30 April 2008

Mr Mike Buckley
General Manager
Network Regulation North Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Buckley

QUEENSLAND DISTRIBUTORS' PROPOSALS FOR SERVICE CLASSIFICATION AND CONTROL MECHANISMS

This submission refers to the proposals made by ENERGEX Limited (ENERGEX) and Ergon Energy Corporation Limited (Ergon) to the Australian Energy Regulator (AER) on 31 March 2008. The proposals are made in accordance with clause 11.16.6 of the National Electricity Rules (NER) and purport to resolve the service classification and control mechanisms for distribution services (as an introductory step to the framework and approach by the AER) for the next regulatory determination and regulatory period commencing 1 July 2010.

Origin Energy (Origin) is the local electricity retailer in South East Queensland and provides retail services under a regulated retail tariff to the majority of ENERGEX's small customers. Consequently, the regulation of distribution network services will directly impact on Origin.

Origin is pleased to respond to these proposals. The purpose of the proposal is to classify the distribution services carried out by the distributors (ENERGEX and Ergon) as either direct control services or negotiated services for the purposes of economic regulation. Furthermore the proposals seek to recommend the appropriate form of regulation applicable to direct control services.

The key points emphasised by Origin Energy in this submission are:

- price cap regulation is the appropriate control mechanism for network services performed by ENERGEX. Revenue cap regulation for distribution networks creates volume and price risk for retailers and customers in circumstances where the network is subject to unpredictable high growth and high demand;
- sub-transmission connection services provided by ENERGEX require regulatory oversight. The form of regulation factors are weighted against classifying sub-transmission connection services as a negotiated distribution service.; and
- many of the specified Customer Services relate to the operational costs of the network service business which are not separately charged. Origin Energy believes customer services cannot logically be decoupled from the DUOS charges. This prevents these services from having a separate tariff basket.

Without accepting the process by which ENERGEX has concluded its findings, Origin generally agrees with the classifications of all distribution services as direct control services except in relation to the issues outlined in this response.

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Control Mechanism

ENERGEX proposes a hybrid control mechanism for standard control services specifically:

- Revenue cap for network services;
- Weighted average price cap (WAPC) for connection and customer services; and
- Weighted average price cap for all other services.

Section 6.2.5 (c) of the NER provides for the criteria for the AER to resolve the control mechanism applicable to regulated services. The criteria consider:

1. the need for efficient tariff structures;
2. the possible effects of the control mechanism on administrative costs for the AER, DNSP and users or potential users;
3. the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination;
4. the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction); and
5. any other relevant factor.

Network Services

After consideration of the criteria, Origin believes that price cap regulation is the most appropriate form of regulation for network services. In theory, both revenue cap and price cap mechanisms will provide for an efficient tariff outcome[1]. However, in circumstances of potential for significant deviations from forecast volumes and demands, price cap regulation will generally provide the most efficient tariff structure. As noted by ENERGEX, a WAPC control mechanism provides tariff flexibility for dealing with unexpected volume variations.[2] Such a scenario is more likely given the high consumption growth experienced in the ENERGEX distribution area of South East Queensland and further supports a price cap mechanism.

It is acknowledged the revenue cap mechanism is the current regulatory arrangement for Queensland distributors, nevertheless the use of a revenue cap for distribution systems has been highly criticised in the past and those criticisms have not been resolved within ENERGEX's proposal. For example, the Parer Report[3] recommended that economic regulation of distribution should be based upon price caps not revenue caps to reduce regulatory uncertainty. This is based on the regulatory risk involved with a revenue cap when actual demand exceeds forecast which can lead to prices being too low to build and maintain the network. Furthermore, problems arise in the reverse, that is, where network demand is lower than forecast demand this produces price and volume risk to the detriment of retailers and other users. Regulated retail prices in Queensland are bundled and do not increase proportionately to increases in the distribution charges. Consequently, unexpected price deviations within the regulatory period create

[1] see control mechanism 6.2.5(c)(1) the AER must have regard to the need for efficient tariff structures.

[2] ENERGEX Proposal, 9.3.2 Justification of WAPC for Connection and Customer Services, page79

[3] COAG Energy Market Review (Parer Report) page 95, www.mce.gov.au/assets/documents/mceinternet/FinalReport20December2002.pdf

uncertainty for retailer's leaving the customer electricity prices at the risk of the retailer.

The EDSD report also criticised the revenue cap approach as it may lead to underinvestment in times of volatile growth and high load growth4 due to the entity's focus on financial outcomes. The report recommended this could be resolved through "off ramps" allowing for intervention when actuals are different from forecasts. This solution was implemented by the QCA in the 2005 determination. It is submitted this solution may result in administrative impacts increasing the regulatory burden and is an impact relevant to criteria 6.2.5(c)(2). The administrative costs of the AER and the distribution network service provider in reopening the determination during the regulatory period will increase the administrative burden for both parties and other stakeholders and ultimately will raise costs for users. Additionally, some users will be disadvantaged by the uncertainty created with unplanned price increases midway through the regulatory period and price risk is further increased for retailers. By utilising price cap regulation these cost uncertainties are removed.

Additionally, criteria 6.2.5(c)(4) seeks to attain consistency of arrangements for similar services. By moving to a price cap, consistency of approach would be maintained with the distributors in metropolitan areas such as the Victoria, New South Wales and South Australia thereby satisfying the criteria. Revenue cap regulation would then remain in the Ergon Energy distribution, Tasmania and ACT maintaining a consistent approach for these networks which have less demand and energy growth. For these networks, a revenue cap addresses the distributors' risk of uncertain demand .

Accordingly, Origin Energy takes the view that to meet the criteria[5] for deciding the appropriate control mechanism for network services, the benefits of a price cap mechanism is weighted against utilising the present revenue cap. A price cap mechanism will achieve the most efficient tariff structure.

Sub-transmission Connection Services

Origin does not agree with the proposal by ENERGEX to classify sub-transmission connection services as negotiated distribution services, at this point in time.

The regulatory framework classifies all "distribution services" as either a direct control service or a negotiated service. In classifying the services, the AER must have regard to the matters set out in cl 6.2.1(c)[6]. In particular, 6.2.1(c)(i) refers to form of regulation factors outlined in Section 2F of the National Electricity Law to determine which services are to be regulated.
In essence, 6.2.1(c)(i) requires an assessment of the potential for market power to be exploited by the service provider.[7] Given ENERGEX is a natural monopoly providing distribution services to customers in South East Queensland, the form of regulation factors should demonstrate a reduced level of market power for sub-transmission

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[4] Page 9 and 10, "Electricity Distribution and Service Delivery for the 21st Century" (EDSD report) 21 August 2006 located http://www.dme.qld.gov.au/Energy/independent_report.cfm

[5] clause 6.2.5(c) National Electricity Rules

[6] (1) the form of regulation factors; (2) the form of regulation previously applicable to the relevant service; (3) the desirability of consistency in the form of regulation for similar services; (4) any other relevant factor.

[7] Hansard Parliament of South Australia, House of Assembly, Thursday 27 September 2007, p964, located at www.parliament.sa.gov.au/Hansard/HistoricHansardAugust1993toSeptember2007.htm

connection services before the AER can logically reclassify these services outside of direct control.

Origin is concerned there is insufficient information to support an assessment of reduced market power in supplying this distribution service.

Origin accepts there is an argument to apply a less intrusive form of regulation where market power is less substantial and the potential for contestability can emerge. If ENERGEX can demonstrate potential contestability in the sub-transmission connection services, the AER has the ability to consider the move away from an intrusive control. For example, there is an opportunity for this service to operate within a light handed regulatory approach such as via the alternative control service approach. Noting Origin does not propose to make assertions as to the applicability of this service as an alternative control service, however would like to acknowledge the potential avenue for less intrusive regulation.

Origin is concerned a premature step to a negotiated service without proper evidence of contestability may render the market inefficient and open to less competitive outcomes. Origin has a preference for a progressive move within the direct control classification as an alternative control service. Such a move enables the AER to utilise a light-handed regulatory approach and enables ENERGEX to demonstrate its ability to provide a competitive service in a market which they hold a significant degree of market power. This also supports a well managed transition to a negotiated service.

The NER provides for a presumption the services currently regulated by the Queensland Competition Authority (QCA) will continue to be regulated by the AER *unless a different classification is clearly more appropriate*[8]. Sub-transmission connection services are prescribed distribution services in the 2005 determination[9]. If submitted for a different classification, ENERGEX must produce evidence which weighs against applying the presumption in 6.2.1(d). At this stage, ENERGEX has not submitted sufficient information to rebut this presumption.

To justify the classification ENERGEX relies upon other factors such as setting a minimum price, the need for funding certainty for larger connections and flexibility to provide timely services to major customers. Origin does not agree proposing a minimum negotiated price will prevent the exertion of market power and in fact it may facilitate it. In addition, Origin does not consider the regulatory classification of a service should impede the timeliness associated with providing the service. Accordingly, none of these matters support a more flexible regulatory approach or support the criteria within the NER.

Classification of services

Customer Services

[8] 6.2.1(d) specifies "*in classifying distribution services previously subject to regulation, the AER must act on the basis that, unless a different classification is clearly more appropriate there should be no departure from a previous classification.*"
[9] AER must have regard to this as part of the classification criteria in cl 6.2.1(c)(2) the form of regulation (if any) previously applicable to the relevant service or services and, in particular, any previous classification under the present system of classification or under the previous regulatory system (as the case requires).

The supplementary information from ENERGEX[10] (Appendix C) currently groups customer services under the category of DUOS services. Customer services are business costs that cannot exist without the network service (ie are not independent from the network service). These services exist as a means to provide continuity of supply to customers, enables billing for network services, provides for customer interaction and investigation of network problems. There is no ability to charge customers to recover the costs associated with the service, the services are not billable items and cannot be separately billed. Accordingly, the recovery of these costs must be via the network distribution charges. It is submitted for these reasons it is not appropriate to decouple from network services or to create independent pricing for customer services.

Enhanced Services

Origin seeks further explanation regarding the purpose and type of enhanced services available. Appendix C refers to six enhanced services which are not sufficiently described to appropriately classify these services.

Quoted Services

Origin seeks further explanation about the application of the Weighted Average Price Cap (WAPC) on quoted services. Each service requires an individual assessment and costs are then recoverable. Origin would be interested to understand how the WAPC will operate in such instances.

Street lighting and Coverage of Low Voltage Mains

- Street lighting is provided in connection with the distribution system and by nature, is part of the distribution system. Accordingly, street lighting services should remain regulated through the NER. Origin understands that not all aspects of the provision of street lighting services fall within the definition of distribution services, however it would not be appropriate to remove all aspects of street lighting from regulation. These comments apply equally to ENERGEX's and Ergon's proposal.
- Coverage of low voltage mains provide a safety measure directly related to the distribution service and therefore fall within the "distribution service" definition. It is appropriate these services remain classified.

Thank you for the opportunity to respond to the proposals put forward by the Queensland distributors. Should you wish to discuss please contact me on (03) 9652 5702 or Madonna Mead on (07) 3405 9255.

Regards

B J Hughson

Beverley Hughson
National Regulatory Manager
Retail

[10] Submitted by ENERGEX to the AER on 8 April 2008