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1. About this document

The document details the consultation that Ergon Energy has undertaken with its Customer Council AER2015 Working Group. It has been prepared by Ergon Energy to record the conversations that have inform the preparation of its Regulatory Proposal for the next regulatory control period, 1 July 2015 to 30 June 2020.

This document is structured as follows:

- Section 2 details the Working Group’s nature, purpose, membership and meeting dates in 2014
- Section 3 details the Working Group discussions about the development of the regulatory proposal and supporting document and the engagement process that Ergon Energy has undertaken
- Section 4 details the Working Group discussions about the distribution services that Ergon Energy provides
- Section 5 details the Working Group discussions about the regulatory framework that Ergon Energy will operate under in the next regulatory control period
- Section 6 details the Working Group discussions about the incentive schemes that Ergon Energy will operate under in the next regulatory control period.

2. About Ergon Energy’s Customer Council Working Group

This section details the Working Group’s nature, purpose, membership and meeting dates.

2.1 Nature and purpose

Ergon Energy is due to submit its Regulatory Proposal to the Australian Energy Regulator (AER) by 31 October 2014 for its next regulatory control period, 1 July 2015 to 30 June 2020.

Ergon Energy has been seeking to understand customers and the community’s views and concerns to inform the development of its Regulatory Proposal. It has undertaken a customer and stakeholder engagement program for this purpose and has established the Customer Council AER2015 Working Group. The Working Group’s Charter (which is re-produced at Appendix A) envisaged that it would provide a forum for Ergon Energy to validate the direction of its regulatory proposal and to explore customer impacts of related regulatory or specific business decisions. The Working Group is advisory in nature and is not a decision making body. Decisions rest with Ergon Energy.

The Working Group:

- Provided advice to Ergon Energy about customers’ needs, issues and services
- Provided feedback on specific issues that Ergon Energy raised with it
- Acted as a link to and from member organisations about the Working Group’s agenda
- Reported to Ergon Energy’s parent Customer Council to help it understand the Regulatory Proposal.

Importantly, Ergon Energy did not present the Working Group with draft forecasts of its expenditure or Annual Revenue Requirements for the next regulatory control period. The Working Group did not, therefore, validate the overall direction of the Regulatory Proposal or key assumptions about costs.
However, Ergon Energy did present potential scenarios and then draft forecasts to a meeting of consumer advocacy group representatives in September 2014. All Working Group members were invited to this meeting and many attended. Additional advocacy group representatives also attended.

2.2 Membership

The following organisations are members of the Working Group, which represent the diversity of Ergon Energy’s customer base:

- Chamber of Commerce and Industry
- Local Government Association of Queensland
- Queensland Council of Social Service
- Council of the Aged Queensland
- Queensland Farmers Federation
- Canegrowers
- Energy Users Association of Australia.

Representatives of Ergon Energy also attend and provide input to the Working Group meetings. The Working Group was chaired by an independent facilitator who was retained and paid by Ergon Energy to perform this role. The independent facilitator is impartial and referred information to and from the Working Group and Ergon Energy outside of formal meetings, as required.

2.3 Working Group Meetings

The Working Group met on the following dates in 2014:

- 16 April, in person
- 19 May, by teleconference
- 18 June, in person
- 22 July, in person
- 28 August, in person.

3. Engagement process

This section details what Ergon Energy and the Working Group discussed about the engagement process that Ergon Energy has now undertaken, the development of the regulatory proposal and the supporting documents.

3.4 Outcomes of consultation

Ergon Energy understands that members of the Working Group found the meetings to have provided a valuable forum to:

- Better understand the regulatory framework under which Ergon Energy provides its distribution services
- Clarify how the regulation of distribution services, and the development of distribution prices, fit into the build-up of retail electricity prices that are charged to end customers
Customer Council AER2015 Working Group Report

- Understand Ergon Energy’s considerations in developing its Regulatory Proposal, including how it addresses the Rules’ requirements and responds to the AER’s Better Regulation Reform Program
- Discuss issues Ergon Energy has identified as being important to the next regulatory control period, particularly where they are either new or where Ergon Energy considers a change in approach is required from what has applied in the current regulatory control period
- Provide input and share views and opinions about other matters relevant to Ergon Energy’s Regulatory Proposal and the basis on which it provides its distribution services, including advice on customers’ needs
- Meet and share experiences with other stakeholders who also have a strong interest in the provision of Ergon Energy’s distribution services
- Provide a link to and from their respective member organisation networks in order to facilitate stakeholder feedback from these networks into the Working Group’s agenda.

3.5 Regulatory proposal and supporting documentation

Ergon Energy explained the importance it sees in the Regulatory Proposal and supporting documentation being written in a manner that is accessible to interested stakeholders and that supports effective engagement after the Regulatory Proposal has been submitted.

Ergon Energy provided the Working Group with:

- Links to the NSW distribution network service providers’ (DNSPs) Regulatory Proposals and supporting documentation
- References to the National Electricity Rules’ requirements about the Overview Document and Regulatory Proposal

The Working Group meeting on 22 July 2014 discussed this documentation.

The Working Group emphasised to Ergon Energy the need for its Regulatory Proposal and supporting documentation to:

- Provide price relief to customers while meeting customers’ expectations of reliability standards. This was especially mentioned by the representatives from the business sector
- Explain how the forecast expenditure in the Regulatory Proposal is prudent and appropriately planned
- Be transparent about the drivers of costs, for example about the maintenance of assets commensurate with service standards and the alignment of forecast expenditure and demand
- Show that the cost of capital is based on the prudent and efficient assumptions.

The Working Group suggested that Ergon Energy’s Regulatory Proposal and supporting documentation would benefit from:

- Discussing the cost drivers, and future risks and assumptions, more fully than what the NSW DNSPs did in their Overview Documents
- Clearly focussing on customer outcomes
- Explaining how Ergon Energy is responding to emerging technologies and seeking to drive improvements through innovation.
The Working Group:

- Supported Ergon Energy’s focus on the importance of electricity being an essential service.
- Expressed some concern about Ergon Energy’s use of the term ‘Best Possible Price’ and emphasised the need for it to be put in the context of value for money and prudent and efficient expenditure.
- Emphasised the need for Ergon Energy to explain the implications of its Regulatory Proposal on customers’ retail electricity bills, although the Working Group recognised the difficulty of doing this for all of the different customer groups, especially given the large proportion of customers that are not exposed to Ergon Energy’s Distribution Use of System charge in its regulated retail price.
- Expressed interest in gaining a greater understanding of the regional demand forecasts, and how they differ by location.
- Emphasised the importance of Ergon Energy supporting its expenditure forecasts with benchmarking data, making clear the differences in Ergon Energy’s operating environment to other Australian DNSPs and how this impacts on its decisions.

4. The service

This section details what Ergon Energy and the Working Group discussed about the distribution services that Ergon Energy provides.

4.6 Affordability

Ergon Energy advised the Working Group that its customer research indicates that the cost of electricity is a significant issue for its customers.

Ergon Energy advised that its expenditure proposals for the next regulatory control period are being developed with the goal to reduce its part of customers’ electricity bills – that is the average network tariffs – and ensure increases over the five-years are kept under inflation.

The Working Group:

- Agreed that affordability of electricity is a critical issue for customers. Customers are looking at ways to reduce their electricity bills and are generally not willing to pay more for higher levels of service.
- Noted that customers’ focus on the final retail electricity bill that they pay, although they recognise that distribution costs are an important component of that bill. It is therefore important always to consider distribution costs in the context of customers’ final retail electricity prices.
- Supported Ergon Energy’s commitment to reducing its part of the electricity bill.
- Supported exploring all opportunities, including through demand management approaches, to deliver the lowest possible distribution prices in the next regulatory control period whilst:
  - delivering prudent and efficient expenditure outcomes.
  - maintaining reliability performance outcomes in line with customers’ expectations across the network.
Raised the matter of asset utilisation. This led to conversations off line and at subsequent meetings around the incentive for network service providers to address asset utilisation. The group were advised that this is a key strategy for Ergon Energy in addressing prices.

4.7 Reliability performance standards

Ergon Energy advised the Working Group that its customer survey indicates that customers:

- Recognise that the reliability of supply has improved but that they have now reached a tipping point where they are no longer willing to pay more for further improvement in reliability (except in those areas where reliability is still poor). Many customers would in fact accept more frequent and longer outages, if it meant a decrease in their bill.
- Reliance on electricity, their current reliability experience and their geographical location can impact their willingness to pay for different reliability standards:
  - customers have a preference not to be impacted at certain times: for business generally their most critical hours are 7am-1pm and for residential customers it is 5pm-8pm
  - those who feel that they are ‘frequently impacted’ by outages consider both ‘price’ and ‘length of outage’ to be important, while those ‘barely impacted’ see ‘price’ as of most concern
  - residential customers inland from the coastal population centres, which typically experience more outages, have a slightly higher willingness to pay for reliability improvements than customers in coastal locations
- Value Ergon Energy’s local presence and its disaster response and support maintaining existing local depots and improving the network’s resilience to severe weather
- Want Ergon Energy’s current service standards to remain as they are, with improvements around the delivery of new connections
- Want one week’s notice before Ergon Energy conducts a planned outage. For unexpected outages, they want updates on restoration times to be available within the hour. However, few believe funds should be prioritised to deliver improvements in these areas
- Do not want to compromise on safety.

The Working Group noted the outcomes of Ergon Energy’s customer research and considered that Ergon Energy’s focus should be on:

- Improving the reliability performance on its existing worst performance feeders
- Increasing the network’s resilience to severe weather and maintain a strong disaster and storm response capability
- Increasing its use of non-network alternatives, wherever feasible.

4.8 Network for the future/emerging technology

Ergon Energy advised the Working Group that its customer research indicates that, despite price being a major concern, customers still support Ergon Energy incurring expenditure to transition towards a smart network in order to allow customers to take up emerging technologies.

Ergon Energy emphasised its need to constantly upgrade the network and evolve the management of it to stay relevant into the future. It highlighted how the take up of air conditioning and solar has changed when and how customers use the network. It foreshadowed that even greater technological
advancements, such as electric vehicles, battery storage and new energy control systems may have an even greater impact on customers’ expectations of the network.

Ergon Energy suggested that, as this new world emerges, it will need to be increasingly ‘information enabled’ and use new technologies to help deliver the service standards customers expect at an affordable price.

Ergon Energy also highlighted the need to make sure that the way it charges for the use of the network best reflects the costs associated with the way different customers use it. It indicated that this requires replacing existing meters with more advanced meters. This could benefit customers by providing them with more information on their electricity supply and to help them better manage usage and reduce bills.

The Working Group noted Ergon Energy’s proposal to transition towards a smart network in order to allow customers to take up emerging technologies. The Working Group noted that this needs to be managed within Ergon Energy’s commitment to reduce its part of the electricity bill and to deliver price reductions in the next regulatory control period. The Working Group emphasised the need for any investment to be carefully managed and demonstrated to be prudent and efficient.

4.9 Metering charges

Ergon Energy advised the Working Group that:

- The majority of metering services are currently classified as Standard Control Services and are included in its DUOS charges
- The AER is proposing to reclassify metering services to become Alternative Control Services in the next regulatory control period. A key reason the AER has given for this change is to facilitate future competition for metering services
- The change in service classification will require Ergon Energy to unbundle metering costs and to levy a separate metering charge (i.e. in addition to DUOS charges)
- There are options for how revenues and prices will be determined for metering services. Ergon Energy indicated that it is evaluating the following charging options:
  - an upfront charge for new and additional meters (labour costs only) plus $/day charge for other metering services (materials, maintenance, reading, provision of data)
  - an upfront charge for new and additional meters (labour and materials costs) plus $/day charge for other metering services (maintenance, reading, provision of data)
  - a $/day charge for all metering services.

The Working Group noted the AER’s rationale for wanting to change the classification of metering services in order to remove any impediments to future competition in the provision of metering services. However, the Working Group expressed concern about the potential for the reclassification to cause a perverse outcome of increasing the total retail charges for those customers who are supplied under the regulated retail tariffs.

This could arise because the Queensland Competition Authority (QCA) only considers network costs associated with Standard Control Services in determining regulated retail tariffs (albeit that they are Energex’s, not Ergon Energy’s, network costs that it considers). Because (Energex’s) metering services are currently Standard Control Services and are recovered through its distribution use of system charges, they are factored into the regulated retail tariffs. The QCA would not consider
metering costs in setting its regulated retail tariffs if metering services became Alternative Control Services.

The Working Group expressed concern that the sum of the QCA’s regulated retail tariffs and the AER’s regulated metering charges may be greater than if (Ergon Energy and Energex’s) metering services remained Standard Control Services. Put differently, the Working Group was concerned that the practical effect of the AER’s proposed decision for customers who pay regulated retail tariffs would therefore be to introduce a new charge that could increase their total electricity bills.

The Working Group suggested that the AER, the QCA, the Queensland Government, customer representatives and Ergon Energy should work together to ensure that a potential perverse outcome does not occur.

4.10 Demand forecasts

Ergon Energy explained to the Working Group that:

- Peak demand on its network occurs during the summer months, lasts for only short periods and fluctuates from year to year
- Peak demand is the main driver of network augmentation investment
- Since it forecast peak demand for the current five-year regulatory control period, Ergon Energy has further developed its forecasting techniques and now incorporates the use of econometric and demographic metrics to ensure our forecasts are robust and reproducible.

Ergon Energy indicated that it is expecting an average annual system peak demand growth of 1.3% per annum in the next regulatory control period. It further explained that this is the system-wide forecast only and that investment is driven at the local level if a capacity constraint is identified. Ergon Energy’s planners use the low growth scenario when testing response to a potential constraint.

Working Group members raised concerns about Ergon Energy’s demand forecast being higher than that being forecast by AEMO. Ergon Energy noted that Queensland load growth without LNG growth is flat overall, however, at the system level some LNG associated load is anticipated.

Ergon Energy informed the Working Group about the changes to the security criteria that have been introduced by the Queensland Government.

Ergon Energy explained to the Working Group how it was responding to demand using both traditional network solutions (frequently modular to avoid upfront investment) and alternative non-network solutions.

5. Regulatory framework

This section details what Ergon Energy and the Working Group discussed about the regulatory framework that Ergon Energy will operate under in the next regulatory control period.

5.11 Classification of services

Ergon Energy discussed with the Working Group the AER’s Framework and Approach Paper, which proposed changing the classification of the following services for the next regulatory control period, as detailed in Table 1.
<table>
<thead>
<tr>
<th>Service</th>
<th>Current classification</th>
<th>Proposed classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commissioning and energisation of large customer connections</td>
<td>Standard Control</td>
<td>Alternative Control</td>
</tr>
<tr>
<td>Real estate development connection</td>
<td>Standard Control</td>
<td>Alternative Control</td>
</tr>
<tr>
<td>Removal of network constraint for embedded generator</td>
<td>Standard Control</td>
<td>Alternative Control</td>
</tr>
<tr>
<td>Accreditation of alternative service providers and approval of their designs, works and materials</td>
<td>Standard Control / Alternative Control</td>
<td>Alternative Control</td>
</tr>
<tr>
<td>Type 5 and 6 metering installation, provision, maintenance, reading and data services</td>
<td>Standard Control</td>
<td>Alternative Control</td>
</tr>
<tr>
<td>Auxiliary metering services</td>
<td>Standard Control / Alternative Control</td>
<td>Alternative Control</td>
</tr>
<tr>
<td>Services provided in relation to a Retailer of Last Resort (ROLR) event</td>
<td>Not currently classified</td>
<td>Alternative Control</td>
</tr>
<tr>
<td>Emerging public lighting technology</td>
<td>Not currently classified</td>
<td>Alternative Control</td>
</tr>
<tr>
<td>Emergency recoverable works</td>
<td>Alternative Control</td>
<td>Unclassified</td>
</tr>
<tr>
<td>High load escorts</td>
<td>Alternative Control / unclassified</td>
<td>Unclassified</td>
</tr>
</tbody>
</table>

Table 1: AER’s proposed changes in service classifications, 2015-20

Ergon Energy explained that it intended to accept the AER’s proposed classification of services in its Regulatory Proposal. It further explained that:

- The main implication for those services that are reclassified from a Standard Control Service to an Alternative Control Service is that the costs of providing the service will be recovered through charges levied directly on the customer requesting the service, rather than being spread across all customers.
- The classification of services provided in a relation to a ROLR event and emerging public lighting technology will allow Ergon Energy to explicitly recover AER-approved costs of providing those services.
- The change in classification for emergency recoverable works and high load escorts to “unclassified” means that the AER will have no regulatory oversight over these services in the next regulatory control period.

The Working Group noted that the practical effect of the AER’s proposed reclassification of Standard Control Services to Alternative Control Services for those customers who pay regulated retail tariffs would be to introduce new charges.

As discussed in section 4.9 in relation to metering charges, the Working Group expressed concern that there is the potential for this to result in a perverse outcome of increasing end customers’ total electricity charges, given the way in which:

- Regulated retail tariffs and Alternative Control Service charges are separately determined by the QCA and AER respectively.
• The Community Service Obligation is currently administered by the Queensland Government. The Working Group considered that the AER, the QCA, the Queensland Government, customer representatives and Ergon Energy should work together to ensure that the reclassification of services does not result in any perverse outcomes for end customers.

5.12 Carry forward of revenue under-recoveries

Ergon Energy explained to the Working Group that:

• Under a revenue cap form of control, its revenues are adjusted to clear any under/over recoveries of actual DUOS revenue from year to year
• This ‘unders and overs’ process is undertaken as part of annual pricing and ensures Ergon Energy recovers no more or no less than the Maximum Allowable Revenue approved by the AER for any given year
• Clearing of DUOS under/over recoveries is subject to tolerance limits set by the AER
• Where tolerance limits are triggered, Ergon Energy is required to spread DUOS under/over recoveries over multiple regulatory years, instead of clearing the entire under/over recovery in setting prices for the forthcoming year
• Ergon Energy first exceeded the tolerance limits that apply to clearing DUOS unders/overs in 2012-13
• The AER approved Ergon Energy’s proposal to introduce a longer term plan to clear DUOS under-recoveries associated with the 2010-15 period in its 2012-13 Pricing Proposal
• Ergon Energy’s DUOS under-recovery plans allows it to:
  – progressively clear the balance of the DUOS unders and overs account in setting prices during the 2010-15 period
  – clear any residual balance left in the DUOS unders and overs account at end of period, through a carry-over adjustment in the Post Tax Revenue Model (PTRM).
• Ergon Energy’s current estimate is that it will have a closing balance of approximately $54 million in its DUOS unders and overs account at the end of the period
• The specifics of how the carry over adjustment will be calculated and entered into the PTRM are still subject to discussion with the AER although Ergon Energy has proposed the following approach to the AER:
  – adjust the closing balance of the 2014-15 DUOS unders and overs account by the Weighted Average Cost of Capital, in order to calculate the amount of the carry over in $2015-16 nominal terms. This is consistent with the current approach applied in the current DUOS unders and overs account to arrive at an opening balance for each year
  – De-escalate the above amount by CPI to arrive at the total carry-over amount in $2014-15 real terms. Ergon Energy proposes to use the same out-turn CPI that is used in the Maximum Allowed Revenue formula in our 2014-15 Pricing Proposal
  – Allow Ergon Energy the discretion to decide the profile of how the carry-over amounts should be entered into the PTRM, and for the AER to approve this through the Distribution Determination process. This approach will allow Ergon Energy to use the carry-over as one of the ‘levers’ and mechanisms to help smooth out any expected volatility in customer prices in the next regulatory control period”.
The Working Group noted the issue of the carry forward of revenue under-recoveries and that the AER’s Framework and Approach paper states that the AER will “continue to liaise with Ergon Energy on its over or under-recovery, and on how this may be managed”\(^1\).

### 5.13 Feed-in tariffs

Ergon Energy explained to the Working Group that:

- On 1 July 2008, the Queensland Government introduced the Solar Bonus Scheme (SBS) to provide eligible customers with credit for the surplus electricity generated by solar photovoltaic (PV) systems and exported into the Queensland electricity network;
- Ergon Energy is liable to pay the amount of the Feed-in Tariff (FiT) credited to the PV customer by the retailer.
- The AER’s Distribution Determination for the current regulatory control period included the actual FiT amount paid to customers as a pass through event. It adopted a two year lag between incurring the difference between forecast and actuals and the resulting adjustment to allowable revenue.
- Changes to the National Electricity Rules mean that in the next regulatory control, the amount paid to customers under the SBS is expected to be treated as a jurisdictional scheme amount, rather than a cost pass through.
- The total amounts relating to the SBS to be recovered in the first two years of the next regulatory control period will be the sum of the pass through amounts from the last two years of the current regulatory control period and the jurisdictional scheme amounts. This results in a significant increase in the quantum of SBS amounts recovered in the first two years of the next regulatory control period, as illustrated in the following diagram.

Ergon Energy indicated that it wants to mitigate the price impacts of transitioning from the current cost pass through arrangements for the SBS payments to a jurisdictional scheme. Ergon Energy further indicated that it is in discussions with the AER about how this is best managed, and that it has identified four potential options for achieving a smoothed price for customers:

- Option 1: Spreading the FiT pass through amounts across the five years of the next regulatory control period.
- Option 2: Early adoption of the SBS as a jurisdictional scheme.
- Option 3: Spreading the jurisdictional scheme amounts for 2015-16 and 2016-17 across the five years of the next regulatory control period.
- Option 4: Delaying the recovering of the annual jurisdictional scheme amount by two years.

The Working Group noted the issue of transitioning from the current cost pass through arrangements for the SBS payments to a jurisdictional scheme. It also noted that the AER’s Framework and Approach paper states that the AER will “consider treatment of solar feed-in tariffs as part of our distribution determination. We are unable to confirm which mechanism we will use to adjust Ergon Energy's revenues. In the meantime, we will liaise with Ergon Energy on this issue”\(^2\).

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5.14 Confidentiality

Ergon Energy explained to the Working Group that:

- The AER has developed a new Confidentiality Guideline that sets out how Ergon Energy must make any confidentiality claims over information that it may submit to the AER.
- The AER has strongly encouraged Ergon Energy to develop its own confidentiality arrangements prior to the submission of their proposals.
- If this does not occur, the AER is more likely to use their information disclosure powers under the National Electricity Law to authorise disclosure.

Ergon Energy further explained that it will need to consider:

- What documents will it not submit as supporting documents to its Regulatory Proposal?
- How will these supporting documents be submitted to the AER?
- When will the supporting documents be submitted to the AER?
- How will confidential documents be treated for the Regulatory Proposal?

Ergon Energy noted that:

- Onus is on Ergon Energy to provide total operating and capital expenditure forecasts to the AER for the upcoming regulatory control period.
- There do not appear to be any provisions in the Rules that suggest the AER must take into account information that is referenced, but not provided.

Ergon Energy also noted that, under the AER’s Confidentiality Guideline, it is encouraged to engage in pre-lodgement discussions with stakeholders. The aim of these discussions is to resolve confidentiality issues prior to the regulatory proposal submission and for Ergon Energy to develop its own methods of sharing information. Ergon Energy indicated that it will participate in pre-lodgement discussions to:

- Engage with stakeholders about the types of information they need access to in order to understand and assess the substance of all issues arising from Ergon Energy’s information.
- Present information in a way that still maintains confidentiality but simultaneously provides other stakeholders with enough information to understand and assess the substance of all issues affecting their interests. Ergon Energy indicated that this could be achieved through any of:
  - minimal redactions
  - narrower confidentiality claims
  - provision of detailed information adjusted to protect sensitive elements
  - limited release of confidential information, such as through confidentiality undertakings.

Ergon Energy indicated that it intended to:

- Publish most supporting documentation on Ergon Energy’s website when it submits its Regulatory Proposal.
- Not publish information that is confidential or subject to stakeholder undertakings, although it will make it available to the AER in a clear and transparent (and replicable) manner.
- Upload some material onto its website before the Regulatory Proposal is submitted in order to facilitate customer engagement.
- Develop a consumer-friendly web design that can enhance stakeholders’ capacity to understand the issues
- Hold a Working Group meeting to answer questions relating to the information provided.

The Working Group noted the AER’s new Confidentiality Guidelines and indicated that it looked forward to:

- Continuing to engage with Ergon Energy about the information that it will make available with its Regulatory Proposal, including how it will treat the specific information that it considers to be confidential
- Engaging with Ergon Energy about confidential information that may appropriately be subject to limited released if stakeholders enter into appropriate confidentiality undertakings
- Reviewing information that Ergon Energy uploads onto its website before the Regulatory Proposal is submitted
- Reviewing the consumer-friendly website that Ergon Energy intends developing to enhance stakeholders’ capacity to understand issues relevant to its Regulatory Proposal.

5.15 Cost of capital

Ergon Energy explained to the Working Group the importance of the rate of return building block in the Annual Revenue Requirement. It explained the Rules’ requirements and the AER’s proposed approach to estimating rate of return set out in its Guidelines, as illustrated in the diagram below.

Ergon Energy highlighted that the AER’s Guidelines are not binding on either the AER or Ergon Energy, but that both parties are obliged to explain any departures that they may make from the Guidelines.

Ergon Energy discussed its proposed approach to estimating the rate or return. It indicated that it is proposing to depart from the Guidelines in relation to:

- Return on equity model
- Market Risk Premium
Ergon Energy emphasised to the Working Group that what it includes in its Regulatory Proposal will only be a placeholder as the AER’s final approach, and the averaging period that is used to prospectively determine rates, will determine the final outcome. The reason that the AER keeps the final averaging period confidential was also explained (i.e. to avoid the potential to impact finance market outcomes to customers’ detriment).

Ergon Energy discussed with the Working Group how it compared to an efficient, privately owned business from a cost-of-capital perspective.

Some Working Group participants expressed the view that Ergon Energy’s return on equity was comparatively high.

There was also a strong message from several participants that they were expecting Ergon Energy to follow the AER’s guidelines for setting the Weighted Average Cost of Capital (WACC) without change or provide a valid explanation as to why Ergon Energy was seeking to depart and how those reasons were quantified. Everyone recognised the significance of the WACC on future network charges.

In our Regulatory Proposal we have proposed inputs and methodologies that we think best meet the requirements in the National Electricity Rules around estimating an appropriate rate of return.

The AER will ultimately set the rate of return based on an efficient, forward-looking benchmark for finance costs, rather than the actual costs to individual businesses. Being forward looking, the AER will ultimately apply a WACC commensurate with the most up to date financial market information at the time of its determination. In the meantime, the WACC in our Regulatory Proposal should only be considered a placeholder.

6. Incentive schemes

This section details what Ergon Energy and the Working Group discussed about the incentive schemes that Ergon Energy will operate under in the next regulatory control period.

6.16 Service target performance incentive scheme

Ergon Energy explained to the Working Group that:

- The AER’s Framework and Approach paper says its likely approach will be to apply the national Service Target Performance Incentive Scheme (STPIS) to Ergon Energy in the next regulatory control period
- The national STPIS requires the AER to determine specific variables to apply in the scheme
- The STPIS would operate concurrently with Queensland minimum service standards and guaranteed service level scheme, as it does in the current regulatory control period
- The STPIS would apply through an “S-factor” adjustment to annual revenue requirement for Standard Control Services (i.e. “incremented” for better performance and “decremented” for worse performance).
Ergon Energy also explained that the AER proposed that the following variables be used in the STPIS as applies to Ergon Energy:

- Revenue at risk of a maximum – +/- 2 per cent of the Annual Revenue Requirement
- Parameters – reliability (i.e. system average interruption duration index and system average interruption frequency index) and customer service (i.e. telephone answering);
- Network segmentation – urban, short rural and long rural feeders
- Performance targets – based on average performance over past five regulatory years
- Incentive rates – for reliability, expressed as a percentage for each 0.01 interruption (duration or frequency) away from the performance target. This would be determined at the outset of the regulatory period, based on:
  - Value of Customer Reliability – as per national STPIS, provides how willing customers are to pay for improved service reliability – based on 2002 and 2003 studies for Vic and SA (i.e. $47,850/MWh adjusted for CPI from the September quarter 2008)
  - weightings for each parameter – as per national STPIS: CBD:1.13; Urban: 0.97; Rural (short and long): 0.92
  - exclusions – as per national STPIS to exclude specific reliability events from calculation of annual performance targets – major event day.
- For telephone answering, a set value of -0.040 per cent per unit.

The Working Group discussed the nature and form of the proposed STPIS and:

- The incentives that it created for Ergon Energy to maintain and improve service performance
- The rewards and penalties that provides Ergon Energy for improved or diminished service compared to predetermined reliability and customer service targets
- The way it could increase or decrease Ergon Energy’s annual revenue based on changes in service performance between regulatory years.

The Working Group noted Ergon Energy’s intention to accept in its Regulatory Proposal the AER’s STPIS as proposed in its Framework and Approach paper.

6.17 Efficiency benefit sharing scheme

Ergon Energy explained to the Working Group that:

- The AER’s Framework and Approach paper says its likely approach will be to apply the new Efficiency Benefit Sharing Scheme (EBSS) to Ergon Energy in the next regulatory control period
- The EBSS is based on the change in the difference between Ergon Energy’s allowed and actual opex between regulatory years (i.e. the incremental efficiency gain / loss)
- The EBSS carries forward Ergon Energy’s incremental efficiency gains for the length of the carry over period after the year in which the gain was made
- The five year carry over period results in Ergon Energy receiving six years of benefits from opex efficiency improvement – this results in a benefit-sharing ratio of approximately 30:70 between Ergon Energy and distribution network users.
  - This means that for a one dollar efficiency saving in opex Ergon Energy keeps 30 cents of the benefits and consumers keep 70 cents of the benefit.

The Working Group discussed the nature and form of the proposed EBSS and its purposes to:
• Provide Ergon Energy with a continuous incentive to improve opex efficiency and thereby reveal efficient level of opex
• Share opex efficiency gains (i.e. underspends) and losses (i.e. overspends) between Ergon Energy and distribution network users
• Allow Ergon Energy to retain the benefits of opex efficiency gains for the duration of the carryover period after which the benefits of these efficiency gains are shared with distribution network users through a reduction in Ergon Energy’s forecast opex (and the equivalent for efficiency losses)
• Provide symmetrical outcomes, so that rewards (for underspends) and penalties (for overspends) are treated in the same way.

The Working Group noted Ergon Energy’s intention to accept in its Regulatory Proposal the AER’s EBSS as proposed in its Framework and Approach paper.

6.18 Capital expenditure sharing scheme

Ergon Energy explained to the Working Group that the AER’s Framework and Approach paper says its likely approach will be to apply the new Capital Expenditure Sharing Scheme (CESS) to Ergon Energy in the next regulatory control period. The CESS involves a four step process:

• Calculating the cumulative capex underspend or overspend for the current control period in net present value terms – if necessary, this will involve estimating the penultimate and final years’ expenditure
• Applying sharing ratio of 30 per cent to the cumulative capex underspend or overspend to determine Ergon Energy’s share
• Calculating the financing benefit or cost that accrues during the period
• Calculating the CESS reward/penalty by subtracting the financing benefit/cost from Ergon Energy’s share of the cumulative underspend or overspend.

Ergon Energy further explained that:

• The CESS will be applied as an adjustment to Ergon Energy’s Annual Revenue Requirement in the following regulatory control period
• Adjustments to the CESS may be made for capex deferrals or for ex post exclusions of capex from the Regulatory Asset Base.

The Working Group discussed the nature and form of the proposed CESS and its purposes to:

• Provide Ergon Energy with an incentive to undertake efficient capex during regulatory period
• Reward Ergon Energy if it spends less than its capex allowance and penalise it if it spends more
• Share efficiency gains and losses on the basis of 30 per cent to Ergon Energy and 70 per cent to distribution network users.

The Working Group noted Ergon Energy’s intention to accept in its Regulatory Proposal the AER’s CESS as proposed in its Framework and Approach paper.

6.19 Ex post capex adjustments

Ergon Energy explained to the Working Group that the AER’s Framework and Approach paper says its likely approach will be to apply the ex post capex adjustments to Ergon Energy as set out in the
AER’s Capital Expenditure Incentive Guideline in the next regulatory control period. There are three circumstances in which the AER may exclude capex from the regulatory asset base (RAB):

- When Ergon Energy has overspent, AER can exclude from the RAB the amount of capex above the allowance that does not reasonably reflect the capex criteria
- When there is an inflated related party margin, AER can exclude from the RAB the inflated portion of the margin
- When a change in capitalisation policy has led to opex being capitalised, AER can exclude from the RAB the capitalised opex.

Ergon Energy further explained that the ex post adjustments would be applied as reductions to Annual Revenue Requirement in next regulatory period.

The Working Group discussed the nature and form of the proposed ex post adjustments and its purpose to help to ensure that distribution network users only pay for capex that relates to network services that reasonably reflects the capex criteria in Chapter 6 of the Rules.

The Working Group noted Ergon Energy’s intention to accept in its Regulatory Proposal the AER’s proposal in its Framework and Approach paper to apply the ex post adjustment framework from the next regulatory control period, albeit that the earliest that it would take any financial impact would be the following regulatory control period.

6.20 Demand management incentive scheme

Ergon Energy explained to the Working Group that the AER’s Framework and Approach paper says its likely approach will be to apply the Demand Management Incentive Scheme (DMIS) to Ergon Energy in the next regulatory control period, including:

- To apply a $5 million Demand Management Innovation Allowance (DMIA)
- Not to allow any adjustment for foregone revenue resulting from demand management initiatives, given that Ergon operates under a revenue cap.

Projects under the DMIA must meet specific criteria and Ergon Energy must report annually on its DMIA projects to the AER.

The Working Group discussed the potential role of demand management in reducing peak demand and future capital expenditure.

The Working Group discussed the nature and form of the proposed DMIS and its purpose to help to incentivise Ergon Energy to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.

The Working Group noted Ergon Energy’s intention to accept in its Regulatory Proposal the AER’s DMIS as proposed in its Framework and Approach paper.
Appendix A. Customer Council AER2015 Working Group Charter

This Charter defines the purpose, responsibilities and composition of the 2014 Customer Council AER2015 Working Group. This Charter is an extension of the Customer Council Charter.

Purpose

Ergon Energy is currently developing its expenditure proposal for the Australian Energy Regulator (AER) to determine the revenue allowance for the 2015 to 2020 regulatory control period.

Customer and community views and concerns are being used to inform Ergon Energy’s priorities in the development of the proposal. To achieve this, while Ergon Energy has been undertaking an extensive customer and stakeholder engagement program, a dedicated working group is now also seen as vital.

This working group will provide a forum through which Ergon Energy can validate the direction of the proposal, and explore any customer impacts of related regulatory or specific business decisions. The working group will enable Ergon Energy to elicit customer input on these matters from the areas represented by the groups’ membership.

The members of the working group will be fully briefed to enable informed and active discussion.

Responsibilities

The working group, like the Customer Council, is advisory in nature and therefore is not a decision making body. Decisions rest with Ergon Energy following consideration of input or advice from the group.

The working group will have the following responsibilities:

- Provide advice to Ergon Energy in regards to customer needs, issues and services across the areas identified as pertinent to developing Ergon Energy’s operational and capital expenditure program
- Act as a link to and from their respective member organisation networks and facilitate customer feedback from these networks on the Working Group’s agenda items
- Report back to the Customer Council to help the wider group better understand the regulatory environment and the direction Ergon Energy is adopting for 2015-2020.

Membership

Members of the working group will consist of representatives from peak organisations representing the following areas: residential customers (including disadvantaged customers); regional development; commercial and industry customers; agricultural sector; and large energy users.

Each member will need to have time, experience (most notably the regional Queensland representation) and the skills required to engage deeply on the matters presented for review by the group (they do not necessarily have to be the same individuals/organisations participating on the Customer Council). To achieve this, the working group will be supported by an external facilitator with regulatory understanding of the industry and the process of revenue determination.
The working group will consist of 5-6 members, as well as Ergon Energy representatives.

The commitment would consist of an initial day long workshop to present the developing proposal, then a meeting every second month where new developments can be presented for review. In addition, there is the potential for email correspondence or out of session teleconference meetings on specific matters.

The working group will operate from March to October 2014 (when Ergon Energy’s expenditure proposal will be presented to the AER), however, maybe reconvened if matters require review or further feedback in the process of the AER making their determination.