SUBMISSION TO ENERGEX AND ERGON ENERGY'S REVISED REGULATORY PROPOSALS (QUEENSLAND)

AER REGULATORY DETERMINATION 2015-2020

24 JULY 2015

INTRODUCTION

About this submission

This submission has been prepared as a part of the Australian Energy Regulator (AER)'s Regulatory Reset of Energex and Ergon Energy's regulated distribution services and the revenue and prices associated with them for the Regulatory Control Period commencing on 1 July 2015 and ending on 30 June 2020.

The AER Regulatory Reset is a rare opportunity for Queensland electricity consumers to have their say on Energex and Ergon Energy's revenues and subsequent electricity prices over the next five years.

Rapidly rising retail electricity prices across Queensland, primarily caused through escalating network prices, is one of the most important issues facing all Queenslanders. Increases in network prices over the last five years have had a compounding impact on every Queensland household, business and local government authority.

High electricity prices have resulted in:

- Cost of living pressures for households;
- Avoided investment and job creation from small business due to squeezed operating margins;
- Uncertainty around the future of economic development in Queensland, due to internationally uncompetitive input costs for trade exposed irrigators and industry; and
- An unavoidable cost impost on local government operations (which is passed on to rate payers).

High electricity prices place the largest burden on the cost of living and the impacts are not just experienced through record electricity bills. Queenslanders pay higher electricity prices through the cost of all goods and services. Increased electricity costs are passed back through the supply chain creating higher prices for every day essentials and higher government rates and taxes.

This submission has been prepared to critically analyse the core elements of the AER's Preliminary Decision for both Energex and Ergon Energy's Regulatory Proposals, such as forecasting, proposed operational expenditure allowances, and the cost of capital parameters for the duration of the next regulatory period.

The analysis conducted by The Alliance, contained within this submission, demonstrates that the efficiency of operation of Energex's and Ergon Energy's distribution networks could be significantly improved. The large improvements in operational efficiency proposed by The Alliance will lead to significant network price reductions for all Queenslanders.

Note on Alliance Calculations

For household and small business customers, the annual network charges, identified by the Alliance in this submission, accounts for approximately 50% of an annual retail electricity bill.

Unless otherwise stated, all data used in this submission has been sourced from AER Regulatory Information Notices (RINs), Regulator Decisions and/or Ergon Energy's Regulatory Proposal.

The Alliance has gone to extensive effort to ensure the data used in the analysis conducted for this submission is true and accurate.

When calculating the impact on consumers, the following average annual consumption figures are used:

- Residential – 5,800 kWh
- Small Business –17,800 kWh
- Large Business – 368.5 MWh
- Irrigator – 230 MWh
- Industrial – 74 GWh

To increase the readability of this submission, existing classes of customers have been renamed:

- Residential = Residential
- SAC Small = Small Business
- SAC Large = Large Business / Irrigator
- CAC & ICC = Industrial

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SUMMARY

- Electricity consumers have been paying far too much, for far too long.
- The network component of retail electricity bills – the "poles and wires" – is the primary reason for retail electricity price increases over the past decade;
- The cost of the network is an unavoidable cost passed on directly to consumers via energy retailers (improving retail competition will not reduce network charges);
- By forensically analyzing Energex and Ergon Energy's Revised Regulatory Proposals, the Alliance has found that the networks are planning substantial price increases for all consumers between 2015-20;
- The Alliance does not support Energex and Ergon Energy's proposals to increase WACC, corporate tax or OPEX allowances;
- Analysis conducted by the Alliance shows prices should be substantially reduced, below the AER's Preliminary Decision – not increased; and
- The Alliance has also found continued evidence of forecasting against trend.

LIST OF RECOMMENDATIONS

The Alliance calls on the Australian Energy Regulator (AER) and the Queensland Government to adopt all of the recommendations for network price reduction contained in this submission.

This submission:

1. Refuse Energex and Ergon Energy's requests for increased revenue allowances; and

2. Forensically investigate the instances of irregularity in Energex and Ergon Energy's forecasting.

Previous submission:

3. Reduce Energex and Ergon Energy's WACC parameters to reflect their actual financing costs of no more than 3%;

4. Remove the cost of the 44c Solar FiT (the Solar Bonus Scheme) from Energex and Ergon Energy's revenues;

5. Approve a revenue allowance for Energex and Ergon Energy's OPEX based only on the efficient frontier, as identified by Economic Insights and CME;

6. Normalise the value of the Regulated Asset Base (RAB) to remove the impact of excess network capacity (gold plated assets) from consumers' electricity bills.

7. Remove unexplained Additional Amounts, Carryovers and Revenue Adjustments from Energex and Ergon Energy's allowed revenues;

8. Forego future Corporate Tax Equivalent payments;

9. Do not apply the STPIS, EESS and CESS incentive schemes; and

10. Revoke future STPIS payments and encourage Energex to forego previous STPIS payments.

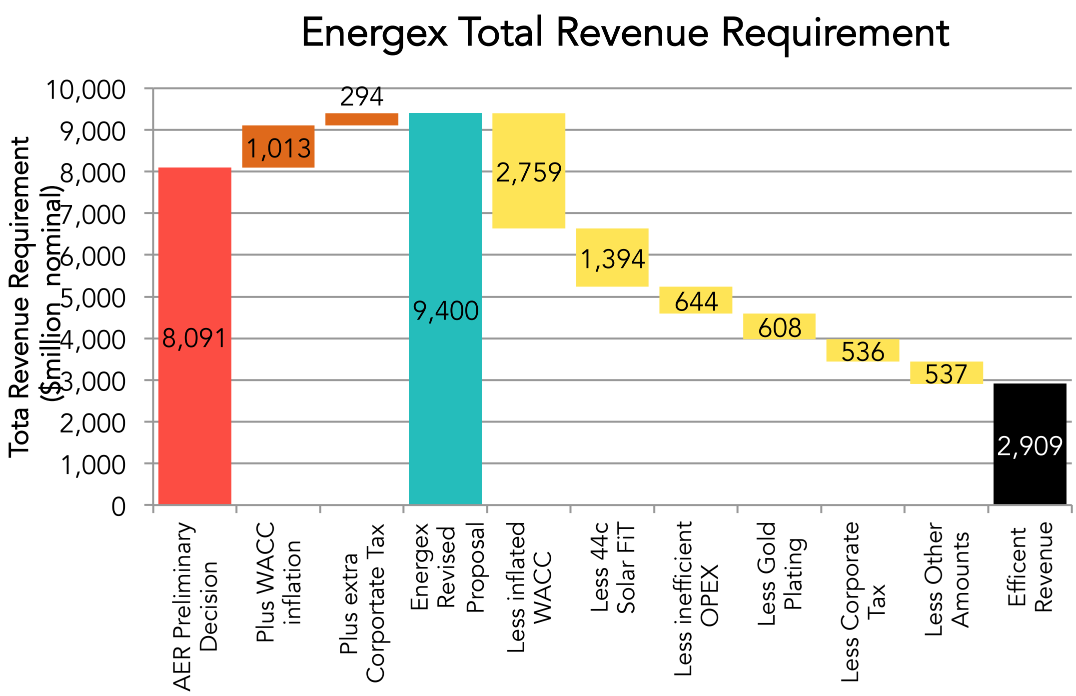
Alliance Proposed Energex Annual Revenue Requirement

Energex has proposed significant increases to their Annual Revenue Requirement. These increases are above the AER's already generous Preliminary Decision and are not in the short or long-run interests of consumers.

Based on analysis conducted by the Alliance that identified the potential for significant reductions to Energex's revenues, the AER should substantially reduce Energex's revenues over the next regulatory control period, beyond the reductions in their Preliminary Decision.

The Alliance urges the AER and the Queensland Government to work collaboratively to incorporate all of the potential reductions to Energex's revenues in the AER's Final Decision, as identified by the Alliance – doing so is essential for both the AER and Energex to demonstrate the Final Decision is in the long-term interests of consumers.

Energex ARR ($million, nominal)	AER Preliminary Decision	Energex Revised Proposal	Efficient Revenues Only
Return on Capital	3,558	4,573	787
Regulatory Depreciation	455	480	894
Operating Expenditure	1,877	1,874	1,228
Revenue Adjustments	354	274	**0**
Net Tax Allowance	242	538	0
Additional Amounts	1,604	1,661	0
Annual Revenue Requirement	**8,091**	**9,400**	**2,909**



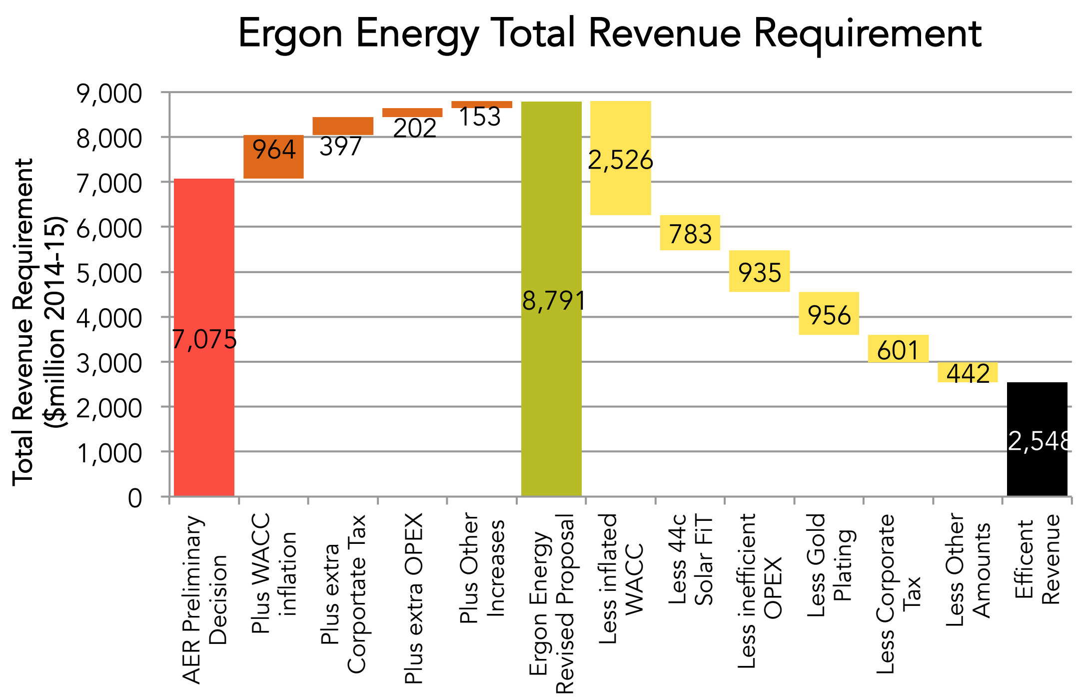
Alliance Proposed Ergon Energy Annual Revenue Requirement

Ergon Energy has proposed significant increases to their Annual Revenue Requirement. These increases are above the AER's already generous Preliminary Decision and are not in the short or long-run interests of consumers.

Based on analysis conducted by the Alliance that identified the potential for significant reductions to Ergon Energy's revenues, the AER should substantially reduce Ergon Energy's revenues over the next regulatory control period, beyond the reductions in their Preliminary Decision.

The Alliance urges the AER and the Queensland Government to work collaboratively to incorporate all of the potential reductions to Ergon Energy's revenues in the AER's Final Decision, as identified by the Alliance – doing so is essential for both the AER and Ergon Energy to demonstrate the Final Decision is in the long-term interests of consumers.

Ergon Energy ARR ($million, nominal)	AER Preliminary Decision	E-Energy Revised Proposal	Efficient Revenues Only
Return on Capital	3,182	4,145	699
Regulatory Depreciation	655	829	794
Operating Expenditure	1,788	1,990	1,056
Revenue Adjustments	184	162	0
Net Tax Allowance	204	601	0
Additional Amounts	1,062	1,062	0
Annual Revenue Requirement	**7,075**	**8,791**	**2,548**



REVIEW OF REVISED PROPOSALS

The Alliance has reviewed Energex and Ergon Energy's Revised Regulatory Proposals and does not support attempts to inflate future revenues beyond the AER's already generous Preliminary Decision.

Analysis conducted by the Alliance (in the previous submission) shows Energex and Ergon Energy's revenues should be 70% lower than the rates outlined by Energex and Ergon Energy in their Revised Proposals.

Increasing allowances for inflated returns on assets, second dividend payments through corporate tax allowances and inefficient operational expenditure is not in the short- or long-run interests of consumers.

Financing Costs = Inflated WACC

Energex and Ergon Energy have proposed significant increases in their allowances for their cost of debt and equity, despite their actual financing costs being considerably lower than the AER's benchmark.

The proposed changes to debt and equity rates mean Energex and Ergon Energy are seeking to collect an additional $1.964 billion from its customers (Energex $1 billion and Ergon Energy $964 million) over the next five years, above the AER's already generous Preliminary Decision.

The only way Energex and Ergon Energy can collect this additional revenue through higher electricity prices for Queenslanders. The primary beneficiary of inflated financing costs is the Queensland Government, who will receive additional pecuniary benefits through higher dividends and Competitive Neutrality Fees. The Alliance does not support increased dividends from Energex and Ergon Energy to the Queensland Government at the expense of electricity consumers.

Significant price relief can be delivered to electricity consumers if the AER and the Queensland Government allow Energex and Ergon Energy to recover only their actual financing costs, which translates to a WACC of below 3%.

Corporate Tax Payments

Energex and Ergon Energy have proposed significant increases in their corporate tax allowances, despite not actually being required to pay corporate tax because the Queensland Government wholly owns Energex and Ergon Energy.

The proposed changes to the corporate tax allowance mean Energex and Ergon Energy are seeking to collect $693 million from its customers (Energex $296 million and Ergon Energy $397 million) over the next five years above the AER's already generous Preliminary Decision. The only way Energex and Ergon Energy can collect this additional revenue is through higher electricity prices for Queenslanders. These corporate tax payments will flow directly to the Queensland Government, effectively as a second dividend from Energex and Ergon Energy.

The Alliance does not support the payment of a second dividend from Energex and Ergon Energy to the Queensland Government at the expense of electricity consumers.

Significant price relief can be delivered to electricity consumers if the AER and the Queensland Government did not force Energex and Ergon Energy to pay an effective corporate tax rate.

Operational Expenditure

The AER's own consultants, Economic Insights found Energex was underperforming and Ergon Energy was the worst performing network in Australia, regarding the efficiency of its operational expenditure (OPEX).

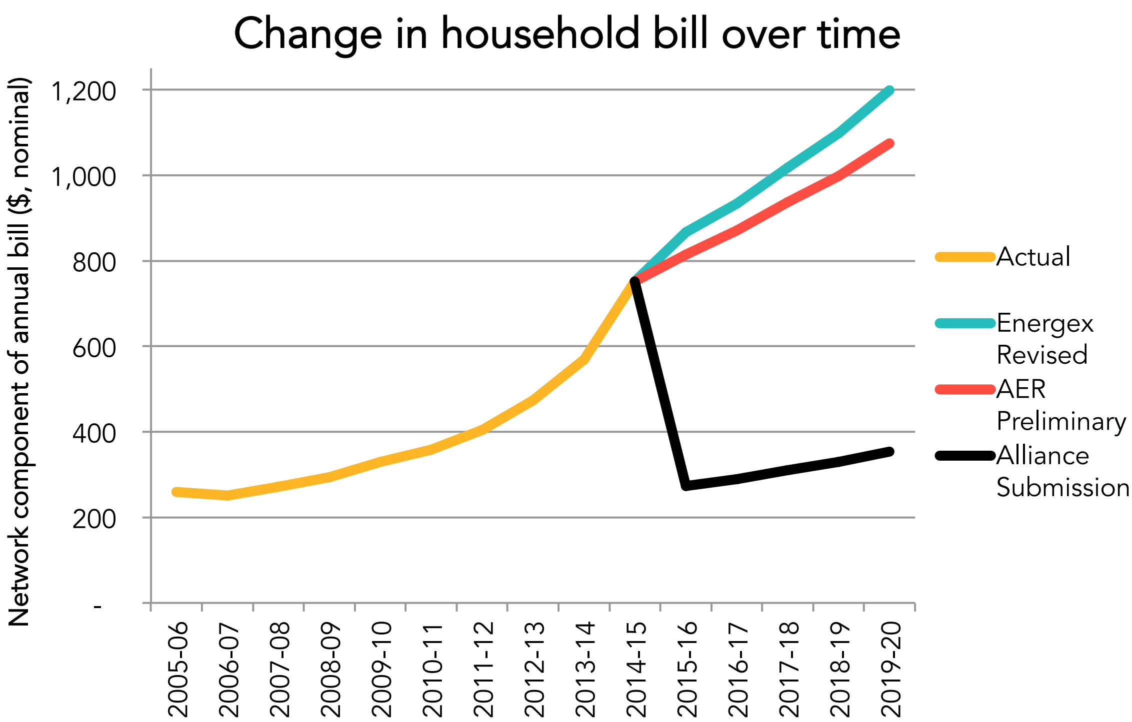
The Economic Insights modeling, analysed by CME found Energex and Ergon Energy's OPEX should be limited at $228 million and $211 million ($nominal) per year. The AER's Preliminary Decision is 64% and 70% above the established efficient rate benchmarks for both Energex and Ergon Energy.

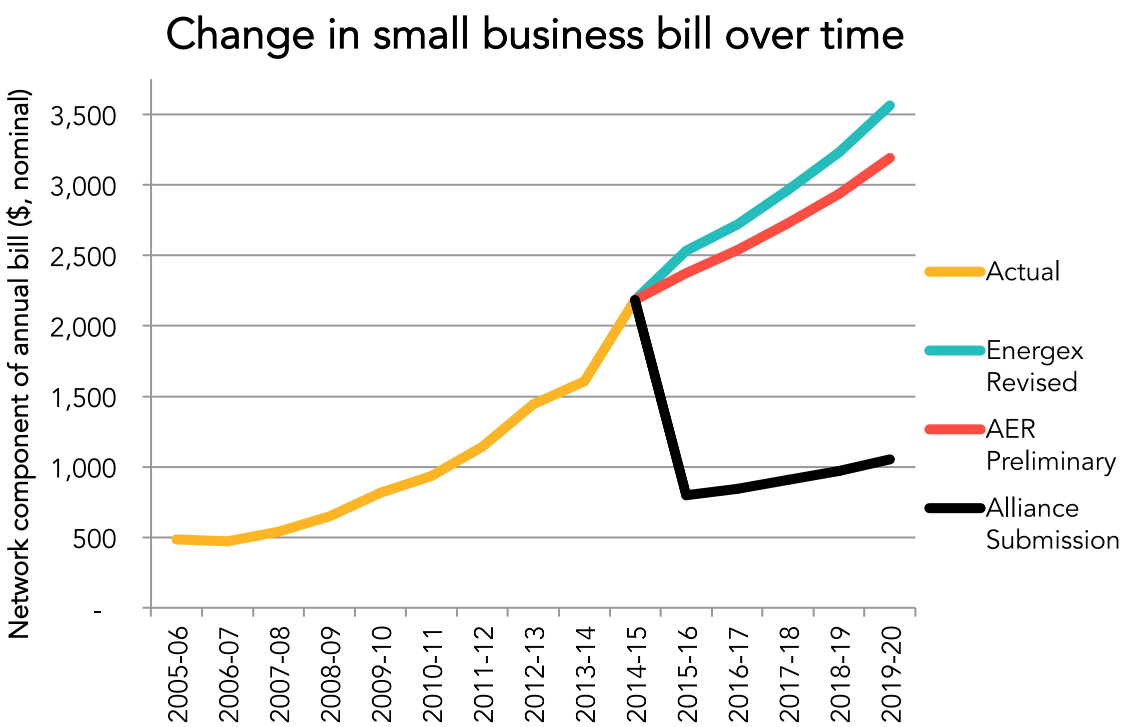
Ergon Energy's Revised Regulatory Proposal seeks to further increase their OPEX allowance from the AER's Preliminary Decision to $398 million per year, which is 85% higher than Ergon Energy's efficient operating level. It is not in consumers' short- or long-run interests to be paying for OPEX above what EI and CME have established as an efficient rate.

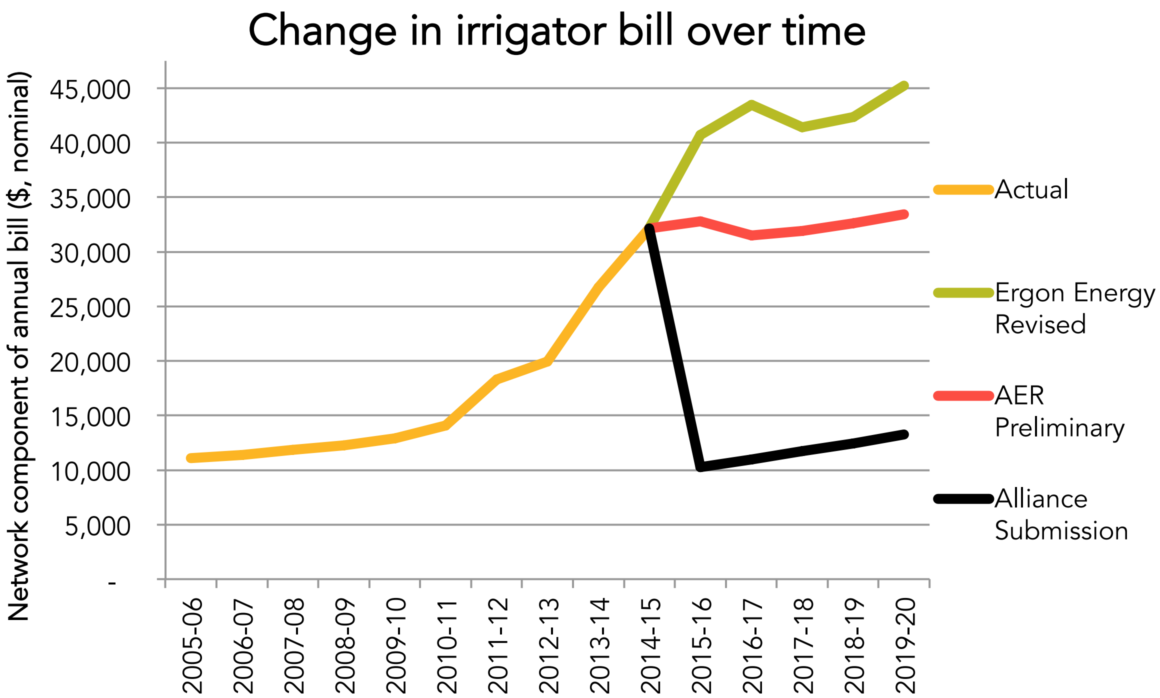
The Alliance calls on the AER to not only reject Ergon Energy's attempt to increase its OPEX allowance, but to make further reductions to Energex and Ergon Energy's OPEX allowance than what was allowed in the AER Preliminary Decision.

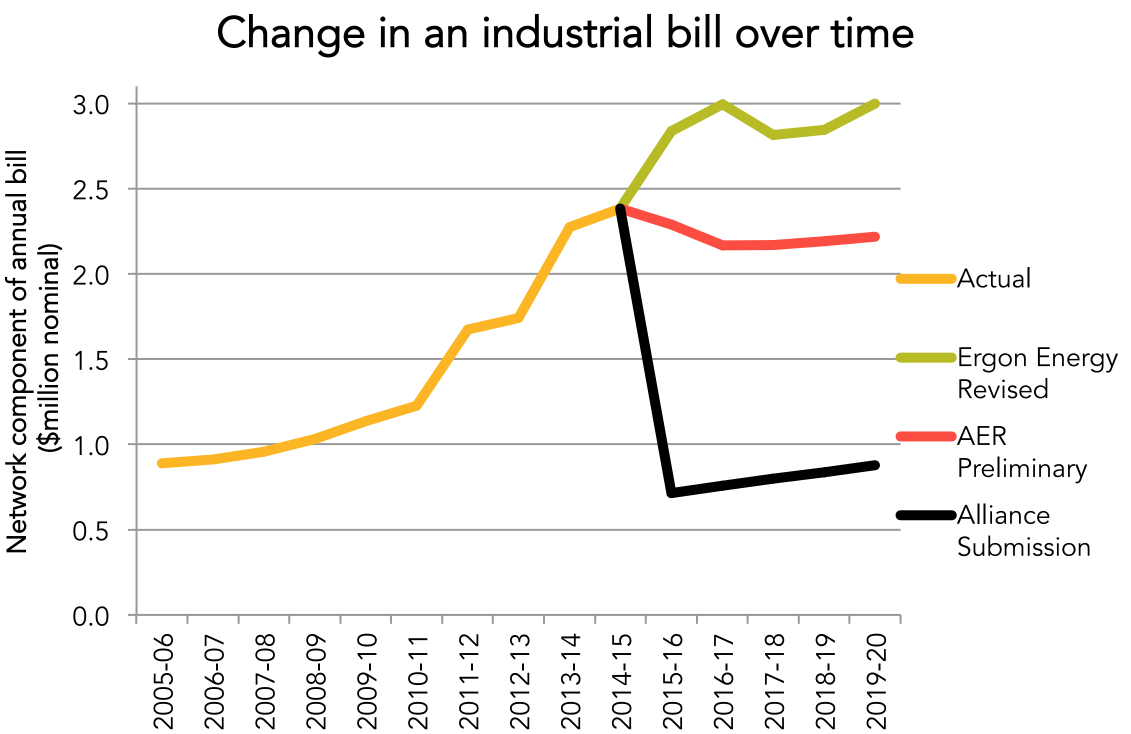
Impact on Prices

The Alliance has calculated the impact of Energex and Ergon Energy's Regulatory Proposals on electricity bills, as well as the potential for price reduction. Energex and Ergon Energy's Revised Proposals will see prices increase, whereas the Alliance believes there is significant scope to heavily discount the AER's Preliminary Decision.






Change in irrigator bill over time
Network component of annual bill ($, nominal)
45,000
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
-
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
2011-12
2012-13
2013-14
2014-15
2015-16
2016-17
2017-18
2018-19
2019-20
Actual
Ergon Energy Revised
AER Preliminary
Alliance Submission


Change in an industrial bill over time
Network component of annual bill ($million nominal)
3.0
2.5
2.0
1.5
1.0
0.5
0.0
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
2011-12
2012-13
2013-14
2014-15
2015-16
2016-17
2017-18
2018-19
2019-20
Actual
Ergon Energy Revised
AER Preliminary
Alliance Submission

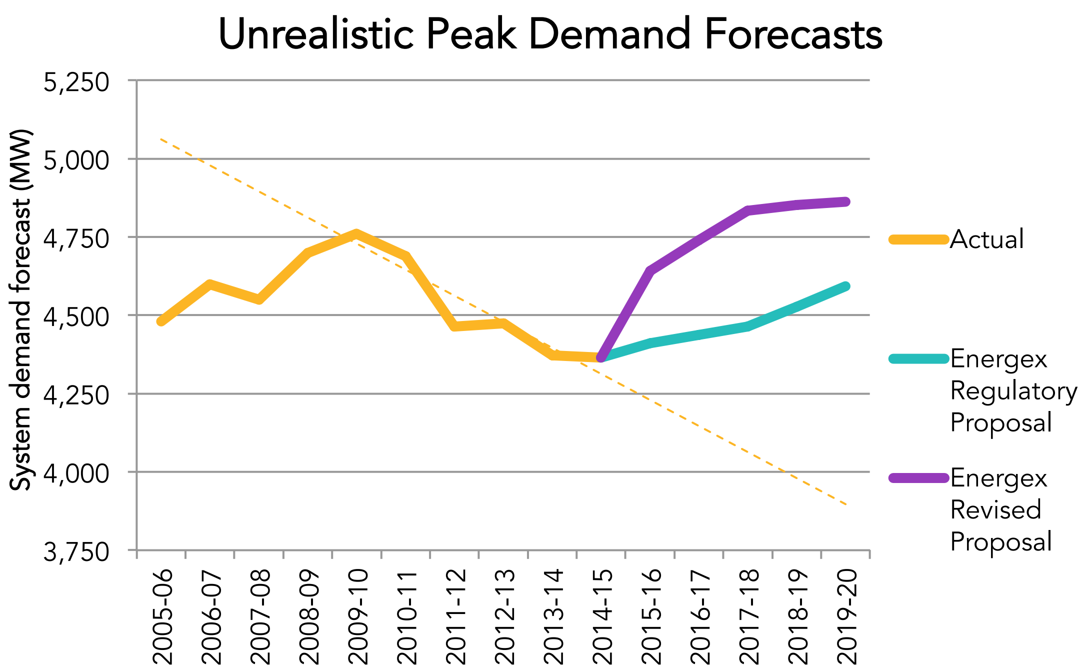
POSSIBLE MANIPULATION OF FORECASTS

The Alliance is highly concerned that Energex may be seeking to manipulate their forecasts to game the AER in an attempt to receive an increased revenue allowance for the next Regulatory Control Period (2015-20).

Energex's proposals detailing increases to existing forecasts (which would give reason to further increase its revenues) irrespective of the trend is not honest or impartial and is not in the short- or long-run interests of Energex's 1.4 million customers in South East Queensland.

Peak Demand Forecasts Revised Upwards

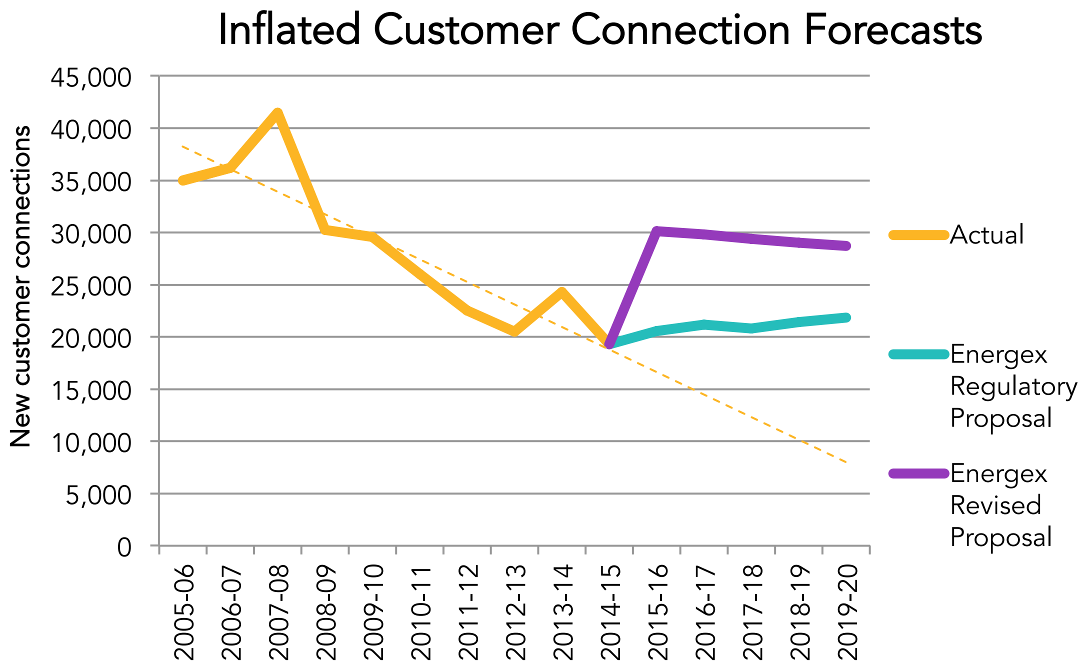
Departing from its Regulatory Proposal, Energex has proposed to significantly increase its forecast network peak demand. These increases are beyond an already optimistic forecast, which appeared to defy a downward trend in peak demand.



The Alliance does not support Energex's attempt to revise its demand forecasts upwards and calls on the AER to forensically interrogate Energex's original forecasts, which ought to be substantially decreased.

Customer Connections Increased

Departing from its Regulatory Proposal, Energex has proposed to significantly increase the number of new connections to its network. The magnitude of increase is particularly concerning, especially as Energex's network has demonstrated considerable and consistent decline in the rate of new connections over time.



The Alliance does not support Energex's attempt to revise its customer connections, especially as the revised forecasts are linked to additional capital expenditure, which will unnecessarily inflate Energex's RAB and increase prices to consumers over time.

The Alliance calls on the AER to forensically interrogate Energex's original and revised forecast customer connections, which ought to be substantially decreased.

Reemergence of "Gold Plating" in CAPEX

It appears the inflation of Energex's forecasts that are related to increasing the size of the network (peak demand and new connections) are linked to increased capital investment (CAPEX), above what the AER has established as an efficient level in its Preliminary Decision.

For example, Energex is seeking $528 million in additional CAPEX allowance above the AER's Preliminary Decision in areas relating to network growth (augmentation), new customer connections and replacement of existing assets, even though trend network demand is in terminal decline.

The Alliance is highly concerned that Energex is attempting to return to a capital program characteristic of network "gold plating", which will see electricity prices continually increase over time.

Forecasting Irregularities from previous Alliance Submission

In the Alliance's previous submission to the AER, a number of serious inconsistencies and cases of potential manipulation of both Energex and Ergon Energy's energy and customer forecasts were highlighted.

All of the irregular forecasts identified below increase Energex and Ergon Energy's total consumption. This analysis clearly indicates a manipulation of forecasts to understate the impact of its Regulatory Proposal on future prices.

The Alliance calls on the AER to forensically investigate the following irregularities in Energex and Ergon Energy's forecasting:

- Overstated forecast residential consumption (Both Energex and Ergon Energy)
- Irregular movements in new customer numbers (Energex)
- Unexplained increase in industrial customers (Ergon Energy)
- Increase in small business consumption (Ergon Energy)

ISSUES FROM PREVIOUS SUBMISSION

Issues for the AER to Consider

The Alliance calls on the AER to continue considering issues and solutions that have been identified by the Alliance in previous submissions. These issues include:

- Reducing Energex and Ergon Energy's WACC to recover only the real cost of debt to QTC, not a hypothetical and inflated benchmark;
- Apply the Economic Insights and CME analysis of the efficient frontier to Energex and Ergon Energy's OPEX allowance; and
- Remove "other amounts" from Energex and Ergon Energy's revenue allowance, such as STPIS, EESS payments as well as allowed recovery of previously "under-recovered" revenues

Issues for the Queensland Government to Consider

The Alliance calls on the Queensland Government to join the AER in removing unnecessary imposts on network prices. These unnecessary imposts include:

- The legacy cost of the 44c Solar Bonus Scheme;
- "Gold Plated" assets in Energex and Ergon Energy's RABs; and
- The corporate tax allowance.

ALLIANCE of Electricity Consumers

ABOUT US

The Alliance of Electricity Consumers was formed to ensure Queenslanders' demands for lower electricity prices could be formally made to the AER, to network companies and to the Queensland and Federal Governments.

Electricity consumers across Queensland have been paying significantly inflated prices for electricity for far too long. The Alliance's simple message to Energex, Ergon Energy and the AER is that network prices are too high and they must be substantially reduced over the next regulatory period.

The Alliance of Electricity Consumers has the support of households, small business, irrigators, industry and local government authorities.

Queensland cannot afford future increases in electricity prices. The Australian Energy Regulator, Ergon Energy, Energex and the Queensland Government must take action to substantially reduce electricity prices.

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