER. In addition, it would be appropriate for the AER to specify the DRP benchmark in periodic reviews to provide sufficient certainty and predictability for NSPs, their financiers and investors given the long-term nature of investment in energy networks. As Ergon Energy manages its debt in line with the regulatory framework and with reference to the AER's methodology for the calculation of the regulated cost of debt, early notification of the DRP benchmark is required to enable NSPs with large debt portfolios to formulate appropriate debt refinancing and hedging strategies for upcoming regulatory resets. The Ergon Energy Board also requires a significant period of time to consider proposed debt refinancing and hedging strategies. This timeframe can span between six and 12 months, and is dependant upon the number and complexity of the strategies being considered. Upon Board approval of the debt refinancing and hedging strategies, the QTC requires sufficient time to execute the strategies without signalling the market. The DRP benchmark should only be updated at the time of the regulatory determination if there are significant changes in data availability or estimation techniques.
33. Is the EURCC's proposal of establishing the cost of debt using historical trailing average compatible with the overall framework for estimating a forward-looking rate of return? What are the potential benefits of using a trailing average and do they outweigh the potential costs if the estimate is less reflective of the prevailing cost of debt for NSPs?	Ergon Energy considers that the Energy Users Rule Change Committee's (EURCC) proposal of establishing the cost of debt using historical trailing averages is not compatible with the overall framework for estimating a forward-looking rate of return and may result in an estimate that is not reflective of the prevailing cost of debt for NSPs. However, Ergon Energy considers that the use of a longer-term moving average may produce benefits for energy users and NSPs which outweigh the potential costs. Potential benefits are:

	• NSPs would not be exposed to risk-free interest rate and DRP volatility at the time of regulatory resets; • The current method of fixing the cost of debt over a short time interval every five years creates significant market signalling and re-pricing risks for NSPs with large debt portfolios. Using a longer-term moving average approach would mitigate these risks; and • Customers would not be exposed to prices being set during periods of elevated risk-free interest rates and / or DRPs. Ergon Energy acknowledges that the QTC has prepared a detailed submission on the 'Moving Average WACC' approach and in this regard, Ergon Energy refers the AEMC to the QTC's submission. Given the timeframe of this Rule change process, and the complexities associated with designing and implementing such an approach, we suggest that these issues be explored as a separate review process to ensure the complexities of this approach can be thoroughly examined.
34. What possible changes would be required in the NER to implement the EURCC's trailing average approach?	Ergon Energy believes that substantial changes to the Rules would be needed to accommodate the adoption of a trailing average approach to the DRP. These are likely to include: • The separation within the Rules of the risk free rate used to estimate the cost of debt from that used to estimate the cost of equity; • The development of a revised overarching principle for application to the debt element of the WACC (alone), adopting the concept that the cost of debt should reflect the "average historical financing costs of a benchmark efficient NSP"; • Potentially, the creation of an annual pass-through mechanism to allow the trailing DRP to be annually updated, through the adoption of a specified updating methodology; and • The need to establish empirical estimates of the DRP over the period of the trailing average (ten years), which coincides with the period of the global financial crisis and its disruptive effects on both the quality and quantity of bond yield data. Ergon Energy strongly believes that this issue should be considered by means of a separate review process, so that the many implementation and other complexities can be thoroughly examined.

Chapter 7: Regulatory Determination Process	
35. What factors or principles would promote an effective regulatory determination process?	Ergon Energy supports the AEMC's view that the regulatory determination process should be consistent and consultative. Consistency and predictability provides certainty to investors wishing to make long-term investments in the energy sector and reduces the administrative burden on all parties. Meanwhile, a consultative framework provides NSPs and other stakeholders with an opportunity to critically examine and comment on evidence used by the AER in its decisions and other material put forward by stakeholders. Finally, we suggest that the process should be transparent and accountable. There should be full disclosure of information from the NSP, the AER and other stakeholders. Ergon Energy agrees with the principles proposed by the AEMC but notes that they should not result in a prohibition on the AER having regard to information provided outside the explicit process steps set out in the Rules. The Rules must allow for consideration of information that for a legitimate reason could not be submitted within the bounds of the steps, where the information is material to the decision of the AER.
36. Which option(s) would be the best way of addressing problems with the regulatory determination process?	Ergon Energy is supportive of the following approaches: • Option 1 – creating a new consultation step (e.g. a mandatory issues paper at the beginning of the regulatory process or a submissions / cross-submissions stage). Ergon Energy believes this approach will allow for greater engagement of other stakeholders; • Option 2 – extending the time period for NSPs to submit revised regulatory proposals. This option addresses our concern in relation to the six week period in which we must respond to the Draft Decision coinciding with the Christmas / New Year period. Please refer to the revised timeframes proposed in the ENA submission; and • Option 3 – commencing the regulatory determination process earlier. Ergon Energy believes this approach will permit the additional stages identified above to be incorporated into the determination process. Ergon Energy also suggests that this should be extended to the Framework and Approach timeframe to ensure there is adequate time between the Framework and Approach Final Decision and the DNSP lodging its regulatory proposal. Ergon Energy is generally unsupportive of delaying the final regulatory determination (Option 4) due to the likely impact this will have on the finalisation of distribution pricing proposals (and therefore, retail prices). If this option is adopted, it should only occur when a NSP needs

	to submit a late submission (e.g. when the AER is proposing a material shift in its position and the relevant matters have not been subject to consultation, or when the information was not available when the NSP submitted its revised proposal). Further, Ergon Energy does not support Option 5 as there are valid reasons why late submissions may be required due to an external event. The proposal would result in material not being considered despite it being relevant to the final determination.
37. Are there any other options that could address the issue of providing adequate time for consultation and assessment during the regulatory determination process?	Nil comment.
38. Should the AER be given more time to consider confidentiality claims in initial and revised regulatory proposals?	Ergon Energy does not believe it is necessary to give the AER more time to consider confidentiality claims. A non-Rules initiative such as an information disclosure protocol could be adopted to address the AER's perceived issue with timeframes. This protocol could outline how the issue of confidentiality should be approached, how that information is identified and how redacted versions are generated.
39. Should the NER be clarified to reflect the NEL and/or common law position with respect to the AER's ability to give weight to confidentiality claims in initial and revised regulatory proposals?	Ergon Energy does not support changes to the Rules. Ergon Energy is cautious about supporting a Rule change proposal that would allow the AER to disregard relevant and probative data which may compromise the quality of the relevant decision.
40. Alternatively, are there any other additional ways to address confidentiality claims in initial and revised regulatory proposals that are not currently available under the NER?	As discussed under Question 38, an information disclosure protocol is another option to address confidentiality claims.
41. Should the framework and approach paper be a discretionary stage in the distribution regulatory determination process? If so, what is the appropriate approach to triggering it? Should stakeholders other than NSPs have the ability to trigger a framework and approach paper, and in what circumstances?	Ergon Energy agrees that the Framework and Approach paper should be optional. We suggest that it should be issued in the following circumstances: • When there is no previous distribution determination applying; • When the AER or the NSP intends to apply a control mechanism and / or service classification that is materially different to what was applied in the previous determination; and • In relation to dual function assets, if the AER or the NSP considers that a different approach to pricing of dual function assets should apply in the next regulatory control period. Ergon Energy considers that NSPs and the AER should be the only parties permitted to trigger a Framework and Approach paper. Having said this, the interests of stakeholders

	should be taken into consideration in determining whether to trigger the process.
42. Is it appropriate if a service classification or control mechanism can only be amended at the time of an AER final regulatory determination for circumstances that were not reasonably foreseeable at the time of the framework and approach paper?	Ergon Energy does not support the proposed “reasonably foreseeable” threshold. The Framework and Approach paper is a preliminary stage in the regulatory process to provide guidance to DNSPs in preparing their regulatory proposals. We therefore suggest that any departure from a service classification or control mechanism should be permitted where the DNSP seeks a departure and the DNSP can provide material to the AER justifying this departure.
43. Is there likely to be sufficient time for a NSP to accommodate an adjustment to a control mechanism in an AER draft regulatory determination?	Determining whether there is sufficient time for an NSP to accommodate an adjustment to a control mechanism in an AER draft regulatory determination is dependent upon the nature and scope of the adjustment. Generally speaking, there is unlikely to be sufficient time for an NSP to accommodate an adjustment arising from a replacement or material change. However, there may be sufficient time if the adjustment relates to a formulaic amendment.
44. Should the material error list under Chapter 6A be amended to reflect the current prescribed list under Chapter 6 of the NER?	Please refer to the ENA’s submission for comments.
45. Has the AER been constrained by the wording of Chapter 6 of the NER in its approach to revoking and substituting regulatory determinations as a result of material errors or deficiencies?	There is no evidence to suggest that the AER has been constrained by the wording of Chapter 6. Ergon Energy is unaware of any circumstances where the AER has considered it appropriate to revoke and substitute a determination as a result of material errors or deficiencies and has not been able to do so.
46. What should be the approach for addressing complex cost pass through, capex reopener or contingent applications? Is the "stop the clock" mechanism appropriate for each type of application?	Ergon Energy supports the “stop the clock” mechanism for cost pass throughs, capex re-openers and contingent project applications. This will ensure sufficient time to assess complex applications. Ergon Energy believes this mechanism is appropriate for each type of application and refers the AEMC to the ENA’s submission for comments on its application to contingent projects.