

Submission to

AUSTRALIAN ENERGY REGULATOR (AER)

on the

Ergon Energy and Energex Regulatory Proposals
for 2015-2020

30 January 2015

QFF welcomes the opportunity provided by AER to make a submission on both the Ergon Energy and Energex Regulatory Proposals for 2015-2020.

Introduction

The Queensland Farmers' Federation (QFF) collectively represents primary producers in Queensland's intensive agriculture industries: sugarcane, cotton, horticulture, dairy, nursery, chicken meat, flowers, eggs and pork. We also represent local irrigator groups and emerging industry groups such as organics and aquaculture. QFF engages in a range of economic, social, environmental and regional issues of strategic importance to the growth, profitability and sustainability of the sector.

Electricity prices have increased significantly since 2006 driving up the overall costs of farming in the irrigation sector across Queensland. This is raising concerns about the ability of farming businesses to remain profitable and the negative impacts that may result on the competitiveness of some agricultural industries in domestic and international markets. The report 'Network Pricing Trends – A Queensland Perspective – January 2015' prepared by Ernst and Young shows that from 1996-97 to 2012-13 there was a 57% increase in the average electricity price in Queensland and network costs contributed 87% of this increase. The factors Ernst and Young believe contribute to these price increases include the conflicting objectives faced by government owned corporations, record capital expenditure programs, costs of servicing a low density population and a summer peak demand and declining consumption.

The 'Advice to Canegrowers and the Australian Sugar Milling Council on Ergon electricity tariff issues' prepared by CME Consultants in August 2014 assessed Ergon network tariffs that would apply to irrigators in Ergon's zones 1, 2 and 3 and found that they would have been significantly higher over most of the period 2007-08 to 2014-15 than what would have been paid to other network service providers in the southern states. For example, in 2014-15 CME estimate prices of 17 to 18 c/kW hour for an Ergon tariff compared with prices in the range of 10 to 15 c/kW hour for the southern networks.

The regulatory proposal submitted by both Ergon and Energex are still projecting price increases (below the Consumer Price Index) over the next five years. Irrigation farmers will face difficulty coping with these proposed increases on top of high current prices. In addition, irrigators face additional annual increases to achieve transition to regulated tariffs by 2020. The competitive position of our irrigation farmers is expected to continue to be eroded over the next five years unless action is taken to reduce projected revenue requirements of both distributors substantially.

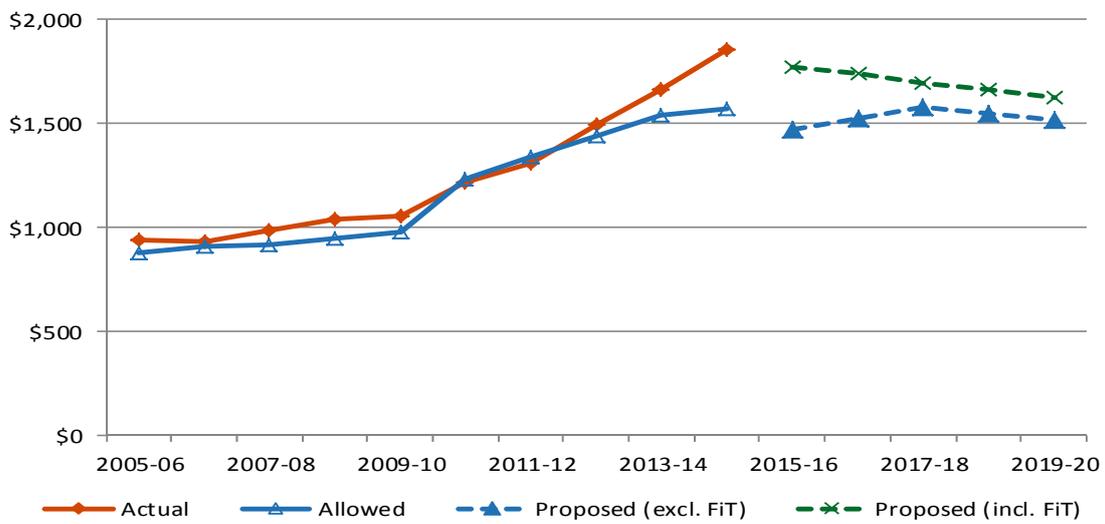
This submission will address the following in turn:

1. Proposed Revenue
2. Capital Expenditure (capex) Proposals and Regulated Asset Base (RAB)
3. Operating Expenditure (opex)
4. Return on Capital (weighted average cost of capital (WACC) proposals)
5. Consumer Engagement
6. Other Issues

1. Proposed Revenue

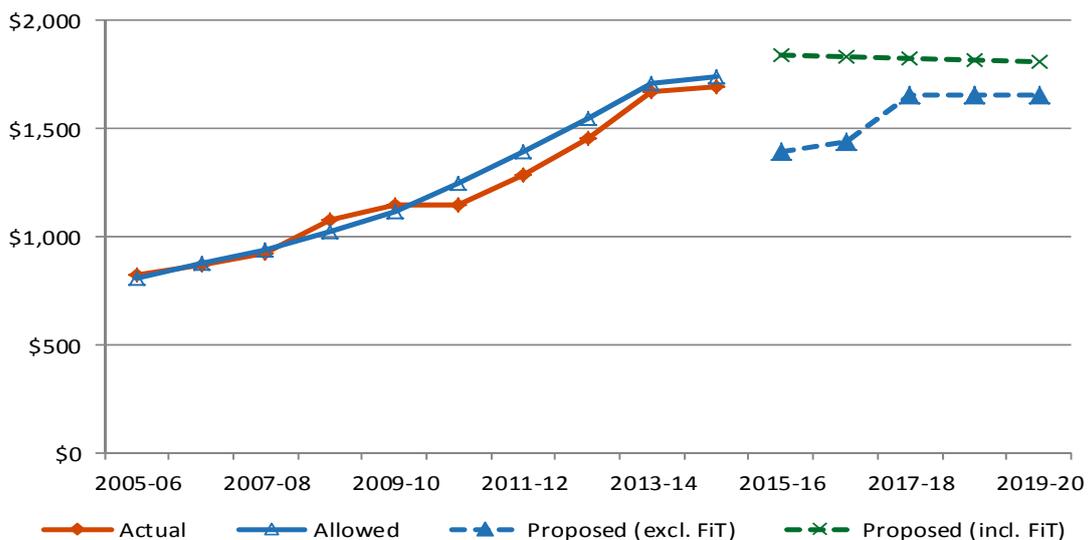
Figures 1 and 2 show the proposed total revenue requirements in 2014-15 dollars for Ergon and Energex (with and without the feed-in-tariff for the Solar Bonus Scheme) for the next regulatory period compared with actual revenue and the allowed revenue for the current regulatory period. The five year revenue requirements have been forecast based on assessments of return on capital, depreciation, operating expenditure, tax allowance and incentive payments.

Figure 1 shows the growth in Ergon’s revenue requirements from 2011-12 to 2014-15 which were well in excess of target levels set by AER. The growth in revenue derived from residential customers was significant since 2009. Growth in low volume demand tariffs for businesses has also been significant. Ergon is proposing small decreases in their revenue requirements of 6% in 2015-16, 4% in 2016-17 and 1% for each year of the remainder of the regulatory period.



Source: AER, December 2014. *Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20.*

Figure 1 Ergon Energy – proposed total revenue (\$million, 2014–15)



Source: AER, December 2014. *Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20.*

Figure 2 Energex – proposed total revenue (\$million, 2014–15)

QFF submits that these revenue forecasts can be reduced significantly with more scrutiny of the proposals for rates of return on asset financing, capex and opex. AER identifies these issues for attention in their 'Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20' December 2014. AER also points out that both distributors are now operating in a vastly changed environment from the current regulatory period. The costs of financing are significantly reduced and the Queensland Government has relaxed security and reliability standards and is implementing other initiatives to improve network efficiency. QFF and our members have continued to raise concerns about declining demand in the face of the significant tariff increases over the current regulatory term. It is expected that this trend will continue in the irrigation industries as farmers adjust to the shift from transitional tariffs and the pass through of electricity costs by irrigation water providers.

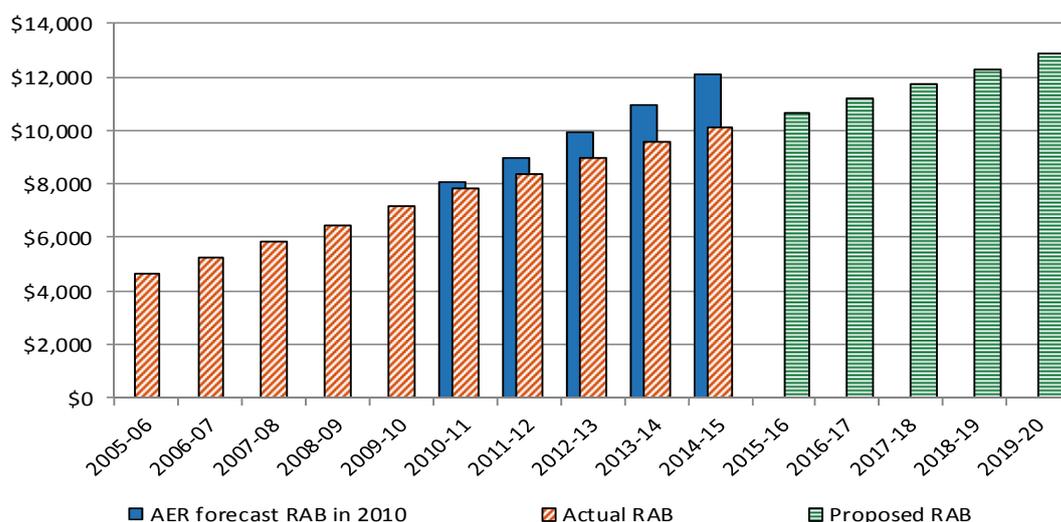
The impact of the Solar Bonus Scheme costs relating to Feed-in-Tariffs (FiT) is very evident in Figures 1 and 2. Ergon forecasts annual FiT costs of \$105 million per year and Energex \$182 million per year for the new regulatory period to 2020. The distributors are allowed to recover these costs in each of the first two years of the new regulatory period together with their FiT costs from the two previous years. This lagged recovery arrangement was due to difficulties faced in assessing these costs in previous years. Energex has adopted this approach but smoothed the revenue impact over the full five years. Ergon has proposed to continue to apply the two year delay in recovering these costs eg payments made for Feed-in-Tariffs made in 2013-14 are included in the 2015-16 revenue proposal. While QFF supports this proposal, the major impact of the Solar Bonus Scheme is an ongoing concern with lagged recovery pushing the impact of this program on tariffs over the coming and subsequent regulatory terms. The new Queensland Government must remove the ongoing cost of this scheme from electricity consumers.

Ergon is also proposing that under recovery of charges in 2013-14 are recovered in 2015-16. QFF understands that the implementation of revenue cap must allow for both under and over recovery charges and a lagged process is the best means of addressing this issue. However, it is expected that electricity consumers will be paying in many ways for not only poor demand forecasting but also poor decision making in regard to capex and opex by the networks in the face of conflicting government policy direction over the current 5 year regulatory term. As result current electricity prices are excessive and are negatively impacting on farm profitability and productivity. Revenue proposals geared to maintain prices at near CPI increases are not acceptable. The Energy Users Association of Australia estimated in 2012 that the allowed revenue per connection in states like Queensland and NSW was of the order of \$1,200 per connection per year (\$2010) which was double the rate in Victoria and well over the rate in South Australia of \$800 per connection per year. While accepting that there is varied supply conditions in each state, differences of this magnitude must be addressed as a matter of urgency.

The AER has indicated in their issues paper that the key drivers of these revenue proposals which they will specifically investigate are the growth of the regulatory asset base given forecasts of weaker demand and lower capex investment and the efficiency of Ergon's opex proposals. QFF supports this commitment.

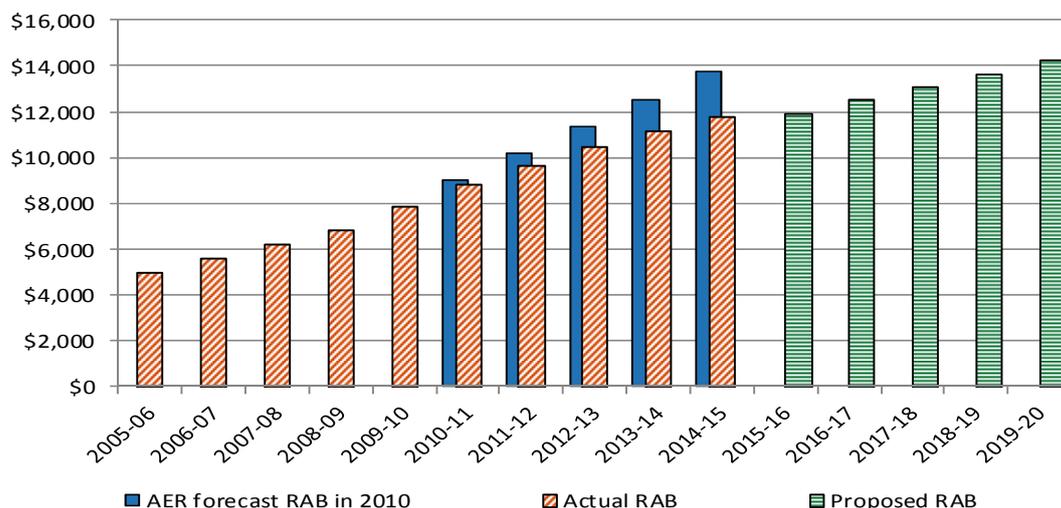
2. Capital Expenditure (capex) Proposals and Regulated Asset Base

Energex proposes a reduction in total capex of 33% over the next five years compared with the current regulatory period while Ergon proposes an 18% reduction. Figures 3 and 4 show the growth in the actual RAB over the period 2005-06 to 2014-15 and the projected growth to 2019-20 for both distributors. Ergon's RAB has more than doubled over the period 2005-06 to 2019-2020 from about \$4.5 billion to just over \$10 billion driven by growth in annual regulated capex which have been less than AER allowances for the current regulatory period. Ergon proposes to expand its RAB by 27% over the new regulatory period.



Source: AER, December 2014. *Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20.*

Figure 3 Ergon Energy – regulatory asset base (RAB) values (\$nominal)



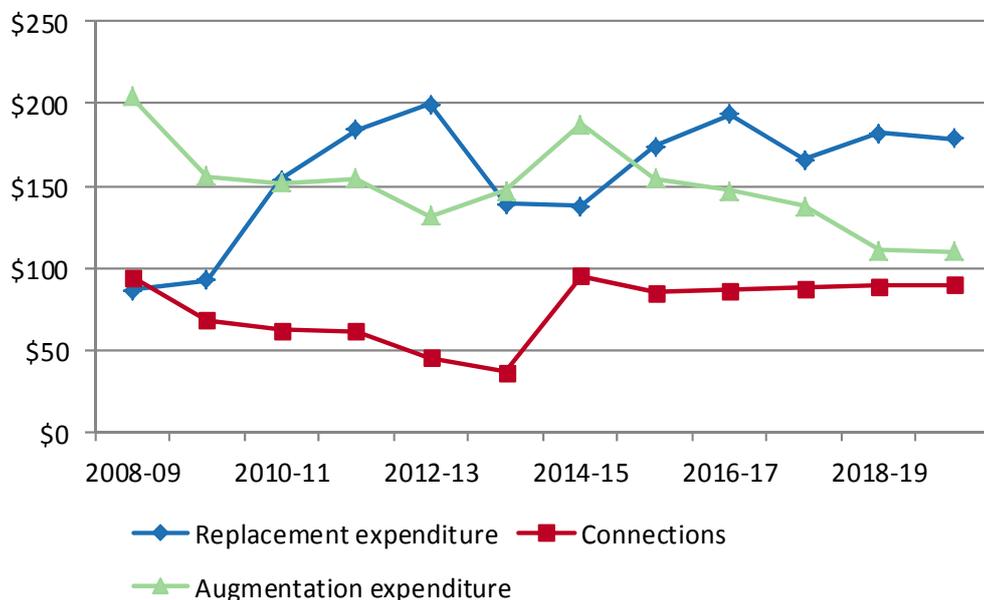
Source: AER, December 2014. *Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20.*

Figure 4 Energex – regulatory asset base (RAB) values (\$nominal)

Energex's RAB has grown from about \$4.5 billion to nearly \$12 billion in 2014-15 and will expand by 21% over the next five years.

The components of capex that will drive these increases include augmentation expenditure, replacement expenditure and connections. Discussions at the AER customer consultation meetings with members of the AER Consumer Challenge Panel highlighted the following issues in regard to the Ergon proposed capex:

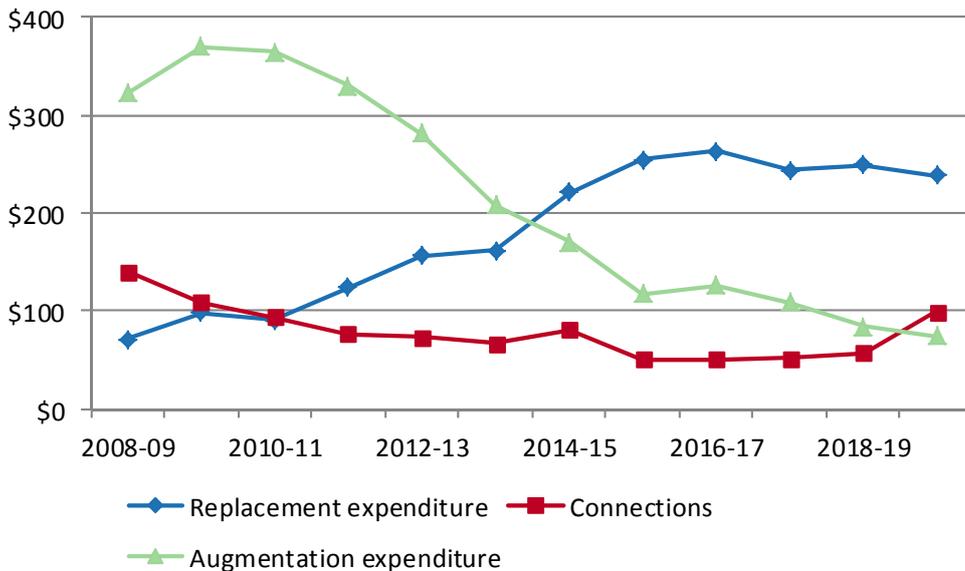
- a. Despite a proposed decrease of 14% in the proposed level of augmentation capex compared with the current regulatory period (see Figure 4), the level of investment still appears to be very high particularly in the light of expected flat demand patterns and reduced reliability standards. Average annual energy use also declined in this period from 21.6MWh to 19.0 MWh. Ergon is forecasting a small growth in demand over the next five years from 14000 to 15000 GWh but does not provide adequate explanation for this forecast. This compares with nearly static demand for each of the customer classes over the ten year period to 2013 despite customer numbers growing by about 70,000.
- b. Ergon is proposing a similar level of ‘Corporation Initiated Augmentation’ capex to the current regulatory period and a significant increase of about 20% for ‘Customer Connection Initiated’ capex (see Figure 4). AER has indicated in the issues paper that this spike will be investigated.
- c. Ergon is proposing a 23% increase in replacement capex (see Figure 4). This appears very high given the significant replacement capex programs over the past two regulatory periods. Account also should be taken of the drop in system utilisation over the 2006 to 2013 period from 45% to 40%. The average age of Ergon’s assets also appears to be dropping but Ergon argues that their networks average age is increasing hence the need for increased replacement capex. Ergon has not adequately explained the need for these proposed expenditures.



Source: AER, December 2014. *Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20.*

Figure 4 Ergon Energy – capital expenditure components (\$million, 2014–15)

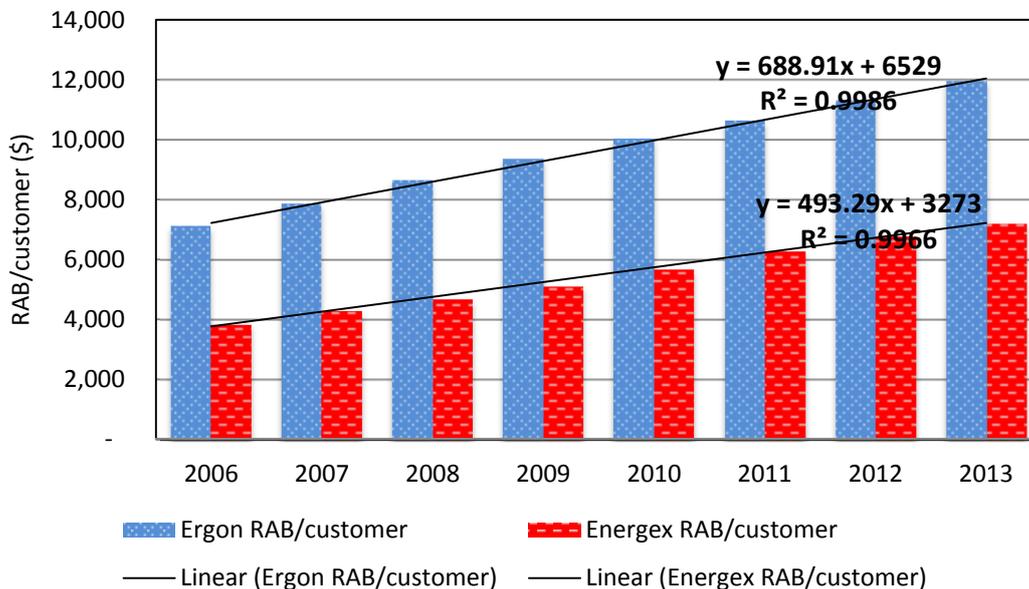
Figure 5 shows the Energex capital expenditure components which at least show a more consistent pattern of capex components.



Source: AER, December 2014. *Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20.*

Figure 5 Energex – capital expenditure components (\$million, 2014–15)

QFF submits AER must fully investigate the need for proposed capex expenditures and the level of efficiencies that will be gained from the investments for both distributors. In particular, QFF is concerned about the size and growth of the Ergon RAB when assessed on a per customer basis. Figure 6 provided by the Consumer Challenge Panel shows that Ergon’s RAB is bigger and growing faster on a per customer basis than Energex.



Source: Consumer Challenge Panel, 18 December 2014. PowerPoint Presentation.

Figure 6 Ergon & Energex: Regulated Asset Base per customer

2.1. Demand Management

QFF has concerns that the existing network is at capacity in many rural areas of the state and particularly west of Toowoomba, Rockhampton and Townsville. This is placing significant limits on development in these areas. Restrained revenue caps into the future

would be expected to continue to limit network development in these areas. The AER investigations focus on the state wide position without giving consideration to the issues of electricity supply and cost in rural and regional areas.

It is for this reason that QFF has a specific interest in efforts by Ergon to undertake focused demand management programs in rural and other areas. These programs need to take into account the significant differences between irrigation areas in their demands for electricity and the constraints availability of water for irrigation place on the timing of demand for energy. QFF welcomes the effort Ergon Energy has made to date to understand these water supply constraints and also to explain the constraints on distributing power in rural areas to supply the needs of the farming sector.

Oakley and Greenwood have reviewed the demand management programs in the proposals submitted by both distributors. In a presentation to the AER Consumers Forum on 18 December the consultants reviewed the different motivations, strategies and outcomes for demand management highlighting such issues as greenhouse gas emissions reductions, wholesale market peak demand reductions, network system peak demand reductions, network augmentation deferral and reduction of network load at risk. Network augmentation deferral was cited as the most challenging. This is an issue that will need to be addressed in rural areas.

Energex's approach is board based for both residential and business and focuses on load control and incentives. Energex proposes to spend \$95 million over the next five years representing 5.5% of opex and 1% of total revenue to achieve 170 MVA of peak demand reduction. Ergon proposes to spend \$70.5 million (3.8% of opex and 1% of revenue) to achieve 80 MVA of peak demand reduction with another possible 20 MVA based on outturn growth of MVA.

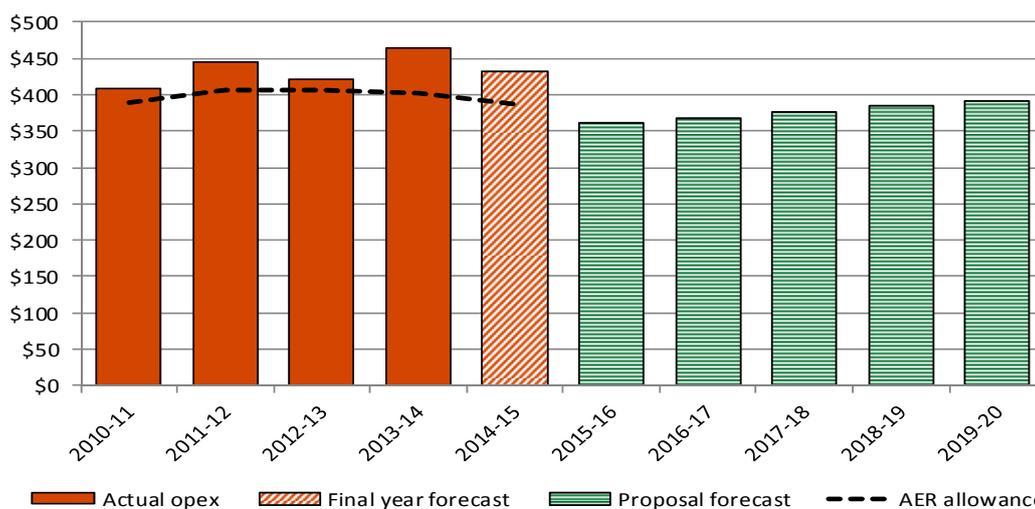
The consultants consider that the Energex approach will be less costly, will send a consistent signal to the market and will be easier to engage with consumers. However, the consultants believe the benefits will not be realised to a significant extent in the short term putting upward pressure on tariffs. They assess there is a risk that some expenditures may not yield benefits.

Ergon is taking a more targeted approach to reducing network costs in the near term which the consultants consider will put downward pressure on tariffs. However, the consultants warn that this approach is likely to be more costly requiring higher transaction costs and may also face difficulties in sending a consistent message to consumers as targeted programs start and stop.

As outlined, QFF supports the approach adopted by Ergon as the only way to address rural issues. There is a concern that the Energex program will 'miss the mark' in important rural production areas like the Lockyer Valley and other irrigation areas in SEQ by failing to take account of constraints faced by irrigators in using electricity.

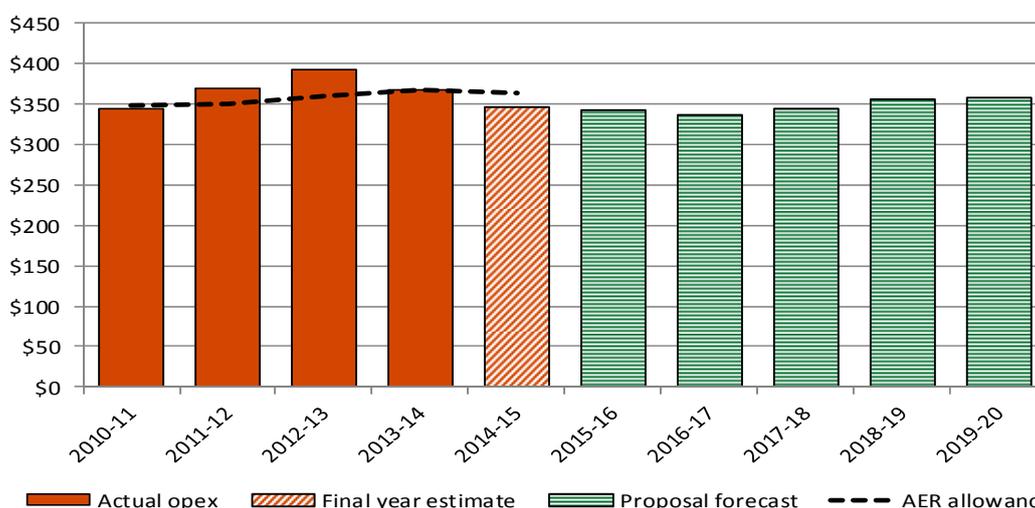
3. Operating Expenditure

Energex plans to reduce opex by 5% from actual levels in the current regulatory period. This is to be achieved through efficiencies in network management, contract management and overheads. Ergon is proposing to reduce opex by 13% through efficiencies in maintenance and management. Figures 7 and 8 shows Ergon and Energex actual opex for the 2010-11 to 2013-14 period, the final year forecast for 2014-15 and proposed annual opex for the new regulatory period. The drivers for the opex forecasts for each distributor are summarised in the AER issues report and include output growth, productivity growth, price growth and allowances for changed circumstances during the regulatory period. These are all matters that need to be investigated by the AER and then monitored during the regulatory period.



Source: AER, December 2014. *Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20.*

Figure 7 Ergon Energy – operating expenditure (\$million, 2014–15)



Source: AER, December 2014. *Issues paper Qld electricity distribution regulatory proposals 2015–16 to 2019–20.*

Figure 8 Energex – operating expenditure (\$million, 2014–15)

It is noted that Ergon has achieved positive Efficiency Benefit Sharing Scheme adjustments totalling \$146.1 million which can be carried over in the new regulatory period. The EBSS carry over amount for Energex includes two years of negative adjustments.

The results of efficiency benchmarking released by AER in late 2014 compares the relative efficiency of distributors across Australia in terms of their total costs including capex and opex. AER indicates in their Issues Paper that the benchmarking shows a 'gap in performance' between both Ergon and Energex and other distributors. AER concludes that Ergon has significant efficiency improvements to make provided the factors they have to address are within the control of the distributor. QFF has not had time to review this benchmarking in any detail so no comments will be provided at this stage. AER must fully investigate the areas where Ergon needs to make efficiency gains and the implications for revisions of opex forecasts. QFF would welcome the opportunity to comment on the AERs findings but would be concerned about any recommendations that would put upward pressure on tariffs.

4. Return on Capital

Ergon has proposed a rate of return of 8.02% and Energex 7.75%. The rate for the current regulatory term is 9.72%. Both distributors departed from the rate of return guideline which was released by AER in late 2013. AER contends that their approach determines a rate of return which 'is commensurate with the efficient financing cost of a benchmark efficient entity providing regulated network services' and 'is estimated as a weighted average of the return on debt and equity.' AER also comments that the application of their guideline has been tested as part of the regulatory determinations released in November 2014 for eight electricity and gas suppliers in NSW, ACT and Tasmania.

Comments made by AER on the Ergon and Energex rate of return assessments address the following key points:

- a. Rates of return assessed for the last regulatory determination reflected the risks from the turmoil in the financial markets as a result of the global financial crisis. Lower rates may now be recommended as interest rates are much lower and market risks have eased.
- b. AER prefers to use a range of models and methods to assess return on equity (return required to attract investment) but has found in the recent determinations that the Sharpe–Lintner Capital Asset Pricing Model (SLCAPM) is their preferred foundation model. Ergon & Energex used a different approach developed by SFG Consulting.
- c. In assessing return on debt (interest rate on loans for capex) AER uses a 10 year trailing average portfolio approach with annual updates after a period of transition and applies a benchmark credit rating of BBB+ based on a median credit rating for a sample of Australian utilities from 2002 to 2012. The published yields from independent third party data service providers are used for estimating the prevailing return on debt for each service provider over the appropriate period. Ergon and Energex used a benchmark credit rating of BBB and Ergon applied a weighted trailing average.

CCIQ has undertaken an investigation of the Ergon departures from the AER Guidelines and concludes as follows:

- a. Return on debt – ‘Credit ratings of BBB and BBB+ are both too low for Ergon Energy given their low cash flow volatility.’ ‘Ergon Energy has the opportunity to manage debt funding risk, base interest risk, credit cost risk and inflation risk completely independently from one another. These flexibilities demonstrate that as a utility provider Ergon Energy has significantly more policy and product flexibility to reduce debt costs and manage risks than private sector borrowers.’ At a time of falling interest rates the BBB credit rating allows Ergon to provide a higher estimate.
- b. Return on Equity - ‘Ergon Energy has chosen not to apply the Sharpe-Lintner model as it under-estimates the return on equity for low risk companies such as electricity distributors.’ A low market risk premium in the range of 5 per cent – 7.5 per cent should be used and ‘the risk free rate should be set over a term shorter than 10 years.’

QFF supports the conclusions reached by CCIQ.

QFF also supports the recommendations on the approach to determining the rate of return made to the AER by the Consumer Challenge Panel (‘Smelling the roses and escaping the rabbit holes: the value at looking at actual outcomes in deciding the WACC - Prepared for the Board of the Australian Energy Regulator – Consumer Challenge Panel’) . The Panel’s survey of actual debt and equity costs has shown that ‘investors are valuing regulated businesses significantly more highly than their regulated asset bases, and that lenders are lending to the regulated business at significantly lower rates than consumers are being charged.’ Accordingly, the Panel recommended that the ‘AER should have regard to actual market and comparative regulatory information in exercising its discretion when determining the regulatory WACC’. The Panel advised a meeting of the AER customer consultation meetings that applying their recommended approach would result in WACCs below 6% (assuming the current risk free rate) which would still deliver good returns to Energex and Ergon while better reflecting their customers long term interests.

5. Consumer Engagement

Ergon and Energex conducted a number of workshops for representatives of stakeholder organisations which included QFF. These workshops informed about the AER framework and about the broader proposals to be included in the Ergon submission. These workshops equipped the stakeholder organisations to understand the approach and structure of the distributor’s submissions and the likely outcome for prices but did little to promote understanding of their forecasts and proposals. In other words little information was provided to help the stakeholder organisations critically analyse their submissions. This approach limited the feedback that the distributors could obtain from the workshops and the opportunity they could have had to consider and respond to stakeholder views.

Input provided by the Consumer Challenge Panel was, however, very valuable in helping stakeholders to understand the issues and develop our submissions to the AER.

This outcome from a regulatory pricing process is expected. A significant responsibility remains with the regulator to inform and promote understanding of the complex issues involved to obtain adequate responses from stakeholders.

6. Other Issues

- 6.1. **Metering** – While QFF understands the reasons for ‘unbundling’ of metering services so that they can be paid for separately and hopefully promote competition in the provision of these services. QFF is concerned about how likely impediments to the provision of competitive metering services in rural areas are to be identified and addressed. It could be expected that the introduction of entry and exit fees by distributors will impede market development particularly in rural areas.
- 6.2. **Cost pass throughs** – Both Ergon and Energex have nominated natural disasters, insurance related events and caps for cost pass through. Ergon has also listed retail separation and isolated network separation and Energex a terrorism event and the introduction of smart meters for cost pass through in 2015-20. Natural disasters and related insurance issues are acceptable and it is understood that Ergon has in the past sought to work through coping with these costs without pass through. Planning for retail separation should allow for costs to be managed without pass through but it is unclear what the cost implications of the separation of an isolated network would be. Again it would be hoped that adequate forward planning would minimise the costs.
- 6.3. **Interrelationships between components of the AER decision** – This submission and, it would be expected, many other submissions will recommend that the AER does not accept the revenue proposals put forward by both distributors. In particular, the issues raised in submissions will necessitate that AER make determinations for both distributors particularly about the efficiencies of capex and proposed rates of return. Serious questions are being raised about the magnitude of the capex investment by Ergon and Energex over the past five years given demand trends and the flow on effects to opex. The balance between repairing or replacing assets has also been questioned. Efficiency benchmarking is highlighting that both distributors and particularly Ergon have significant improvements to make to lift efficiency ratings to the levels of better performing distributors across Australia. These matters must be addressed by AER in assessing the revenue requirements to provide distribution services over the five year period.

To some extent the distributors will have to take some responsibility for balancing the interrelationships through the implementation of the AER determinations but care must be taken to ensure that flow on effects through incentive schemes and cost pass through arrangements do not allow significant additions to revenue allowances throughout the regulatory period.

7. Conclusion

Over the coming five year regulatory period both distributors must give priority to achieving efficiency gains which drive down the costs of distributing electricity. Accepting their proposals for capex, opex and rate of return will do little to achieve this outcome. Irrigation customers have not adjusted to the significant increases in electricity prices over the past five years and further increases will only make the process of adjustment much more difficult.