

EXECUTIVE SUMMARY

Introduction

This is the Authority's Final Determination on the Regulation of Electricity Distribution for the period 1 July 2005 to 30 June 2010. This is the Authority's second determination in relation to electricity distribution with the 2001 Final Determination applying to the four year period commencing 1 July 2001 and ending 30 June 2005.

As the Authority noted in its Draft Determination, it is necessary to review the events of the current regulatory period, particularly those of 2004, in order to place this Determination in an appropriate context. In January and February 2004, a series of storms swept through the south east of the State. The effect of these storms was that a large number of Energex customers were left without power for varying lengths of time.

As a result, there was a good deal of public concern regarding the state of the distribution networks in Queensland. In response, the Government appointed an independent panel to review the state of both the Energex and Ergon Energy distribution networks. That review - the Electricity Distribution and Service Delivery (EDSD) Review - was established in March 2004 and reported in July 2004.

The Review found that:-

- there had been under-investment in both the Energex and Ergon networks for an extended period of time;
- as a result of that under-investment, the Energex network was operating at an unacceptably high utilisation level - a rate higher than any similar network in Australia;
- the high utilisation rate in the Energex network had severely depleted the capacity of that network to absorb pressures created by severe weather events, be they storms, high temperatures or other events;
- while Ergon had itself identified many of the problems in its network and was already acting to correct them, it had taken too long to bring together the various networks it had inherited; and
- significant new investment and operating expenditure was required for both networks.

There was no doubt that growth in demand, and particularly peak demand, had outstripped the expectations of all parties over the term of the present four year regulatory period. As a consequence, difficult decisions had to be made in an environment where business managers were confronted with conflicting objectives. On the one hand, there was the financial performance of the business while, on the other, there was the service performance of the network.

In August 2004, the Government provided its response to the EDSD Review. The Government accepted all 44 recommendations and gave a commitment to implement them as rapidly as possible.

Key elements of the Government's response, at least in terms of the Authority's Determination, were the introduction of minimum service standards as part of the distributors' licensing regime coupled with the introduction of a range of service quality guarantees to come into effect in a staged manner during the first half of 2005. The Authority fully supports these initiatives.

Early in 2004, the Authority appointed its own independent consultants to provide specialist advice on: the likely levels of demand on both the Energex and Ergon networks during the five year period commencing July 2005; the value of the existing assets used by the distributors to provide services;

and the most likely levels of capital and operating expenditure that would be necessary over the last year of the current regulatory period and the five years of the next.

Predicting future levels of demand on the networks is extremely difficult. Past outcomes give little guide to the future, particularly for peak demand which is a key driver of necessary network investment. The Authority has put in place mechanisms which are designed to manage the worst consequences of unpredictable demand.

The EDSR Review recommended that the Authority introduce a greater degree of flexibility into the regulatory arrangements in the future. The Authority has accepted that recommendation. There remains significant uncertainty regarding the amount of investment that may be required in the networks in order to meet service obligations. The Authority has included mechanisms to manage that uncertainty.

While increased flexibility provides greater certainty and less risk for the distributors, it comes at the price of greater uncertainty and more risk for customers, particularly non-franchise customers, as they do not have the benefit of the Government's CPI guarantee.

Following the very public debate surrounding the EDSR Review and the release of information by the Authority in its Draft Determination, no one should be surprised to find that the cost of electricity distribution in Queensland is set to rise substantially. To some extent, the increases that will flow from this Determination are the product of past low levels of investment and resulting favourable prices to consumers. However, it is clear that the community is not prepared to risk falling service quality and potential system failure in return for lower prices. On the contrary, there is an apparent expectation that service quality should increase and that system security should be paramount. Both of these come at a price.

Nevertheless, the Government has made a commitment in its response to the EDSR Review recommendations that, regardless of the cost, final electricity prices for franchise customers will not rise by more than the general level of inflation. As a result, these customers will be substantially shielded from the price increases which would otherwise flow to them from this Determination. Contestable customers do not enjoy the benefit of this shield and the Authority has taken particular interest in trying to ensure that price impacts for contestable customers are reasonable, given the circumstances facing the networks.

Form of Regulation

In June 2003 and in accordance with the requirements of the National Electricity Code that it give two years notice, the Authority released its decision on the form of regulation it would be applying in the next regulatory period. The Authority decided that it would continue with a revenue cap form of regulation based on a cost linked 'building block' approach to assessing the future revenue needs of the distributors.

Building Blocks

As the name suggests, the building block approach involves attributing costs to the basic components of the business. Typically, this involves establishing the current value of assets employed so as to determine the reasonable return on that investment and the annual loss of value that results from the use of those assets. Since the asset base is not static over time, it is necessary to estimate future capital expenditure requirements so that the asset base can be updated over the regulatory period. Finally, it is necessary to arrive at estimates of the operating and maintenance expenditure that will be required across the regulatory period in order to maintain assets appropriately and provide the range of services sought by customers. The building blocks include expected efficiency gains but also provide the incentive for the distributors to improve their business performance.

Asset Valuation

The Authority contracted Sinclair Knight Mertz (SKM) to prepare a new asset valuation for both Energex and Ergon. The Authority decided, consistent with its previous approach, to value the assets on a depreciated optimised replacement cost (DORC) basis.

SKM reported that the value of Energex's assets was \$3,834 million and for Ergon \$3,704 million, as at December 2003. These valuations were then rolled forward 18 months to arrive at opening asset values for the next regulatory period commencing 1 July 2005, based on proposed capital expenditure over the period and allowing for further aging of the assets. The opening asset values calculated in this way were \$4,308 million for Energex and \$4,198 million for Ergon. The change in opening asset bases from the Draft Determination reflects slightly revised forecasts of likely capital expenditure in 2004-05.

The valuations determined by SKM were higher than the previous valuations, as one would expect given the passage of time. The increased values also reflected some method changes and changed circumstances. For Ergon, the increase also reflected the substantial capital expenditure program it had embarked upon to address the network deficiencies it had identified.

One change that had a significant impact on the asset valuations was the decision to extend the overall life of some assets. This increased the asset base for Energex by \$225 million and for Ergon by \$460 million, by writing back depreciation. This increase in asset life, and hence value, will lead to an over-recovery of depreciation in the future.

Recognising the uncertainty that surrounds the treatment of depreciation prior to the 2001 Determination, the Authority has adopted a lower estimate of the future over-recovery, based on the known level of over-recovery during the current regulatory period.

The Authority has made an adjustment to the distributors' future revenue that reflects this decision. For Energex, this amounts to around \$46 million and for Ergon \$65 million.

This decision involves a forward looking adjustment to revenue that will ensure that the distributors are able to recover their investment in assets over the lives of those assets, no more and no less.

Finally, the Authority is concerned to ensure that the asset base developed in this current process provides a robust foundation upon which to base future decisions. In its Draft Determination and in earlier discussions with the distributors, the Authority flagged its intention to update the capital expenditure forecasts used to roll forward the asset base to the start of the next regulatory period (that is, for 2004-05) once actual expenditure outcomes are known. This is still the Authority's intention. This will mean that there may be some minor change to the opening asset base, and hence forecast revenue, once this information is incorporated.

Capital Expenditure

To forecast the development of the asset base over the next regulatory period, the Authority needs to estimate how much will be invested in new assets over that period. The Authority contracted Burns and Roe Worley (BRW) to advise on this aspect and on the likely operating costs discussed below.

At the time of preparing its Draft Determination, the Authority recognised that there was significant uncertainty surrounding likely future costs, particularly in relation to the costs of implementing the Government's response to the EDSD Review. Rather than delay the release of its Draft Determination until such costs were able to be forecast more accurately, an option which was precluded by requirements of the Code relating to the approval of prices for 2005-06, the Authority provided the distributors with an opportunity to present revised opex and capex forecasts following release of the

Draft Determination. Both Energex and Ergon availed themselves of this opportunity. The Authority requested BRW to undertake a review of the revised forecasts.

Responding to the EDSD recommendations and incorporating costs that will flow from the recent Enterprise Bargaining Agreement (EBA) has increased forecast capex and opex costs from those proposed at the time of the Authority's Draft Determination. These forecasts have been scrutinised by BRW and the Authority is of the view that the costs of recognising both requirements should be accepted.

Energex

Energex proposed that it required \$3,427 million over the five years from July 2005 in order to reinstate capacity to its network and to meet future customer demand. This represents a significant increase on the amounts spent during the current four year regulatory period but no increase since the Draft Determination. At that time, BRW believed that Energex had overestimated its requirements and assessed that \$2,666 million was necessary to achieve Energex's goals.

BRW was also concerned that Energex may not be capable of ramping up resources fast enough to undertake even this lesser amount of work. The views of BRW echoed the findings of the EDSD Review which raised concerns about the depletion of resources within Energex and its resulting lack of planning capacity to address the needs of the network.

These concerns led BRW to suggest that it could only be confident that Energex would be able to spend around 80 per cent of the expenditure BRW had identified as needing to be invested in the five year period. The Authority acknowledged BRW's concerns and opted to include only 80 per cent of the capex identified by BRW as being required over the next regulatory period.

In response to this proposal in the Draft Determination, Energex devoted considerable effort to rebuilding its planning capacity and developing its resourcing strategy. Following receipt of Energex's revised capex and opex forecasts, accompanied by a more thorough resourcing document, BRW was able to allay its previously expressed concerns. BRW has now recommended to the Authority that the full amount of its assessed capex requirement for Energex be included in the building block.

The Authority has accepted this recommendation and has included \$2,707 million in capex for Energex, a slight increase on the Draft Determination due to the inclusion of EBA costs.

Energex did not fully address its likely capex needs resulting from the implementation of the EDSD recommendations in its submission following the release of the Draft Determination. Energex focussed instead on establishing its capacity to undertake the level of expenditure BRW had advised was required. Energex has indicated its view that it will require additional capex during the next regulatory period to meet its EDSD obligations.

The Authority is concerned that there is still considerable uncertainty surrounding the forecasts of capex. The amounts of capex being forecast by BRW and the distributors are unprecedented. The Government's response to the EDSD Review has placed new and unfamiliar obligations on both distributors. The difference between what is forecast by BRW as being required by Energex and that which Energex still believes may be needed is significant. To ensure that customers do not suffer a shortfall in service quality due to a lack of sufficient financial capacity, the Authority has included a pass-through mechanism which will apply to the gap between the amount BRW considered Energex required for capex (\$2,707 million) and that which Energex proposed (\$3,427 million).

If Energex is able to establish to the Authority's satisfaction that it needs to spend more in total on capex than BRW has assessed as necessary and that it could undertake this expenditure in an efficient and properly planned manner, the Authority will consider re-opening that aspect of its Determination

to allow all stakeholders to comment on whether this additional expenditure should be incorporated in the revenue cap immediately or left unrecognised for revenue cap purposes until the next regulatory reset. The projects the Authority will consider for pass-through under this mechanism will be limited to reinstatement of those matters specifically rejected by BRW and new projects required to implement the EDSR recommendations.

Introduction of this pass-through mechanism reflects the EDSR Review recommendation that the Authority provide greater investment certainty to the distributors and consider approaches to introduce a greater degree of flexibility into the next regulatory arrangements. Should this mechanism be activated, there may be a resulting price increase for customers.

Ergon

Ergon has now proposed that it will require \$3,303 million in capital expenditure over the next regulatory period. This represents a significant increase from that proposed by Ergon at the time of the Authority's Draft Determination (\$2,654 million). While BRW was comfortable with Ergon's capacity to deliver on the forecasts prepared for the Draft Determination, it was somewhat concerned that the increase now proposed might stretch Ergon's capabilities.

Over the current regulatory period, Ergon identified that its previous forecasts were deficient and that the state of the assets it had inherited from its six founding corporations was not consistent across regions and, in general, was not as good as it had initially believed.

Ergon put in place a new asset management system and embarked on a detailed review of its assets. It increased its capital expenditure in response to that review, to a level well in excess of that which it had previously forecast as being required, and above that which had been incorporated into the Authority's 2001 Final Determination.

While the Authority acknowledges BRW's concerns following this latest increase, it does not propose to reduce Ergon's forecasts at this time. This decision in large part reflects Ergon's past performance in managing its network and meeting resourcing challenges. However, the Authority will review Ergon's progress in undertaking forecast work in the context of any applications by Ergon for pass-through of other costs during the regulatory period.

BRW suggested a minor reduction in Ergon's capital expenditure requirements, suggesting that \$3,169 million was necessary.

The Authority has accepted BRW's recommendation in relation to Ergon's capital expenditure requirements.

As suggested by the EDSR Review, endorsed by BRW and supported by Ergon, the Authority has removed from Ergon's capital expenditure building block an amount of \$400 million, representing the estimated costs associated with a number of large capital expenditure projects. These are projects that Ergon has identified as having a value greater than \$5 million; are associated with meeting the needs of single large customers; but are less than 80 per cent certain in their timing.

Because of its dispersed network and its disproportionately high number of large resource and industrial customers, Ergon faces an unusual problem in ensuring that it has the capacity to meet the needs of such customers should their projects come to fruition, due to the high degree of uncertainty regarding the eventual timing of these projects, which are often driven by world commodity markets.

The Authority has agreed to remove these projects from Ergon's forecast capital requirements and set them aside until such time as they actually come on stream. At that point, Ergon will be able to approach the Authority to have the associated capital expenditure, and the resulting revenue entitlement, recognised. Because these projects are tied to a single customer who will be bearing all

the associated costs, this provision, whether activated or not, has no implications for prices to other customers.

Accordingly, \$2,769 million will be incorporated into Ergon's capital expenditure building block and a further \$400 million will be set aside for the time being.

In the interests of equity, the Authority has also decided to extend the capex pass-through provision discussed above for Energex, to Ergon. However, as BRW made only a modest reduction to Ergon's forecast capex, and Ergon was able to submit detailed proposals to address its ESDS obligations following the release of the Draft Determination, the gap between that recommended by BRW and that sought by Ergon is much narrower than for Energex.

Depreciation

The Authority has decided to continue to use a straight line method of depreciation to reflect the consumption of assets over time. The Authority recognises that other methods might better reflect the way in which some asset values actually move over the life of the asset but considers that a straight line approach is the preferred compromise given a range of considerations.

Return on Assets

The Authority has decided to use a CAPM/WACC method to determine the reasonable return on assets. The Authority has reviewed its preferred method and has made changes to the way it determines some elements under this approach. Reflecting those changes and the current and forecast market conditions, the Authority has used a post-tax nominal Weighted Average Cost of Capital of 8.5 per cent, applied to the regulated asset base, to determine the return on assets the distributors can reasonably earn over the next regulatory period. This equates to a return on equity of 11.01 per cent, 540 basis points above the risk free rate.

Operating and Maintenance Expenditure

As noted, BRW was contracted to assess both capital and operating expenditure forecasts. Because of this, BRW was able to consider the trade-offs that can occur between capital investment and operating costs. As for capex, both distributors provided revised opex forecasts following release of the Authority's Draft Determination.

Energex has forecast that its operating costs over the next regulatory period will amount to \$1,289 million, a significant increase on its operating costs to date and an increase of \$168 million on its forecasts included in the Draft Determination (\$1,121 million). Ergon has forecast that its operating costs over the same period will total \$1,286 million, an increase of \$222 million on its forecast at the time of the Draft Determination (\$1,064 million). While this is a significant increase on Ergon's planned level of expenditure over the current regulatory period, it is not such a significant increase on its actual recent annual expenditure, reflecting the fact that Ergon had some time ago realised that it needed to spend more on its network and had been acting accordingly.

BRW assessed that Energex had slightly overestimated its operating cost needs and suggested that only \$1,269 million was required. In light of Energex's revised resourcing plan, BRW is now reasonably comfortable that Energex could ramp up its expenditure from past levels to those now proposed.

Despite the increase in Ergon's forecast opex, BRW remained reasonably confident that Ergon would have the capacity to increase its operating expenditure to this higher level. Ergon had previously demonstrated that it had plans in hand to ramp up its operating expenditure in response to identified needs and that it had been increasing its operating expenditure over the current regulatory period.

BRW identified some minor savings that could be expected by Ergon and assessed that Ergon required \$1,253 million in operating and maintenance costs over the next regulatory period.

The Authority has accepted BRW's recommendations, less self-insurance estimates, and included \$1,237 million as Ergon's opex costs over the five year regulatory period.

Recovery of Previous Opex Provision

According to its regulatory accounts, Energex had consistently under-spent on operating and maintenance costs during the current regulatory period.

The EDSD Review concluded that Energex had been too focussed on the financial bottom line, at the expense of its network performance. Effectively, Energex had improved its profits during the current regulatory period by failing to undertake necessary investment and maintenance.

To avoid customers being required to pay twice for the same work, the Authority proposed in its Draft Determination to remove this entire under-spend from Energex's revenue in the next regulatory period. The Authority noted that, had Energex's under-spending on opex been the result of improved operating and maintenance activity and greater efficiency in its operations, the Authority would not have ventured down this path.

In response to the Draft Determination, Energex claimed that much of this under-spend reflected sound management decisions that would provide enduring cost reductions for customers. Energex was of the view that it should not be penalised for these decisions.

The Authority had always acknowledged that there were no doubt some useful cost reductions made by Energex that would be of lasting benefit to customers. The problem had always been that Energex had consistently been unable to provide information on which a reasonable assessment of the balance of efficiency gains and losses could be made.

Following release of the Draft Determination, Energex provided an assessment and valuation of a number of initiatives that it believed represented real cost savings. Energex also argued that some element of the past under-spend represented the normal unders and overs that occur in any business, and that the Authority should not seek to recover these one-off variations.

The Authority has considered the arguments and supporting material put by Energex and accepts that \$66.9 million of the under-spend should not be recovered. As a result, the Authority is now seeking to recover \$87.2 million in nominal terms. The Authority considers this represents a generous approach to the issue.

The Authority reinforces its view that this adjustment has only been made necessary by the unusual circumstances culminating in the EDSD Review and would not expect that such an adjustment would be warranted in the future.

Revenue Caps

Were the Authority to accept all the inputs to calculating the revenue caps as proposed by the distributors, Energex would require total revenue of \$4,442 million or \$888 million per year over the next regulatory period. Ergon would require total revenue of \$4,402 million or \$880 million per year. For Energex, this would represent an increase in average annual revenue of 52 per cent compared to the average for the four years of the current regulatory period and, for Ergon, an increase of 57 per cent.

Following consideration of all elements of the building blocks, the Authority has arrived at a total revenue cap for Energex of \$4,419 million or \$884 million per year over the next regulatory period

and for Ergon \$4,208 million or \$842 million per year. No account is taken in these figures of the potential for both Energex and Ergon to have their revenue caps increased during the next regulatory period as a result of the pass-through mechanisms the Authority has included in this Determination.

Energex and Ergon Revenue Caps (\$million)

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Energex (\$million)	730.3	812.3	889.1	966.8	1,020.3	4,418.8
Ergon (\$million)	754.7	798.8	853.5	874.2	927.3	4,208.1

Despite the reductions in revenue relative to that sought by the distributors, the Authority does not believe that any compromise in performance should result. In other words, the Authority is of the view that the revenue caps it is proposing provide the necessary capacity for the distributors to undertake all the works and investment necessary to achieve their operational objectives as disclosed to the Authority.

It should also be noted that the Authority's decision only determines how much revenue the distributors will be able to earn over the regulatory period. This is not the only source of funds available to the distributors. Retained earnings and borrowings are further sources of funds to support the distributors' needs.

As owner, the Government may also be called upon to contribute. Such decisions are not matters on which the Authority has, or is prepared to express, any views.

Aggregate Annual Revenue Requirements

While these revenue caps set the maximum amount of revenue each distributor is entitled to earn, not all this revenue is to be raised from customers via distribution charges. The Authority has made a number of decisions, such as adjusting future revenue to remove the over recovery of depreciation and the recovery of Energex's past opex under-spend, which will reduce the revenue requirement to be targeted by the distributors in setting prices. These decisions are discussed in detail in Chapter 8.

As a result of those decisions, the Authority has set an aggregate revenue requirement to be raised from distribution customers over the next regulatory period of \$3,962 million for Energex and \$3,869 million for Ergon.

Aggregate Annual Revenue Requirements (\$million)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	Total	NPV
Energex (\$million)	561.9	629.7	717.9	806.8	879.6	927.9	3,961.9	3,073.5
per cent change		12.1	14.0	12.4	9.0	5.5		
Ergon (\$million)	525.9	692.3	734.7	786.8	802.1	853.1	3,869.0	3,024.2
per cent change		31.6	6.1	7.1	1.9	6.4		

Revenue Smoothing and Prices

The above annual revenue requirements include a degree of volatility from year to year. It has become common practice for regulators to at least smooth this series of annual revenue requirements to allow prices to increase or decrease over the regulatory period in an orderly fashion. This smoothing process is also often used to level out any step up or step down in prices that can occur when moving from one regulatory period to the next.

Preferably, the approach to smoothing would: leave the distributor no worse off in real terms, though there may be changes to the timing of receipt of funds; arrive at a revenue requirement in the final year that offers the prospect of a smooth transition into the next regulatory period; and, to the extent possible, avoid severe price shocks for customers. This is not a simple process and often all of these competing objectives will not be able to be fully satisfied.

The impact of demand growth is important in considering smoothing since it is not so much revenue, but resulting prices, that are the main interest. Some part of the increase in revenue simply reflects growing consumption and hence will have no effect on prices.

As noted earlier, franchise customers will be shielded from price increases beyond CPI due to the Government's commitment in its response to the EDSR Review. Contestable customers do not have the benefit of such a commitment. Price increases for these customers will be paid by the customer.

For the Authority, this distinction is important in its consideration of price increases. In balancing the interests of distributor and customer, there is little to be gained by the Authority attempting to produce an outcome that reduces the impact on franchise customers. At the end of the day, this group of customers face a bundled electricity price that is set by the Government. Under the Government's uniform tariff policy, any increase in distribution prices that would raise final retail prices above the price set by the Government will be picked up by the Government through its Community Service Obligation (CSO) arrangements with the retailers. In its submission, the Government indicated that the Authority should ensure rates of return are sufficient to meet the investment needs of the distributors, particularly in respect of their obligations stemming from the EDSR Review.

In these circumstances, the Authority is prepared to pass through the full revenue effects to franchise prices. It is also advantageous to ensure that distribution prices for these customers are fully cost reflective while the franchise protection remains so that, should there be an expansion of competition, customers contemplating alternate supply options will be fully informed of their likely real costs.

However, the Authority does need to have regard to the price impacts for currently contestable customers.

In considering revenue smoothing and price impacts, it is important to remember that these are distribution prices, not retail electricity prices. While distribution cost are a significant portion of the final cost of electricity (around 40%), increasing distribution prices will only have that proportional impact on final electricity prices.

A guide to pricing impacts can be calculated by dividing each of the above AARRs by the forecast level of electricity consumption for each DNSP¹. This provides an average cent per kilowatt hour (c/kWh) price. This is a notional price only and will mask significant differences across and within customer groups.

For Energex, this calculation indicates prices will grow on average by 6.1 per cent per year in nominal terms.

For Ergon, the same approach indicates growth in nominal prices of 7.6 per cent over the period. However, this includes a substantial increase in year one which raises a significant issue in terms of acceptable price impacts.

Energex

For Energex, it was not possible to smooth the raw revenue streams in a revenue neutral manner without the resulting final year revenue being significantly above the preferred final year target.

¹ Price impacts are a guide only and are based solely on forecasts of consumption.

The pass-through provisions included in the new regulatory arrangements could see Energex's revenue cap increased during the regulatory period. If this were to happen, it will be more likely to occur in the later years of the regulatory period than in the early years and will require a review of not only the capex to be included but also the revenue and price implications of such a move. With this in mind, rather than adopting a more severe approach to smoothing, such as straight line smoothing, the Authority has opted to hold Energex's final year revenue to that implied by the raw numbers and smooth the revenue stream from the start through to the second last year (2008-09). This approach will involve a loss of revenue to Energex in net present value terms of around \$30 million, less than 1 per cent of the total revenue cap for the period.

Energex: Smoothed Aggregate Annual Revenue Requirements

	<i>2004-05</i>	<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>Total</i>	<i>NPV</i>
Energex (\$million)	561.9	628.5	703.0	786.4	879.6	927.9	3,925.3	3,043.7
per cent change		11.9%	11.9%	11.9%	11.9%	5.5%		

Ergon

As noted above, Ergon's raw revenue streams pose quite a different challenge when it comes to smoothing and prices. The significant step up in revenue required in the first year of the regulatory period dominates the outcomes for Ergon. However, Ergon has significantly fewer contestable customers and hence raises much more of its revenue from franchise customers than does Energex. In addition, Ergon has much less movement of customers out of the franchise group and into the contestable market than does Energex. For Ergon, this lower churn rate means that the revenue requirement across the period can be allocated between customer groups on a fairly predictable basis. These two revenue streams can be smoothed independently to remove volatility while maintaining the real value of each, and in total, over the period.

However, smoothing Ergon's contestable customer revenue stream on a revenue neutral basis was not possible without a significant step up in revenue in the first year. While the Authority would have preferred to maintain the net present value of the revenue, the pricing implications for contestable customers were too severe. The Authority therefore decided to straight line smooth the contestable customer revenue. In discussions, Ergon noted that it would experience a step change increase in consumption by contestable customers in 2005-06, due to the impact of tranche 4a customers. This increase was allowed for and the revenue requirement was then straight line smoothed over the remainder of the period. This produced annual revenue requirements as presented below and a revenue loss to Ergon of \$19 million in net present value terms. Again, this is less than 1 per cent of the total revenue cap for the period.

Ergon: Smoothed Aggregate Annual Revenue Requirements by Customer Group

	<i>2004-05</i>	<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>Total</i>	<i>NPV</i>
Franchise	492.8	644.8	681.8	721.0	762.5	806.3	3,616.4	2,824.2
per cent		30.8	5.7	5.7	5.7	5.7		
Contestable	33.1	39.5	42.7	46.2	50.0	54.1	232.6	181.0
per cent		19.3%	8.2%	8.2%	8.2%	8.2%		
Total	525.9	684.3	724.5	767.2	812.5	860.4	3,849.0	3,005.2

Pricing Constraints

Consistent with the Authority's view that there is little to be gained by restricting the flow through of revenue increases to franchise customers, all side constraints will be removed from distribution prices for franchise customers.

For contestable customers, the approved AARRs provide a guide to pricing outcomes. However, within the average price increases discussed above, there can be a wide range of outcomes for individual customers. During the current regulatory period price increases have been side constrained to CPI + 5% per annum for individual customers. Continuing this side constraint for contestable customers would be consistent with the indicative price impacts for Ergon. For Energex, a slightly lower side constraint of CPI + 4.5% per annum for individual contestable customers would achieve the same outcome for it.

This slight difference between Ergon and Energex is consistent with their past pricing where Ergon customers have benefited from lower prices over the current regulatory period than might have otherwise been the case.

To avoid any revenue loss due to the impact of the side constraints simply flowing through to franchise customer prices, the Authority has provided for separate unders and overs treatment of revenue associated with each group of customers.

However, as a result of past pricing practices, there is a small group of contestable customers who continue to pay prices above and below the cost of providing their service. Such an outcome in a supposedly contestable market is unsustainable. The Authority had hoped that such anomalies would have been removed over the current regulatory period. However, for some customers, the scope of change required was more than was able to be accommodated within the prevailing constraints. This situation needs to be addressed.

For contestable customers, any customers currently paying above cost should have their prices reduced to the cost reflective level immediately. For any contestable customers paying below cost reflective prices, the distributors will be required to provide price paths that would move these customers' prices to a cost reflective level desirably by the end of the next regulatory period. These price paths will be presented to the Authority for approval and the Authority will consider the extent of price increase that will potentially flow to these customers. Given other increases flowing from this Determination, it may not be reasonable to move prices for these customers to full cost reflectivity by the end of this regulatory period.

Nevertheless, for some customers, this proposal may result in a significant price change in a relatively short period of time. However, the significance of the change will reflect the past level of benefit these customers have received from cross subsidies and not the imposition of an unreasonable penalty at this time.

It is proposed that the distributors be required to disclose to affected contestable customers their approved price path for the remainder of the period by 30 October 2005.

In its Draft Determination, the Authority had proposed to introduce a safety net side constraint for unforeseen movements in distribution and transmission prices. Given it has now imposed formal side constraints on distribution price movement for contestable customers the Authority does not propose to proceed with this alternative proposal.

As in the current period, the Authority will not apply Part E of the Code, but continue the requirement for the distributors to provide a Pricing Principles Statement for approval by the Authority.

Pricing Approvals Process

At present, the Authority requires the distributors to submit their pricing principles for approval at the start of the regulatory period and annually thereafter should they require amendment. Having approved the principles, the Authority has committed to approving the resulting prices so long as they conform to those principles.

The Authority proposes to continue with this broad process but has proposed some amendments to move the focus away from inspecting the detail of prices to concentrate more on the impact of changes during the next regulatory period. This will be a less intrusive process but will better focus attention on relevant matters.

The Authority is also encouraging the distributors to consider how best to develop their pricing structures in the future so as to provide meaningful signals to customers regarding their costs of connection and consumption, and their likely future charges. The present approaches of distributors to pricing can at times convey quite perverse price signals to customers regarding such matters.

There will continue to be a requirement for the distributors to show that any proposed changes/rebalancing in the structure of network tariffs meets key economic criteria.

Future Reporting

As noted above, there were no doubt some on-going cost savings made by Energex and reflected in its past operating cost performance. However, the regulatory accounts received from Energex during the regulatory period did not allow for meaningful comparisons of performance to be made from year-to-year or across the regulatory period relative to forecasts at the start of the regulatory period.

Throughout the current regulatory period, the Authority has tried to address this issue by making adjustments to its regulatory accounting guidelines and by requiring changes to the distributors' cost allocation manuals. This has not resolved the issues of concern to the Authority.

For the next regulatory period, the Authority has revised its regulatory accounting guidelines and will re-issue them following the release of this Final Determination.

The objective of the new Guidelines is to enhance the capacity of the Authority to make performance comparisons from year-to-year and to the initial forecasts underpinning this Determination. To reinforce the rationale for the Guidelines, the Authority has changed the name of these to Regulatory Reporting Guidelines.

Given the substantial cost increases the distributors are seeking and the current community focus on network performance, the Authority believes that monitoring the distributors' performance against the assumptions underlying the pricing determination is critical for all stakeholders.

Service Quality

In April 2004, the Authority released its final decision on a service quality incentive scheme to be incorporated in future regulatory arrangements. The Authority has decided to delay the full implementation of that scheme for the time being.

A service quality incentive mechanism is designed to provide a financial incentive for distributors to lift the standard of the service they provide, to a level which reflects community desires, in the absence of any other incentive to act in this way.

At the time, the Authority was concerned that service quality generally may have been less than the community expected and that there may also have been pockets of particular need that were not being addressed.

Following the release of the EDSR Review, it is now clear the Authority's concerns were well founded. The public reaction and the Government response mean the distributors currently have an overwhelming incentive to meet community expectations regarding the services they provide.

The Government is instituting Guaranteed Service Level requirements on both distributors as well as service obligations, including minimum service standards. It has also made clear its expectation that the problems identified by the EDSR Review are to be addressed in a comprehensive and timely fashion.

In light of these developments, the Authority sees no need to provide additional financial incentives to the distributors to address these very same issues. Instead, the Authority proposes to support the Government's proposed minimum service standards by continuing to monitor and publish service quality outcomes.

However, the Authority has flagged some options that customers and distributors might pursue in order to support the negotiation of enhanced service quality outcomes for large consumers who have needs beyond those likely to be addressed through the system wide measures being pursued for the majority of customers.

The Authority will pursue amendments to its *Electricity Distribution: Service Quality Reporting Guidelines* to increase the detail of the information it collects and to adopt the same approach to the statistical treatment of unusual events that is proposed to be included in the minimum service standards, a recommendation of the EDSR Review.

The Authority does not propose to change its decision on the nature of a service quality incentive scheme, just the timing of its introduction. This will rely on the distributors' networks being returned to acceptable operating performance and will then be focused on encouraging incremental gain in line with identified customer needs.

Moving Forward

This is the Authority's Final Determination on the Regulation of Electricity Distribution for the period 1 July 2005 to 30 June 2010.

This Determination includes a number of on-going responsibilities which the Authority will address during the regulatory period. These relate to the adjustment, if necessary, of the distributors' annual revenue requirement to reflect the balance of their unders and overs account, any cost pass-throughs and a number of other matters discussed in the Determination. Prices reflecting the annual revenue requirements will be approved on an annual basis by the Authority in accordance with the requirements of the Code and the provisions of this Determination. The Authority will continue to monitor and report on a regular basis the financial and service quality performance of the distributors and assess their compliance with the Authority's ring-fencing guidelines to support open and fair competition.

There are provisions in the Determination that may require stakeholder comment during the regulatory period in order to assess the need for change. Most notable in this area is the provision for the distributors to have the revenue requirement associated with additional capex incorporated into prices within the regulatory period rather than being delayed until the next reset.

The Authority appreciates the participation of those individuals and organisations who provided submissions during this review process.