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Introduction

Queensland Council of Social Service (QCOSS) is the state-wide peak body representing the interests of individuals experiencing or at risk of experiencing poverty and disadvantage, and organisations working in the social and community service sector. For more than 55 years, QCOSS has been a leading force for social change to build social and economic wellbeing for all people and communities in the state.

QCOSS is pleased to provide this submission in response to the Australian Energy Regulator's (AER) Preliminary Framework and Approach (F&A) paper for regulating Energex and Ergon Energy Regulatory Proposals for the 2020-25 period (RESET 2020-25).

We acknowledge that the F&A is the first step in a two year process to determine efficient prices for electricity distribution services in Queensland (Qld). In the F&A, the AER will determine, amongst other things, which services they will regulate and the broad nature of the regulatory arrangements. The F&A also sets out guidance on the form of control and matters including the incentive arrangements and the approach to depreciation.

QCOSS's submission focus on these issues:

- Service Classification for major customers, metering and other services;
- Forms of Control;
- Incentive arrangements; and
- Destroyed and/or obsolete assets.

Service classification

Service classification is an assessment of services based on the extent of their monopoly characteristics. This determines how the services offered by distribution networks are regulated, in particular which services the AER will regulate and how distributors will recover the cost of providing those regulated services. QCOSS regards this as an important process in the AER's strategic objectives to drive effective competition where it is feasible and provide effective regulation where competition is not feasible.

The AER has set out three broad types of services depending on the extent of their monopoly characteristics:

- Standard control: Services considered to be monopoly services and provided on a shared basis. These will be subject to direct price control under a revenue or price cap. All customers, regardless of customer class will pay for these services.

- Alternative control: Services subject to some prospect of competition and where the beneficiary is clear. These services will be subject to a price cap on a user's pays arrangement.
- Negotiated or unregulated: Services considered to be contestable and subject to a negotiation framework established by the AER or not regulated at all.

The AER is proposing a number of changes in classifications and QCOSS has provided some comments below on these proposed changes. In making these comments it would have been helpful to understand the materiality of the proposed changes in service classification on revenues and ultimately prices. QCOSS recommends that Energex and Ergon Energy document these changes in their regulatory proposals for RESET 2020-25. This will improve the transparency of the changes in classification. As QCOSS represents small residential customers it is especially important to understand the materiality of the changes for this customer class. QCOSS has commented on changes to services classification for Major Customers Connections, metering and other services.

Major customer connections

In the Preliminary F&A paper the AER is proposing to change the classification of major customer:

- augmentations from alternative control to standard control: and
- extensions from alternative control to standard control "*where the distributor considers there is a reasonable likelihood that the network extension will be used to supply another customer or customers within the time period set out in the distributor's Connection Policy (i.e. will form part of the shared network)*".¹

A change in classification to standard control would mean all customers pay for these services rather than just the major customers which request the extensions or augmentations and who are the beneficiaries of the investment.

The AER argues in the Preliminary F&A paper that it may make the change in classification because:

A key consideration for us in deciding whether to classify a distribution service is the extent and effectiveness of competition in the market for the service. We also take into account the existence and extent of any barriers to entry by alternative service providers. In preliminary discussions with the distributors, Energex indicated that around 70 per cent of the design and construction of contestable major customer connection assets are being provided by alternative providers. While in Ergon's distribution area, around half of new major customer connections are provided through competitors. As a result, we consider that the Qld distributors are still able to exercise considerable monopoly power in this market. (p. 29)

QCOSS does not agree with the AER position with respect to changing the classification for large customers and strongly advocates that all major customer augmentations and extensions should continue to be classified as alternative control services as they were in the Regulatory Period (RP) 2015-20.

In QCOSS's view, the above AER reasoning actually justifies retaining alternative control regulation of major customer connections and does not justify moving these services from alternative control to standard control services. Although there is some degree of monopoly service there is also a large contestable market, especially in the Energex area. Classifying these services as standard control is very likely to reduce competition in the provision of these services, as major customers will be able to

¹ Appendix B indicates that extensions major customer extensions would be alternative control but the text in the Preliminary F&A paper at pp. 28-29 indicates that some extensions would be standard control.

connect without paying specific charges for these services and services will not be provided by Energex and/or Ergon.

Furthermore, other reasons to retain alternative control are because the major customer is the beneficiary of the extension or augmentation, the major customer is identifiable, and no other parties benefit from the investment. This is consistent with the position that the AER has adopted in relation to ancillary services and streetlighting² as well as in South Australia RESET for these type of services. Further, where a second customer comes to benefit from that extension or augmentation within a reasonable period of time (7 years), distributors already have mechanisms in place to manage the situation by making the second customer pay the first customer an amount for sharing the benefit.

QCOSS is concerned that the position in the Preliminary F&A paper to allocate extensions to common distribution services “where the distributor considers there is a reasonable likelihood that the network extension will be used to supply another customer or customers within the time period set out in the distributor’s Connection Policy (i.e. will form part of the shared network)”, is very vague and non-transparent.

The problem with this approach is that it is very vague and non-transparent. In other words, it leaves the decision on where to allocate the expenditure between standard control services and alternative control services at the discretion of the distributors.

At the start of the 2020-25 regulatory period, the AER will have allowed an RP which will have an allocation for new connections within standard control services for major customers. In addition, distributors will be able to earn revenue directly from major customers for alternative control services. There is an incentive for distributors to overstate their forecasts of the likely number of major customers who may meet this criterion. They will receive a revenue allowance for this within standard control services (even if they do not meet the criterion) while also potentially earning additional money within alternative control services. Distributors can exercise their discretion in such a way as to require most major customers to pay through alternative services for network extensions.

Metering

QCOSS notes that the Queensland Government paid for 5,500 digital meters to be installed (and paid the upfront capital costs) in the Ergon distribution area prior to introduction of new metering arrangements under the Power of Choice Reforms in 1 December 2017. These meters were installed as part of the Energy Savvy Families Phase one project. They are Type 4 meters; however, they were installed prior to the Power of Choice Reforms. As such it is not clear if the amendments to the National Energy Retail Rules with respect to metering contestability apply to them.

The Queensland Government has announced a second phase of Energy Savvy Families estimated to cost \$4m and which will provide digital meters to 4,000 households. It is clear that these digital meters will be classified as Type 4 meters for the purposes of pricing. However, going forward it will be important that Ergon is not allowed to earn any capital costs associated with these meters.

² The Preliminary F&A paper states that the AER intends to classify ancillary services as alternative control “because the Qld distributors provide these services to specific customers ...even though ancillary services do not exhibit signs of competition or potential for competition.” (p. 29). The AER also intends to classify streetlighting as an alternative control service despite a level of monopoly control by the distributors through their control of access to poles for mounting streetlights because “the Qld distributors can directly attribute the costs ... to a specific set of customers” (p. 31).

QCOSS has raised this issue with the Queensland Competition Authority in a submission³ to its draft determination for Retail Regional Regulated Prices 2018/19. It has also been raised it with the Queensland Government through the Department of Natural Resources, Mines and Energy.

Other services

In Appendix B the AER lists some services that it proposes to move from unregulated to alternative control, including:

- Network related property services;
- Training third parties for network related access; and
- Security lights.

QCOSS supports this reclassification as these services require access to the network and therefore could not be offered by a third party, except with the network's cooperation. At the same time, the services are provided to specific customers, which makes it appropriate to classify them as alternative control rather than standard control services.

Forms of control

The Preliminary F&A paper also sets out the AER's proposals on controls over the prices (and/or revenues) of direct control services as required under the National Energy Rules (NER). For the Queensland RESET 2020-2025 the AER proposes to use a revenue cap (as opposed to a price cap) as the form of control for standard control services. In setting out their decision the AER states that:

A revenue cap will result in no additional administrative costs and allow for consistency of regulatory arrangements for standard control services both across regulatory periods and across jurisdictions. A revenue cap will also result in benefits to consumers through a higher likelihood of revenue recovery at efficient costs and will provide better incentives for demand side management. Furthermore, our recent approach to the operation of the revenue cap has reduced the magnitude of overall price variability during a regulatory control period, which has been a concern in the past. We provide our consideration of these issues below.⁴

In contrast, the Preliminary F&A paper argues that distributors may understate demand under a price cap to earn more revenue (above efficient cost levels). The AER points out that "A systematic recovery of revenue above efficient cost recovery results in higher bills for consumers".

While QCOSS is concerned about any policy that puts pressure on bills it must be noted that distributors need to balance this incentive against the risk that if they understate demand, they will be awarded less capex (and associated opex). Under a revenue cap, distributors have a clear incentive to overstate demand and associated required capex (and related opex) to maintain the capex once assets are built), rather than the balance of countervailing incentives that applies under a price cap.

There is a significant history of overstated future demand and associated over-allocation of capex in past regulatory decisions. The AER have tried to counteract these incentives in part by introducing a Capital Expenditure Sharing Scheme (CESS) to provide countervailing incentives to underspend capex. For example, in the RP 2010-15, Energex was awarded \$6.2458 billion but actually spent \$4.4207 billion (both nominal dollars), even though arguably it overspent relative to what was required to meet demand.⁵ The error resulted from a major over-forecast of demand and therefore required

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⁴ AER 2017 Preliminary Framework and Approach, P38

⁵ Energex RP Summary 2015-2020, p. 10

capital expenditure. It is noted that the final RP 2010-15 did not restrain Energex from spending the additional \$1.8251 billion that it was allocated. Instead, the Queensland Government as the owner of Energex stepped in part way through RP 2010-15 to restrain Energex from spending the full capital allowance.

If a price cap was in place during RP 2015-20, it may have corrected for the forecasting errors in the RP. It could have acted as a mechanism to restrain the spending of the over-allocation, because as demand fell, the over-expenditure would not have been returned in the form of revenue.

Overall, a price cap is likely to:

- Constrain distributors from spending allowed capex where they see demand could fall. This may provide a better incentive than the CESS for distributors to constrain capex; and
- Encourage distributors to estimate demand than a revenue cap would do.

Further, the Preliminary F&A paper argues that a price cap may undermine incentives for demand management. However, distributors have not exhibited a tendency to manage demand under revenue caps to date and Energex has not taken up all of the management innovation allowance mechanism. It remains to be seen how successful the new demand management incentive scheme published by the AER in December 2017 will be in providing incentives for demand management.

The choice between a price cap and a revenue cap critically depends on whether the environment is one of rising, flat, or falling demand. Given that there is an increasingly uncertain environment for forecasting demand with emerging technologies, tariff reform and more energy efficient appliances there is a need for further analysis of the pros and cons of each form of control. Consequently, QCOSS recommends that the AER should conduct a more comprehensive review, including a public consultation process, of the respective advantages of revenue versus price caps and their related incentives. That review process could occur across the NEM networks regulated by the AER.

Incentive arrangements

Overall, QCOSS would prefer the AER to apply a mix of incentives and penalties to distributors rather than a set of incentive arrangements alone.

At present, there are effectively no penalties for distributors who underspend their allowed revenue. For example, instead of a Capital Expenditure Sharing Scheme (CESS), penalties could apply for spending more capital than required in view of actual demand (as distinct from the demand forecast at the start of the RP). At present, distributors are entitled to spend the full amount of the capital allowance even if it is not required to meet demand. Where the distributor has not overspent its capital allowance, there is no realistic prospect that allowed capex will be excluded from the Regulatory Asset Base (RAB) on the basis that it was not necessary. This overspending can provide upward pressure on prices, impacting on consumers.

Service target performance incentive scheme (STPIS)

The AER's distribution STPIS provides a financial incentive to distributors to maintain and improve service performance. It operates as part of the building block determination and contains two mechanisms:

- A guaranteed service level (GSL) component composed of direct payments to customers experiencing service below a predetermined level. This component only applies if there is not another GSL scheme already in place.
- The service standards factor (s-factor) adjustment to the annual revenue allowance for standard control services rewards (or penalties) distributors for improved (or diminished)

service compared to predetermined targets. Targets relate to service parameters pertaining to reliability and quality of supply, and customer service.

The AER is proposing to not apply the GSL component of the national STPIS while the GSL arrangements in the Queensland remain in place. QCOSS supports this approach but would however ask that the AER compare its GSL Scheme with that regulated by the QCA to identify any inconsistencies between the schemes. It is also noted that the QCA is currently undertaking a review of its distribution GSL scheme and QCOSS has made a comprehensive submission⁶ where it has made a number of recommendations to improve the equity and effectiveness of the GSL Scheme.

The AER's approach with respect to the s-factor is to apply the national STPIS to the Queensland distributors in RESET 2020–25 by setting revenue at risk for each distributor within a range of ± 5 per cent. This is a departure from previous practice when the revenue at risk was set at ± 2 per cent.

QCOSS supports a STPIS to provide incentives for distributors to maintain service quality. However, QCOSS does not support increasing the revenue at risk from ± 2 per cent to ± 5 per cent. The last major review of reliability in Queensland was by the Independent Review Panel on Network Costs prior to RP 2015-2020. The Panel⁷ found that reliability standards were too high and that this was feeding into prices that were:

- well above the point where users were willing to pay for them; and
- which were causing financial hardship and energy poverty for a significant number of users.

This is supported by Queensland Households Energy Survey 2017⁸ has found:

- That bill concern has increased significantly to the highest levels yet recorded, with 51% of South East Queensland households and 59% of regional Queensland households being concerned about their ongoing ability to pay their electricity bill; and
- Consumers have not expressed a wish for increased service at a higher cost with 72 per cent of households not wanting any change to the balance between electricity costs and reliability. Only six per cent said that they would pay more for increased reliability.

The AER stated as part of the Better Regulation Program that capex and opex programs should be based on consumer preferences. Accordingly, it should be up to Energy Queensland across both networks to demonstrate that customers would be willing to pay 5 per cent more for an improvement in reliability. QCOSS asks that if the AER implements a s-factor of ± 5 per cent that it should consult carefully with Queensland consumers and require distributors to provide proof through their consumer engagement programs that consumers wish to pay more for increased reliability in the services standards.

Capital expenditure sharing scheme (CESS)

The CESS provides incentives for distributors to undertake efficient capex throughout the regulatory control period by rewarding efficiency gains and penalising efficiency losses. The CESS approximates efficiency gains and efficiency losses by calculating the difference between forecast and actual capex. It shares these gains or losses between a distributor and network users on a 30/70 basis.

⁶ QCOSS (2018) [Submission](#) to the Review of the Queensland Distribution Guaranteed Service Levels

⁷ Independent Review Panel (2013) Review into networks costs

⁸ Energy Queensland (2018) Queensland Household Survey 2017 Insights Report, P18. This can be retrieved [here](#).

The AER proposed to retain the CESS on a 30/70 basis between distributors and consumers, that is distributors retain 30 per cent of savings in capex compared to allowed capex.

QCOSS considers that a CESS only works if the regulator can accurately forecast demand and actual capex. Otherwise, there is an incentive to overstate demand and hence greater forecast capex. This allows for a windfall to the distributor when there is an underspend and distributors are allowed to keep 30 per cent of the difference in the next regulatory period. This also puts upwards pressure on prices and customers' bills.

In situations where there are non-network alternatives to capital spending, the new demand management incentive scheme (DMIS) provides incentives to install demand management instead of spending capital on the network. There should be an adjustment to either the CESS or the DMIS to avoid providing rewards under both schemes when there is a capital underspend.

Assets that are destroyed or taken out of service (obsolete assets)

It is understood that distributors continue to earn a return on assets and a return of assets (depreciation) that have been destroyed (for example during a cyclone) or otherwise taken out of service, until the assets are fully depreciated. That is they remain in the asset base for the period of their economic life.

This raises three issues:

- Is there a transparent process of excluding these destroyed assets from earning an opex allowance?
- If distributors are earning a return on destroyed assets, is it reasonable to allow distributors to include the cost of insurance or self-insurance premiums in their regulated revenues? Arguably if these assets are still in the distributor's asset bases then they are not able "to suffer a loss" and should not be compensated for the cost of insurance or self-insurance.

Again, if distributors are still earning a return on and of destroyed assets, should they be able to access pass-through arrangements other than for opex costs? Pass-through arrangements aim to compensate distributors for large, unplanned losses. However, if the destroyed assets are still in the distributors' asset bases for pricing purposes and still earning an income then has the distributor incurred a financial loss?

QCOSS is seeking guidance from the AER in the Final F&A paper on its likely approach to these issues.