



ALLIANCE of Electricity Consumers

SUBMISSION TO THE AUSTRALIAN
ENERGY REGULATOR'S PRELIMINARY
DECISION (QUEENSLAND)

ENERGEX 2015-16 TO 2019-20
AND
ERGON ENERGY 2015-16 TO 2019-20

3 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.

Principal supporters of the Alliance



3rd party endorsements for Alliance submission



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 analysing Energex and Ergon Energy’s regulated revenues, the Alliance has found that substantial price reductions for all consumers can be achieved between 2015 and 2020, resulting in substantial cost savings for consumers.
- For example, the annual network costs should be substantially reduced:
 - The average household should be paying \$241 per year, not \$879 per year proposed by Energex – a 72% reduction;
 - The average small business should be paying \$794 per year, not \$2,897 per year proposed by Energex – a 72% reduction;
 - The average irrigator should be paying \$8,602 per year, not \$34,099 per year proposed by Ergon Energy – a 75% reduction; and
 - The average industrial customer should be paying \$727,000 per year, not \$2.882 million per year proposed by Ergon Energy – a 75% reduction.
- These reductions can be achieved through:
 - Improving the accuracy of Energex and Ergon Energy’s future energy consumption and customer numbers forecasting;
 - Reducing Energex and Ergon Energy’s financing costs (Weighted Average Cost of Capital – WACC) to reflect their actual borrowing costs through QTC;
 - Removing the cost of the 44c Solar FiT (the Solar Bonus Scheme) from network charges and paying for the legacy costs through consolidated revenue;
 - Removing “gold plated” capital expenditure from the Regulated Asset Base (RAB);
 - Excluding non-accounted for amounts from the AER’s Preliminary Determination in Energex and Ergon Energy’s regulated revenues.
 - Significantly improving the efficiency of Energex and Ergon Energy’s operational expenditure; and
 - Foregoing Corporate Tax Equivalent payments, paid from Energex and Ergon Energy to the Queensland Government.

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.

1. Investigate irregularities in Energex and Ergon Energy's forecasts;
2. Revise down Energex and Ergon Energy's forecast consumption;
3. Reduce Energex and Ergon Energy's Weighted Average Cost of Capital (WACC) parameters to reflect the Queensland Government's actual financing costs;
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.

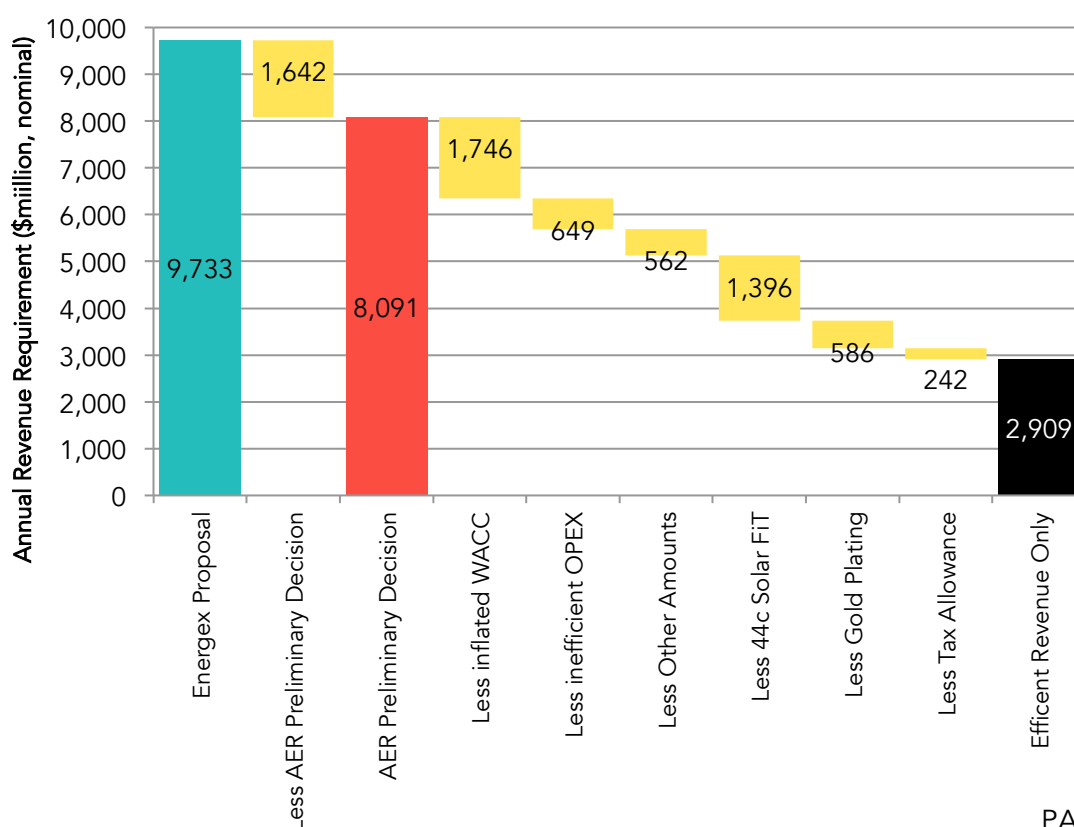
Alliance Proposed Energex Annual Revenue Requirement

The Alliance has found that significant reductions to Energex’s revenues can be achieved through the AER Regulatory Reset. However, realising the full scope of potential price reduction requires concerted action by both the AER and the Queensland Government, as identified in the table below.

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) | Energex Proposal | AER Preliminary Decision | Alliance Submission to AER | Efficient Revenues Only |
|---|-----------------------------|---|---|--|
| Return on Capital | 4,844 | 3,558 | 1,812 | 787 |
| Regulatory Depreciation | 502 | 455 | 455 | 894 |
| Operating Expenditure | 1,877 | 1,877 | 1,228 | 1,228 |
| Revenue Adjustments | 508 | 354 | 0 | 0 |
| Net Tax Allowance | 602 | 242 | 0 | 0 |
| Additional Amounts | 1,401 | 1,604 | 1,396 | 0 |
| Annual Revenue Requirement | 9,733 | 8,091 | 4,891 | 2,909 |

Possible reductions in Energex's Revenues



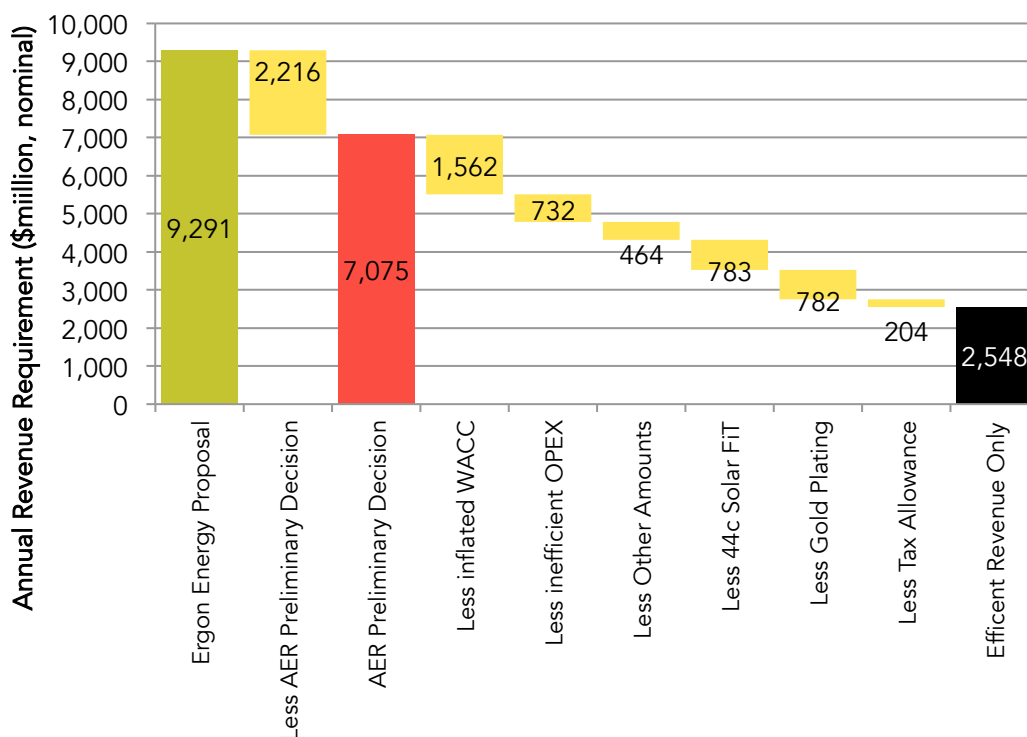
Alliance Proposed Ergon Energy Annual Revenue Requirement

The Alliance has found that significant reductions to Ergon Energy's revenues can be achieved through the AER Regulatory Reset. However, realising the full scope of potential price reduction requires concerted action by both the AER and the Queensland Government, as identified in the table below.

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) | Ergon Energy Proposal | AER Preliminary Decision | Alliance Submission to AER | Efficient Revenues Only |
|--|--------------------------------------|---|---|--|
| Return on Capital | 4,488 | 3,182 | 1,620 | 699 |
| Regulatory Depreciation | 904 | 655 | 655 | 794 |
| Operating Expenditure | 2,035 | 1,788 | 1,056 | 1,056 |
| Revenue Adjustments | 181 | 184 | 0 | 0 |
| Net Tax Allowance | 621 | 204 | 0 | 0 |
| Additional Amounts | 1,062 | 1,062 | 783 | 0 |
| Annual Revenue Requirement | 9,291 | 7,075 | 4,113 | 2,548 |

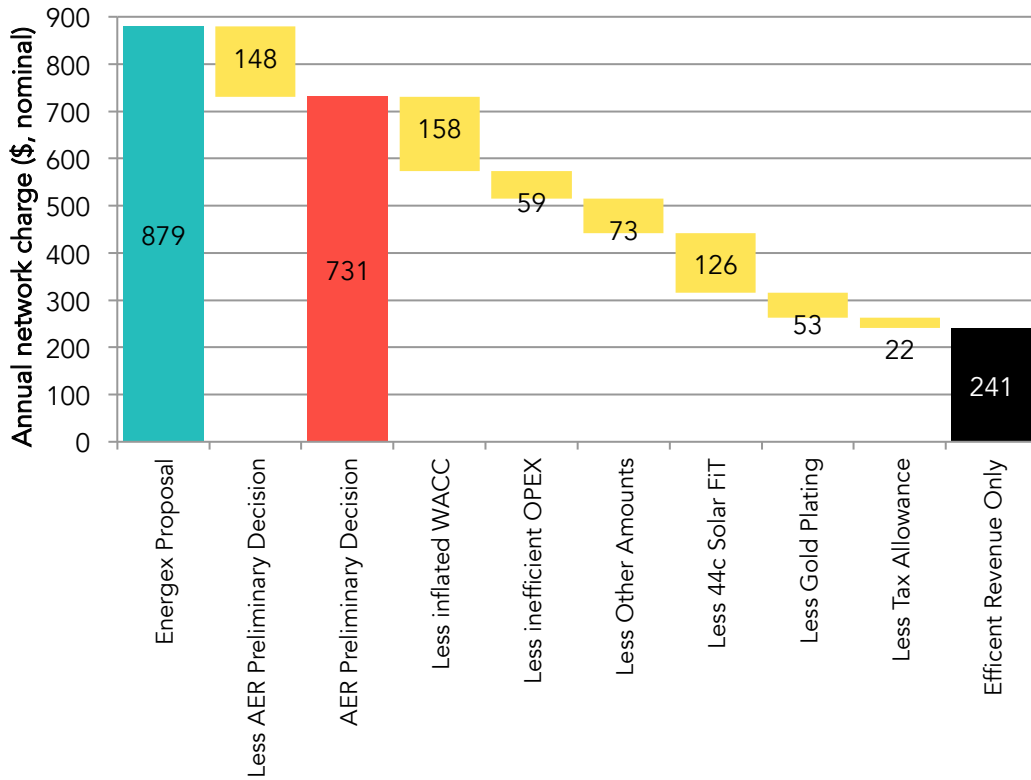
Possible reductions in Ergon Energy's Revenues



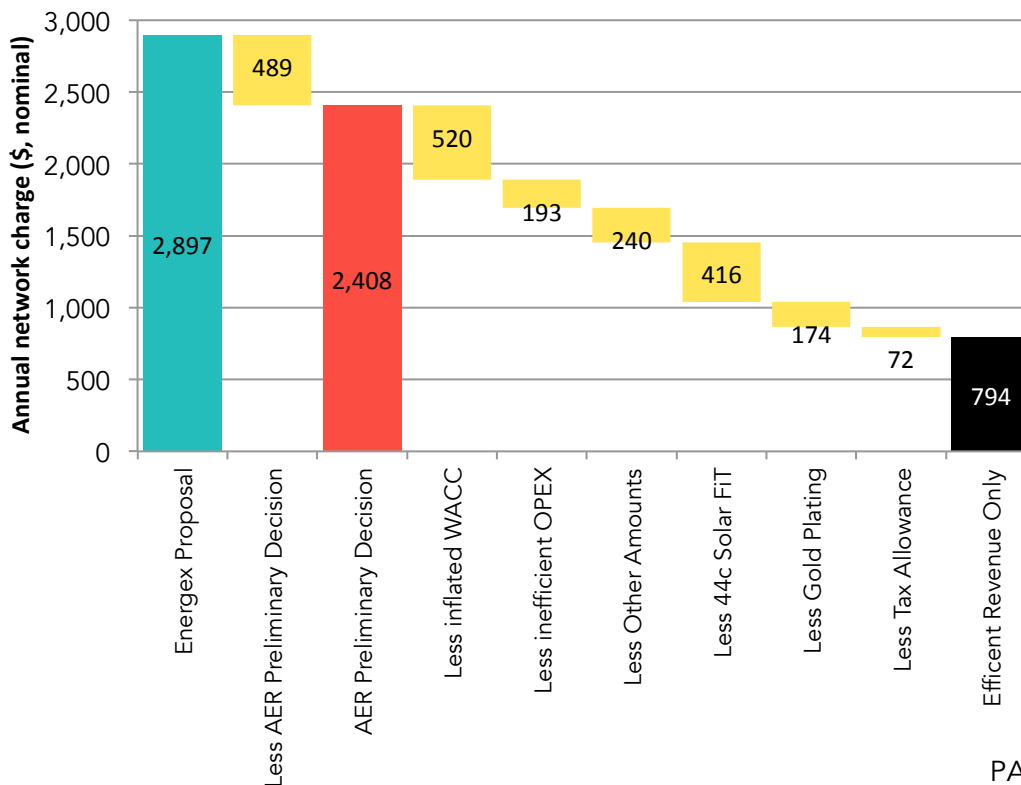
POTENTIAL FOR PRICE REDUCTION

The reductions in Energex and Ergon Energy’s revenues identified by the Alliance provide significant price relief for all electricity consumers in Queensland.

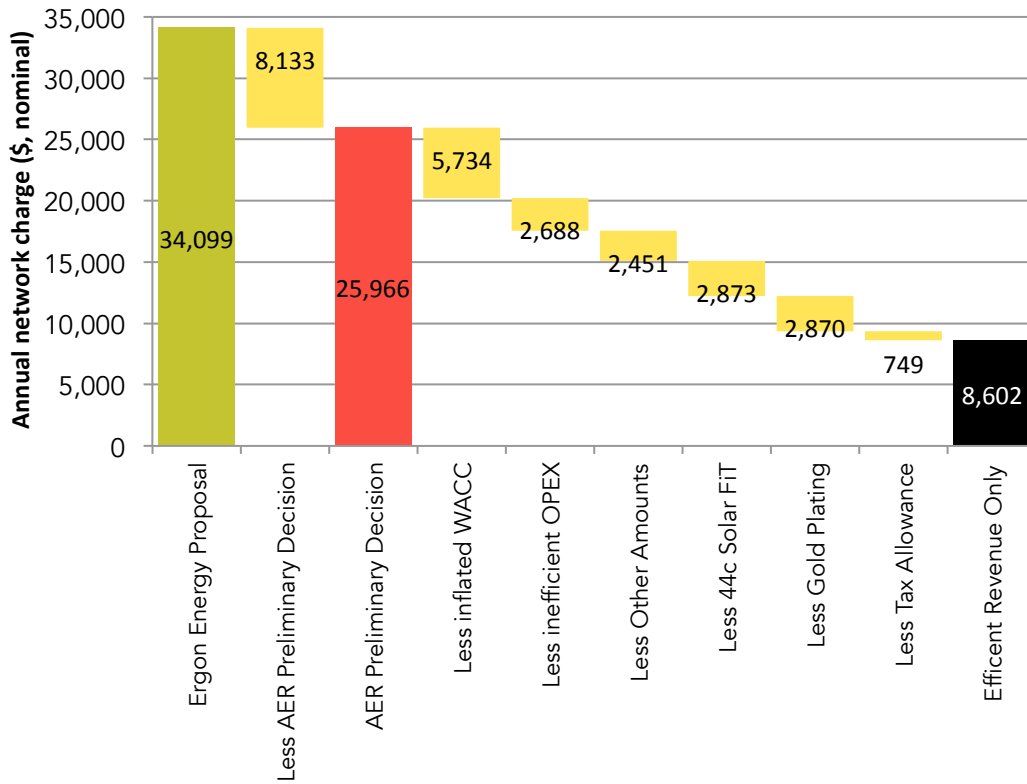
Possible reductions in household bills



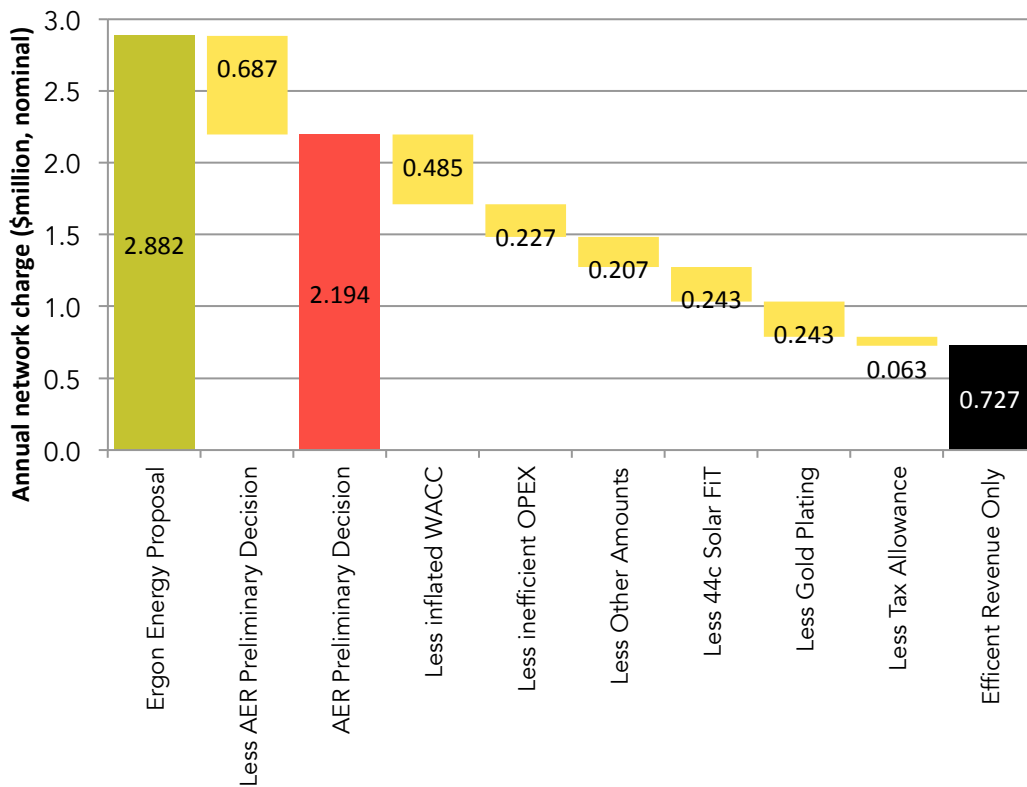
Possible reductions in small business bills



Possible reductions in irrigator bills



Possible reductions in industrial customer bills



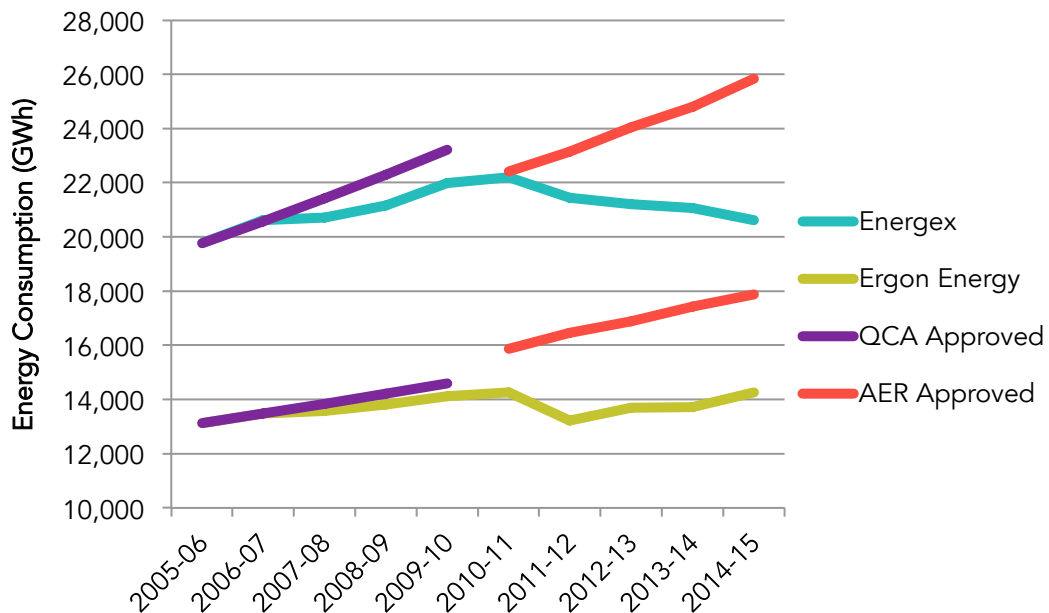
FORECASTS

Consumers Pay for Over-Optimistic Forecasts

Energy forecasts proposed by Energex and Ergon Energy (and accepted by regulators) have always been overly optimistic. These are easily observed in the current Regulatory Control Period (2010 to 2015).

In 2010, the AER agreed to Energex and Ergon Energy's forecasts, suggesting that electricity consumption would significantly increase. Over this time, electricity consumption across the Energex network has fallen every single year and also failed to increase in the Ergon Energy distribution area.

Forecasts historically over-optimistic



Under the AER's preferred control mechanism, it is consumers, not network companies who have paid for historic forecasting errors. Over the current Regulatory Period, consumers have paid severely for these errors.

Since 2010, the AER has approved network price increases above consumer expectations, totaling \$372.1 million for Energex and \$194.5 million for Ergon Energy, due to softening electricity consumption.

The extra recovery of revenue is equivalent of \$264 per connection for both Energex and Ergon Energy customers respectively, over the past five years.

Evidence of Forecast Irregularities and Manipulation

Analysis of Energex and Ergon Energy's Regulatory Proposals, highlights serious inconsistencies against trend and potential manipulation of energy and customer forecasts, through rebalancing and recalculation without substantial justification.

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.

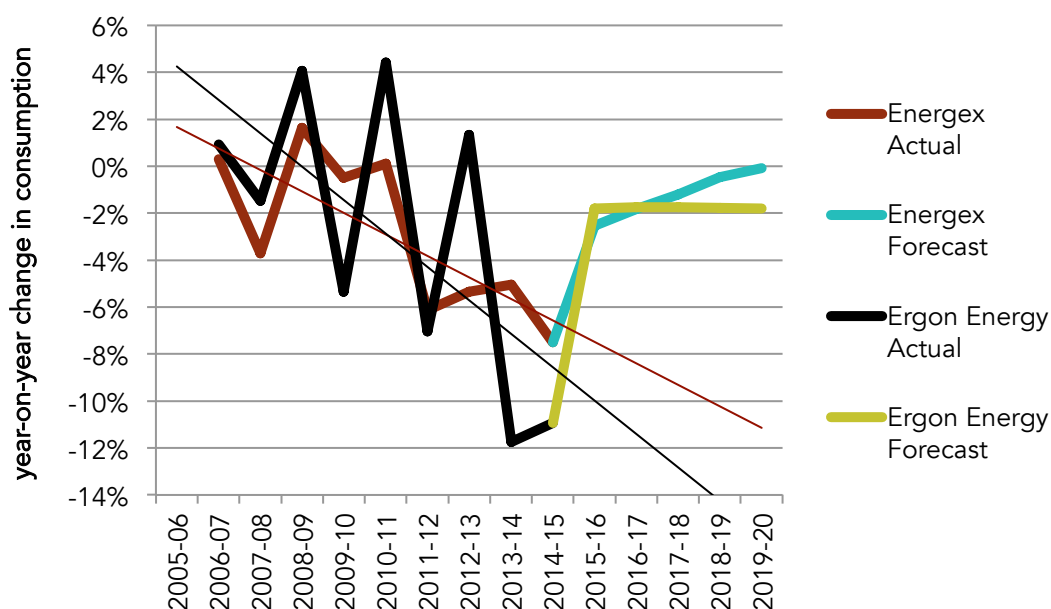
The Alliance calls on the AER to forensically investigate the following irregularities and search for other forecasting irregularities.

Overstated Forecast Consumption

Within Energex and Ergon Energy's forecast energy consumption, both companies claim that the rate of change in which consumers are reducing their average energy consumption will also reduce.

Energex's forecasts for domestic consumption are 11% above trend consumption by 2020 and Ergon Energy's are 17% above trend consumption levels. Energex and Ergon Energy have failed to justify these deviations from trend in their Regulatory Proposals.

Forecast Average Residential Consumption



Energex and Ergon Energy have not provided evidence to support their forecasts, which are grossly inconsistent with trend analysis.

Most commentators predict continued reduction in grid-delivered household electricity consumption, due to continued installation of Solar PV, increasing efficiency of household appliances as well as the introduction of large-scale,

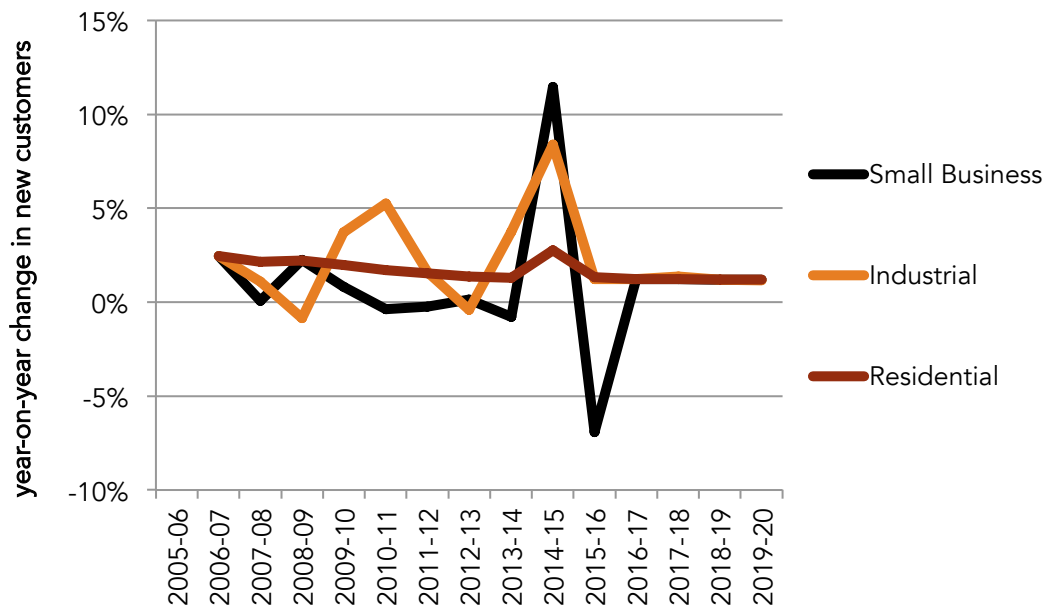
commercial battery technology.

Furthermore, many business customers are also attempting to bypass the network (especially irrigators) or wind-down electricity intensive components of industrial operations.

Irregular Energex Customer Numbers

In 2014-15 year, the rate of growth of customers on the Energex network rapidly increased, seemingly without explanation. The Alliance calls on the AER to investigate this irregularity prior to its Final Determination.

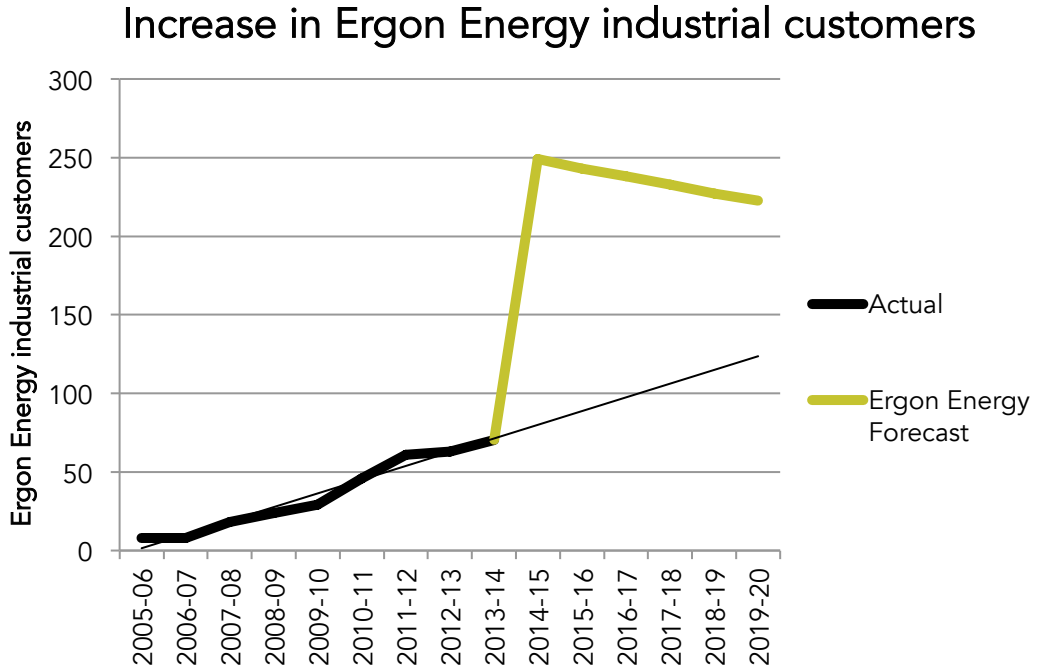
Irregular spike in new Energex customers



Inflated Ergon Energy Industrial Forecasts

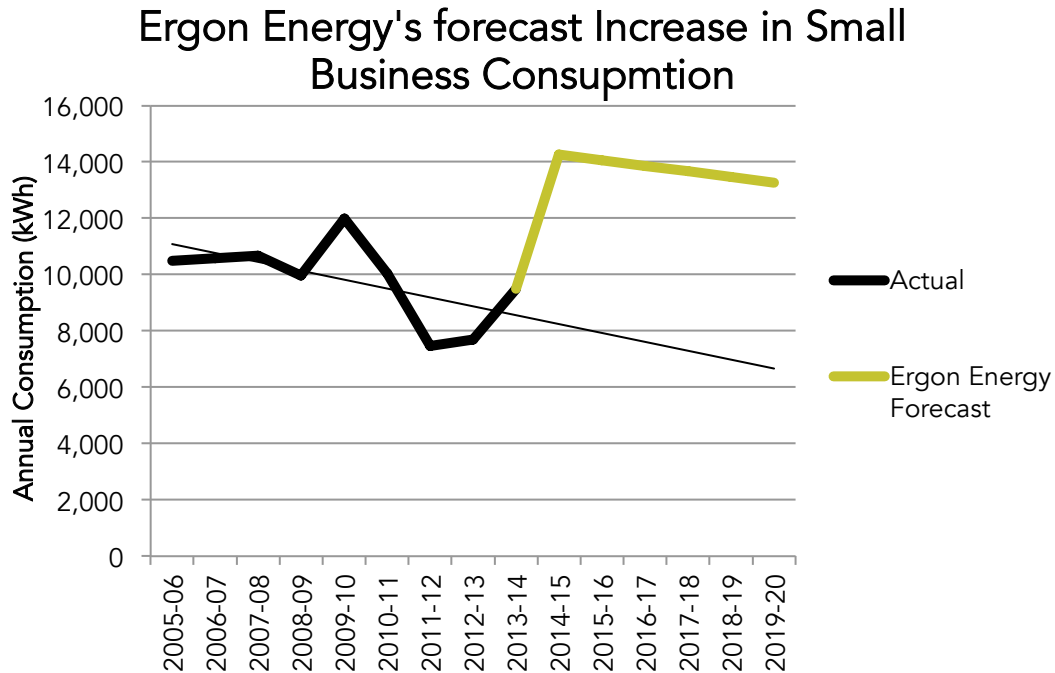
In its Regulatory Proposal, Ergon Energy has forecast a 253% increase in industrial customers across Queensland, in one year alone. The Alliance does not believe these forecasts are supported by real-world evidence.

The Alliance calls on the AER to investigate this unusual increase in industrial customers.



Inflated Ergon Energy Small Business Consumption

Ergon Energy has suggested average small business consumption will significantly increase over the next Regulatory Control Period, which is a 50% inflation, compared to trend consumption. The Alliance does not support this assertion and asks the AER to investigate this unfounded increase in small business consumption.



Realistic Forecasts Show Large Price Increases

Throughout the Regulatory Reset, both Energex and Ergon Energy have claimed that their Regulatory Proposals will lead to low or no price increases. However these claims are based on what are very clearly overly optimistic forecasts of consumption and customer numbers. Similarly, the AER has used optimistic forecasts to promote the benefits of its Preliminary Decision to future network prices.

This strategy, if employed deliberately by both Energex and Ergon Energy is unconscionable, as it sends a misleading signal to consumers, policy makers, and the network shareholder – the Queensland Government.

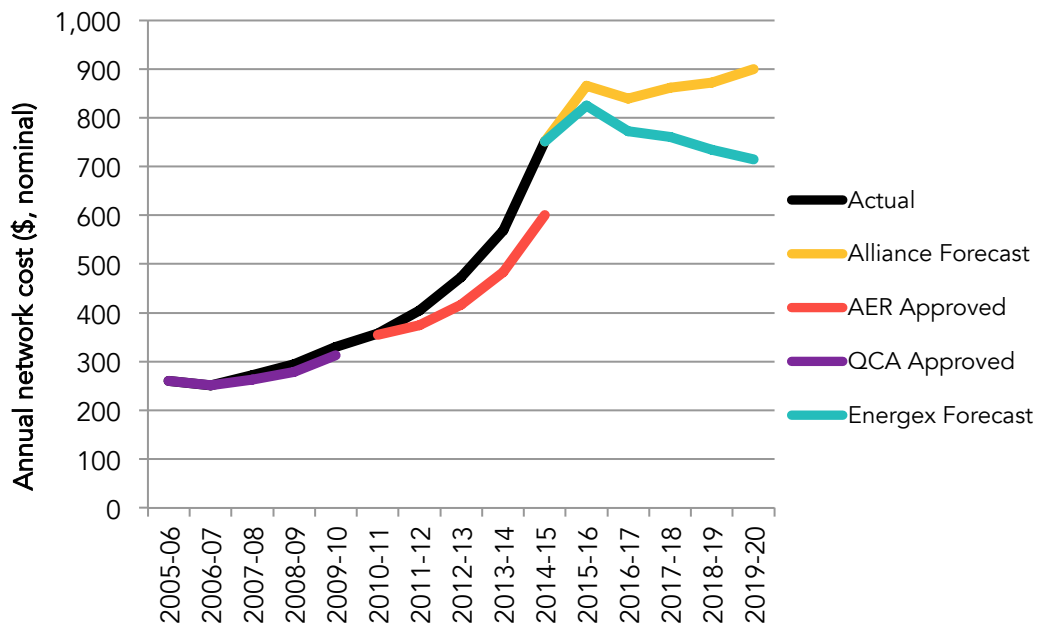
Replacing Energex and Ergon Energy's current forecasts, with more realistic forecasts show that consumers will face another five years of record prices, significantly above rates promoted by networks in their Regulatory Proposal (refer below).

Examples of the Consumer Impact of Forecasting Errors

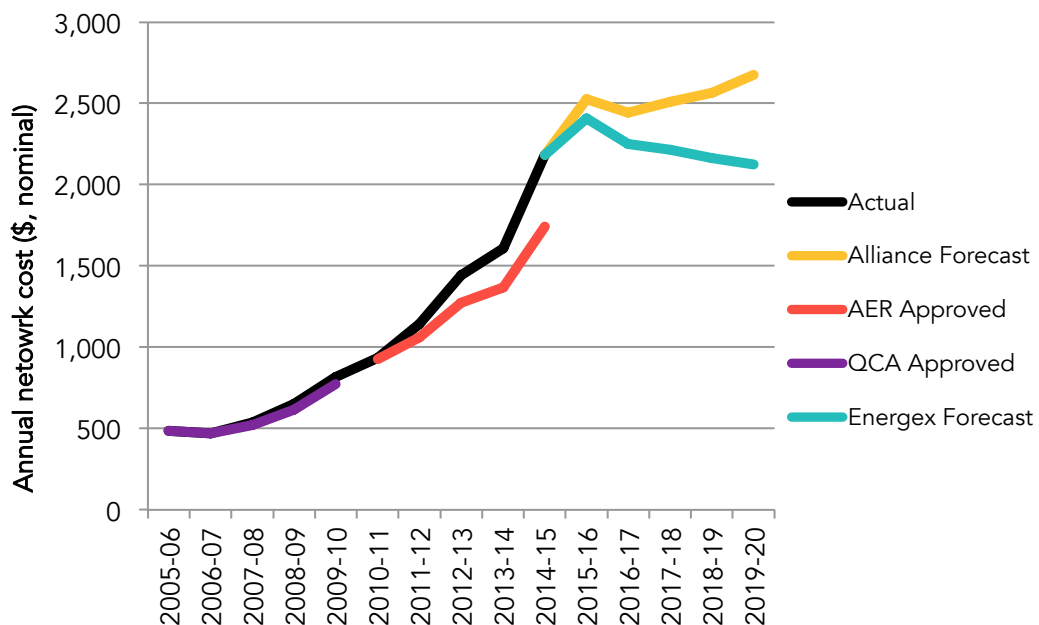
As a result of forecasting inaccuracies, network prices have risen faster than expected for all electricity consumers in Queensland.

The Alliance expects Energex and Ergon Energy's optimistic forecasts will result in an unprecedented price increase above the AER's expectations.

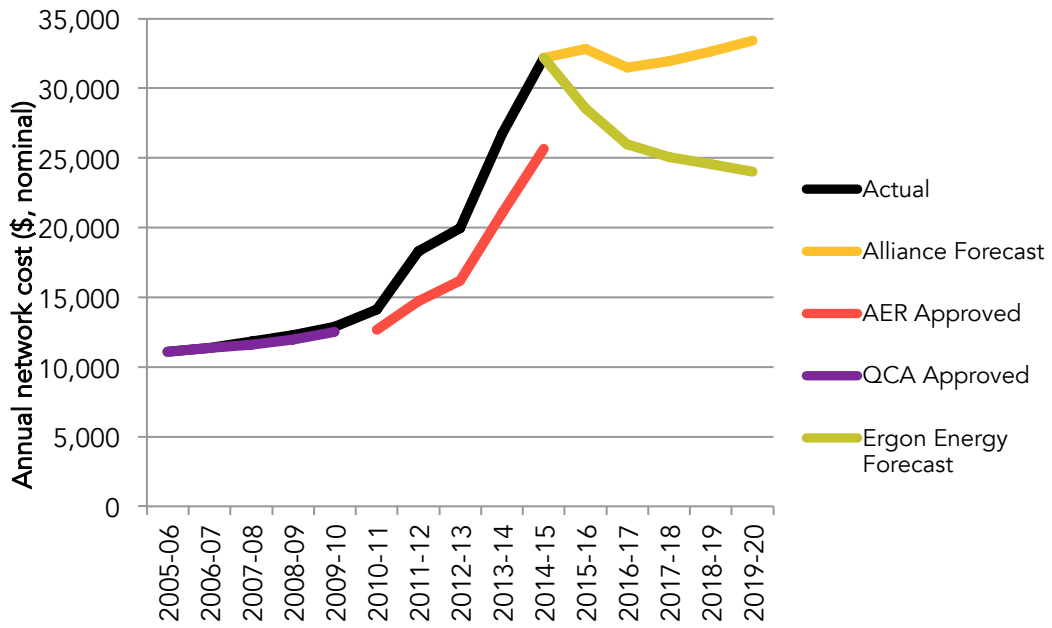
Forecast error impact on households



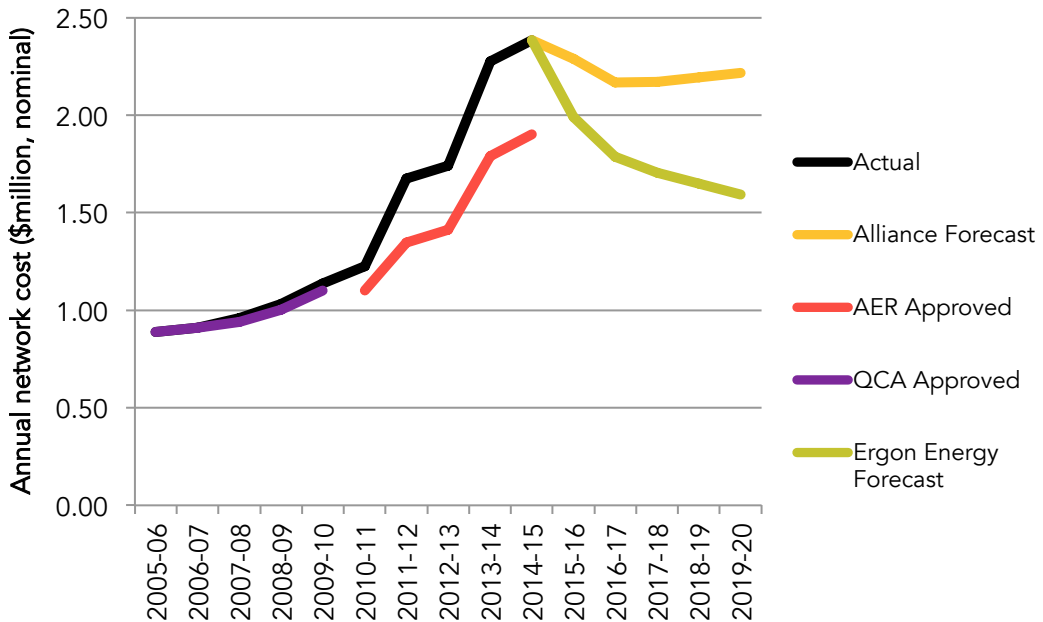
Forecast error impact on small business



Forecast error impact on irrigators



Forecast error impact on industrial customers



Price Increases Causing Demand Destruction

The Alliance understands recent record price increases have resulted in both demand reduction and demand destruction across Queensland. Demand destruction is a rare phenomenon where demand for a good is permanently removed from the market, not reduced or suppressed.

There are many instances where consumers are now looking to voluntarily restrict their use of electricity. These include bypassing the network through Solar PV, on-site diesel generation and/or large-scale batteries (or in the case of business, irrigators and heavy industry) scaling back or shutting down operations.

If network prices are not substantially reduced as a result of this Regulatory Reset, the electricity sector will be sent into a death spiral, where electricity consumption will continue its downward trend, resulting in higher prices - further destroying electricity consumption across Queensland.

Alliance Proposed Forecasts

The Alliance has developed alternate forecasts for the AER to adopt in its Final Decision. The Alliance's forecasts are based on the following formula.

Total energy = Average consumption by customer class × customers by customer class

The Alliance calls on the AER to endorse the forecasts in this submission as they protect the long-run interests of consumers by reducing the risk of manipulation and forecasting error.

A detailed overview of the Alliance's review of Energex and Ergon Energy's forecasts have been included in the appendix.

| Energex Forecasts | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
|---------------------------|----------------|----------------|----------------|----------------|----------------|
| Total customers | | | | | |
| Ergon Energy | 754,036 | 773,199 | 791,100 | 809,915 | 829,471 |
| Energex | 1,395,230 | 1,412,707 | 1,430,614 | 1,448,631 | 1,466,911 |
| Total Energy (GWh) | | | | | |
| Ergon Energy | 12,500 | 11,972 | 11,513 | 11,130 | 10,742 |
| Energex | 19,597 | 18,888 | 18,118 | 17,422 | 16,775 |

OPERATIONAL EXPENDITURE

Alliance Overview

The rapid increases in Energex and Ergon Energy's revenue allowances, which include ever-increasing allowances for OPEX, has been a major contributor to record network price increases over the current Regulatory Control Period.

It is not in consumers' short or long-run interests to be paying higher electricity prices due to inefficient management and an under-productive workforce.

The Alliance is disappointed that the AER's Preliminary Decision regarding Energex or Ergon Energy's OPEX did not follow the recommendations of their own consultants or the AER's Consumer Challenge Panel for more substantial cuts to Energex and Ergon Energy's existing OPEX levels.

In order to make the substantial price reductions consumers are calling for, the AER must change its current approach to Energex and Ergon Energy's operational expenditures.

For example, the Alliance calls on the AER to:

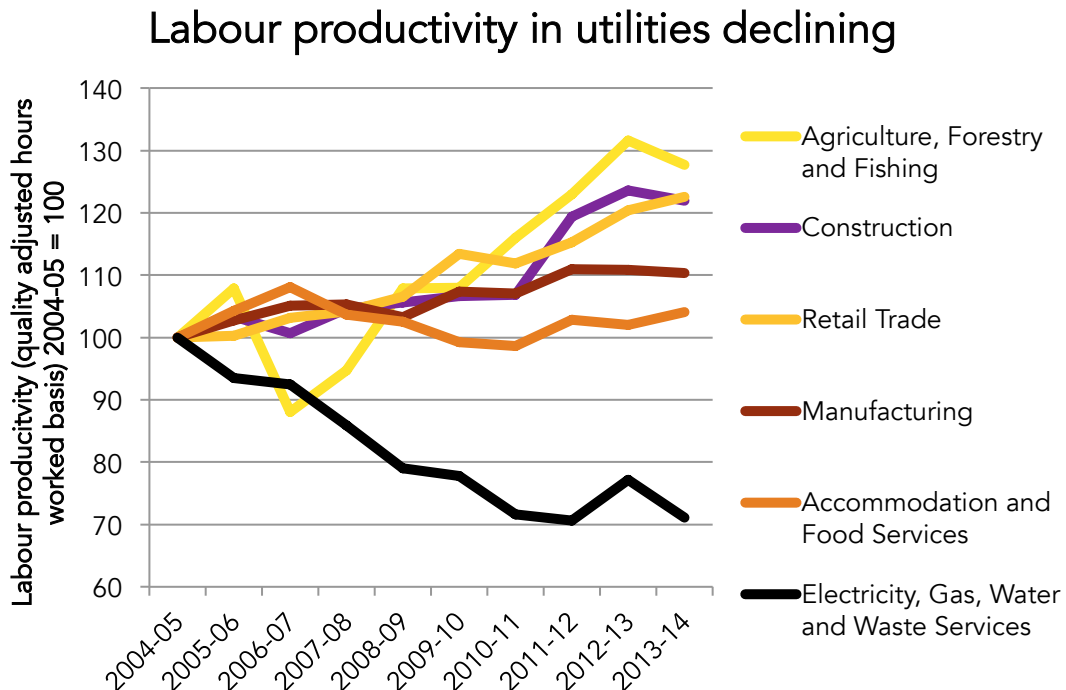
- Stop allowing future increases to Energex and Ergon Energy's record-high OPEX levels; and
- Apply the Economic Insights findings and ensure Queensland electricity consumers only pay for OPEX that is comparable to the absolute efficient frontier.

If Energex, Ergon Energy or its shareholder (the Queensland Government) have concerns about the impact of a reduced OPEX allowance on jobs, apprenticeship numbers or local depots, the Alliance recommends the non-efficient activities be funded through retained earnings within Energex and Ergon Energy, or through a Community Service Obligation payment from consolidated state revenue.

OPEX in Utilities Increasingly Inefficient

Energex and Ergon Energy are amongst the least efficient distribution networks in Australia. All electricity consumers in Queensland are paying for this inefficiency through higher electricity prices.

Data from the Australian Bureau of Statistics (source: ABS Data: 5260.0.55.002 Estimates of Industry Multifactor Productivity, Australia) shows that labour productivity in the utilities sector has been deteriorating for a long time and the efficiency gap between utilities and their major customers is growing.



Analysis of OPEX performance by Deloitte Access Economics, for the AER, supports the application of the conclusions drawn from the ABS data to Energex and Ergon Energy's operations. The Deloitte Access Economics report found a substantial productivity gap between Energex and Ergon Energy and their peer networks.

The cause of the lack of productivity was caused by:

- High overall labour costs – Ergon Energy has the highest overall labour costs per customer in the National Energy Market;
- High average staffing levels;
- Underproductive workforce culture, management and operational decisions;
- Significant underutilisation of labour due to poor workforce planning and trade union control of work activity;
- EBA restrictions on workforce flexibility, including:
 - Restrictions on involuntary redundancies;
 - Restrictions on single person activities;

- Restrictions on the introduction of new tasks;
 - Requirements for parity wages and conditions for all external contractors;
 - Number of hours of leave taken (holiday, sick leave, long-service leave);
 - Requirement to pay for a minimum number of hours work;
 - Mandatory breaks between work;
 - Restrictions on contractor switching; and
 - Minimum apprentice numbers.
- A substantial number of staff receiving more than 50% of their wage in overtime – Energex has the highest proportion of Gross Base Salary Ratios in the National Energy Market;
 - Time lost to disputes;
 - Low employee engagement, cooperation and collaboration;
 - Reportedly unusual treatment capitalising IT overheads with SPARQ;
 - A number of low-activity depots, which could be replaced with Local Service Agents; and
 - Very low levels of outsourcing.

The Alliance is deeply concerned about the findings of the Deloitte Access Economics report.

The Alliance notes its disappointment with the AER's unwillingness to release the full, unreacted version of the Deloitte Access Economics Report.

Past OPEX has resulted in higher prices

Queensland electricity consumers have been paying for inefficient OPEX for too long. The quantum of inefficient OPEX has been growing over time and is placing upward pressure on network prices.

The Alliance has calculated the impact of inefficient OPEX on electricity prices from the findings of Economic Insights and AER Consumer Challenge Panel Member and electricity sector expert, Mr Bruce Mountain, CME.

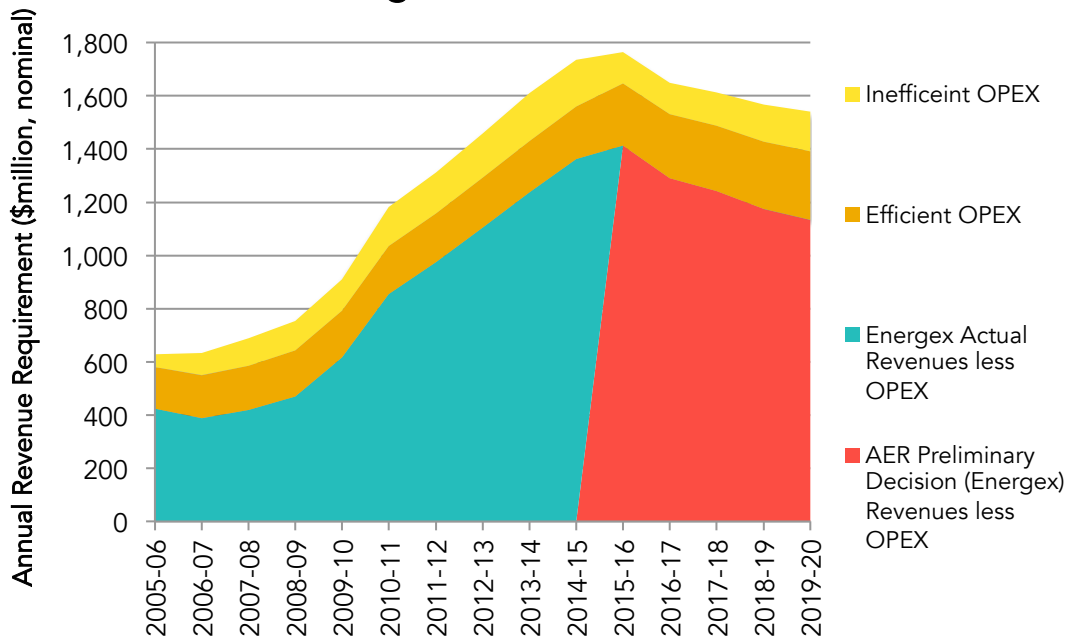
CME estimates that the efficient OPEX levels for Energex and Ergon Energy are:

- Energex
 - \$203 million per year (\$2014) for the period 2006 to 2013; and
 - \$228 million per year (\$2014) for the period 20016 to 2020.
- Ergon:
 - \$175 million per year (\$2014) for the period 2006 to 2013; and
 - \$196 million per year (\$2014) for the period 20016 to 2020.

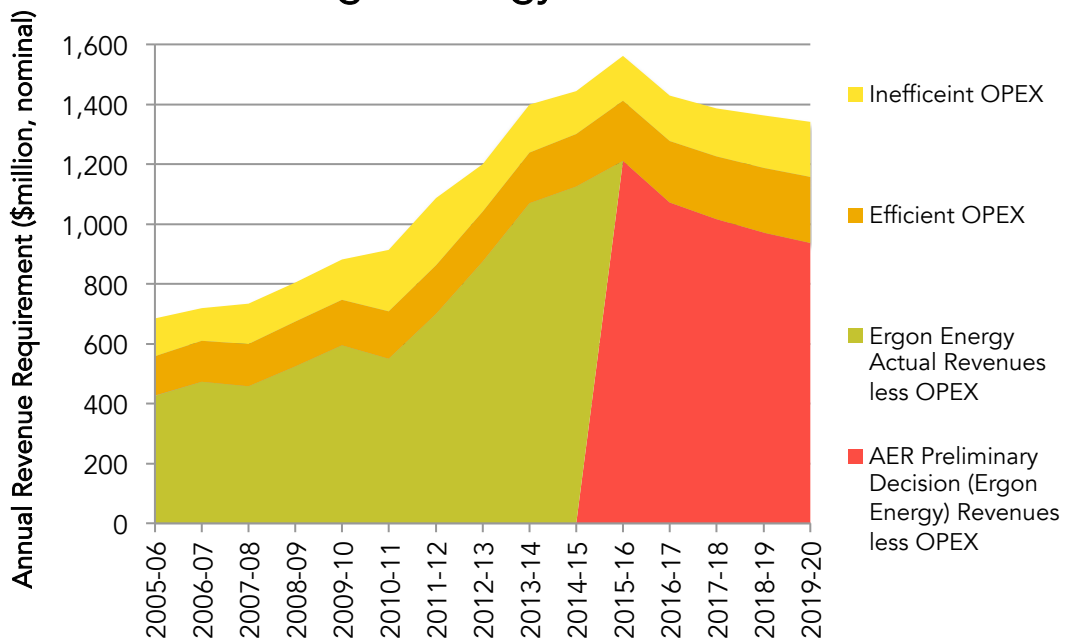
Based on Economics Insights and CME's calculations of efficient OPEX, The Alliance estimates that consumers have paid \$2.8 billion in inefficient OPEX over the past decade through higher electricity prices.

If the AER doesn't take action on Energen and Ergon Energy's OPEX costs, The Alliance estimates consumers will pay another \$1.47 billion in inefficient OPEX costs over the next five years, through higher electricity prices.

Energen inefficient OPEX



Ergon Energy inefficient OPEX



Per average customer, the Alliance calculates that the cost of inefficient OPEX over the next five years amounts to:

- \$295 per household
- \$965 per small business
- \$13,440 per irrigator (Ergon Energy)
- \$1,135,795 per industrial customer (Ergon Energy)

Allowing Energex and Ergon Energy to recover revenue from customers through higher electricity prices for inefficient OPEX is not in the short- or long-run interests of consumers.

Poor Application of AER Benchmarking

The Alliance acknowledges the expert work of the AER’s consultants, Economic Insights. The Alliance supports the Economic Insights work, as it is the first analysis of Energex and Ergon Energy’s OPEX that is honest, robust and focused on providing efficient outcomes in the short- and long-run interests of consumers.

The Alliance is very concerned that the AER has chosen not to apply the outcomes of the Economic Insights analysis in its Preliminary Decision.

Alliance Proposed future OPEX

The Alliance has developed alternate OPEX allowances for the AER to adopt in its Final Decision. A detailed overview of the Alliance’s review of Energex and Ergon Energy’s OPEX has been included in the appendix.

| Alliance OPEX | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
|---|---------|---------|---------|---------|---------|
| Efficient OPEX only (\$million, nominal) | | | | | |
| Ergon Energy | 201 | 206 | 211 | 216 | 221 |
| Energex | 234 | 240 | 246 | 251 | 257 |

The Alliance calls on the AER to adopt these OPEX forecasts in its Final Decision.

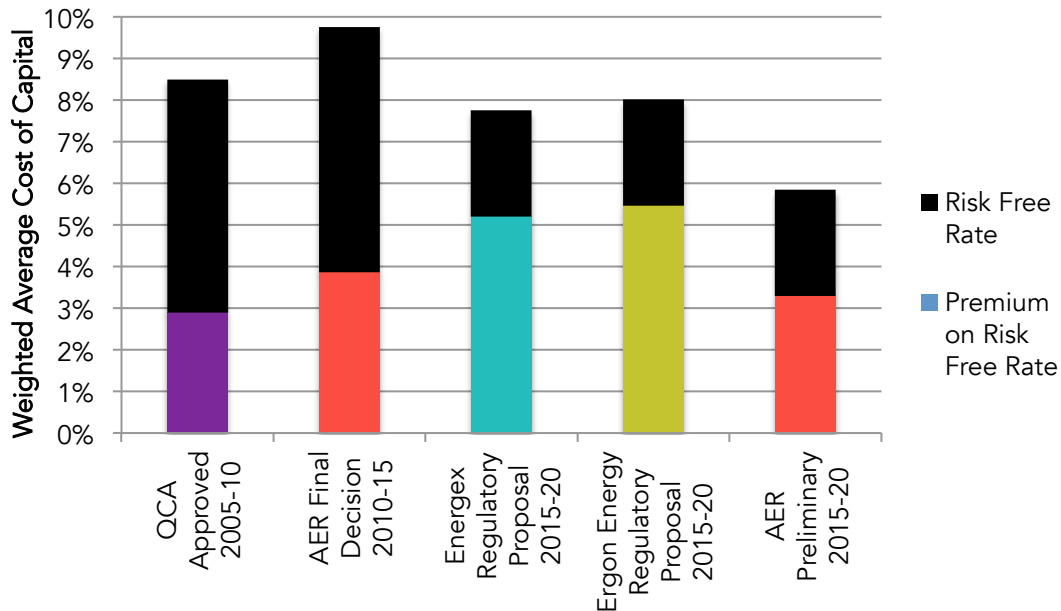
COST OF CAPITAL

Inflated WACC = Inflated Revenues = Inflated Prices

The Alliance does not support the AER Preliminary Decision on Energex and Ergon Energy's Weighted Average Cost of Capital (WACC). The Alliance believes the AER Preliminary Decision inflates revenues for networks, which unnecessarily inflates prices for consumers, which is not in the short- or long-run interest of consumers.

The Alliance is also concerned about Energex and Ergon Energy's continued attempts to expand the WACC premiums they receive over the risk free rate.

Increase in premium over risk free rate



Due to the public ownership of Energex and Ergon Energy, as well as their utility function within the economy, Energex and Ergon Energy should receive a return on capital that reflects the Queensland Government's actual financing costs.

The difference between Energex and Ergon Energy's actual financing costs, through QTC and the AER's revenue allowances for inflated hypothetical financing costs, provides substantial financial gain to the Queensland Government. This is at the exclusive expense of electricity consumers, through higher electricity prices.

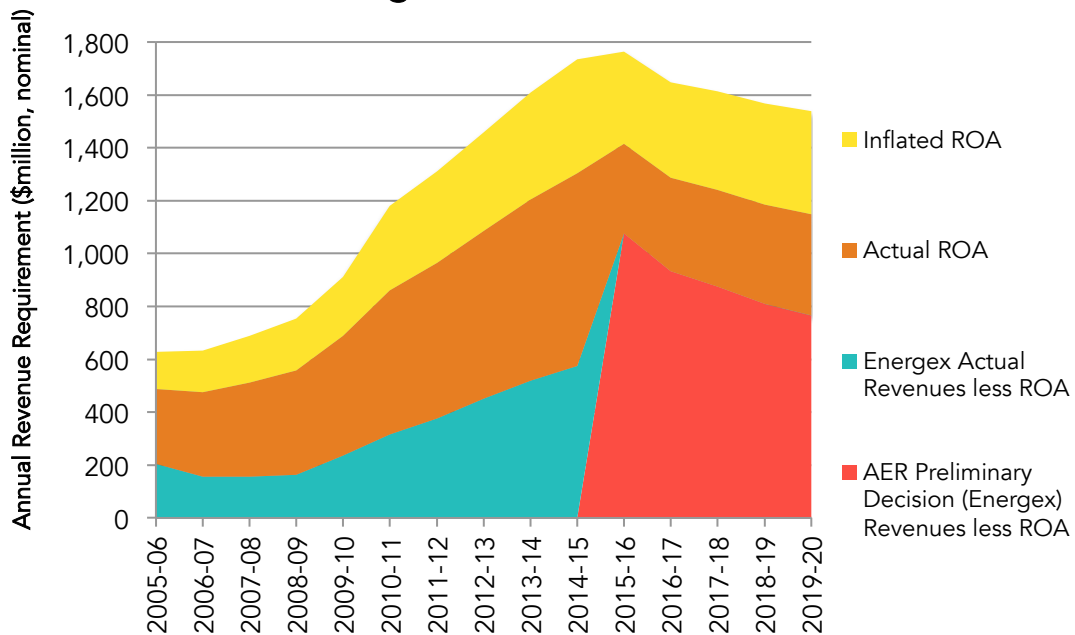
The Alliance has calculated the impact of inflated WACC estimates on electricity prices, based on the AER's regulated cost and Energex and Ergon Energy's shareholder's actual financing costs.

Based on the Alliance's calculations of actual financing costs, The Alliance estimates

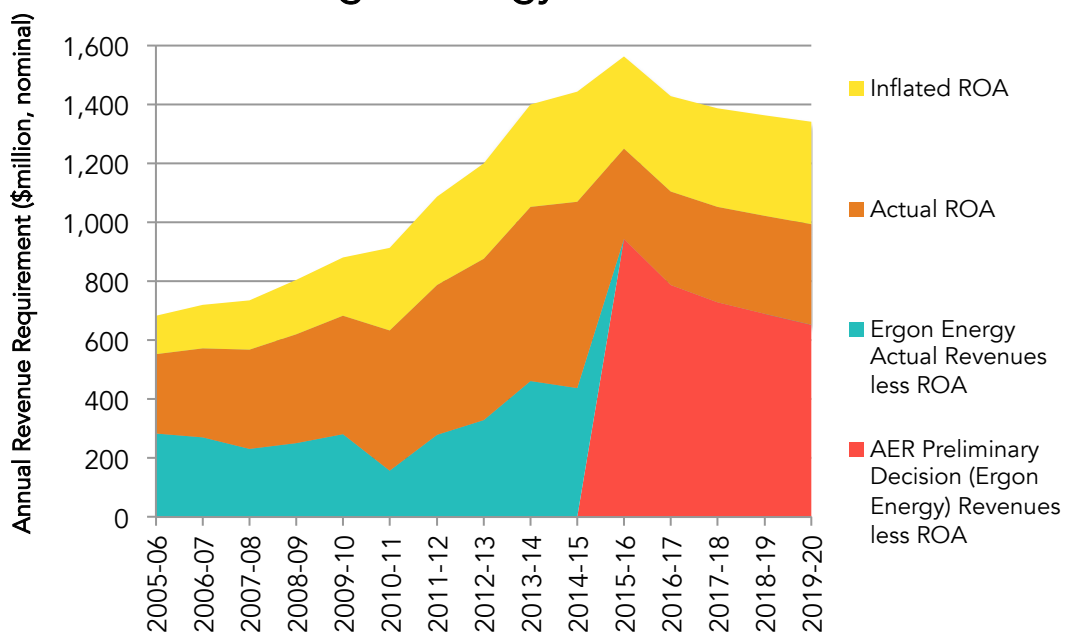
that consumers have paid \$5.2 billion through higher electricity bills, caused by inflated WACC estimated over the past decade.

If the AER does not change the way Energex and Ergon Energy can recover their financing costs, The Alliance estimates consumers will pay another \$3.5 billion in inefficient financing costs over the next five years, through higher electricity prices.

Energex inflated WACC



Ergon Energy inflated WACC



Per average customer, the Alliance calculates that the cost of the AER artificially inflating Energex and Ergon Energy’s WACC (over and above the Queensland Government’s actual financing costs) over the next five years amounts to:

- \$790 per household
- \$2,600 per small business
- \$28,670 per irrigator (Ergon Energy)
- \$2.4 million per industrial customer (Ergon Energy)

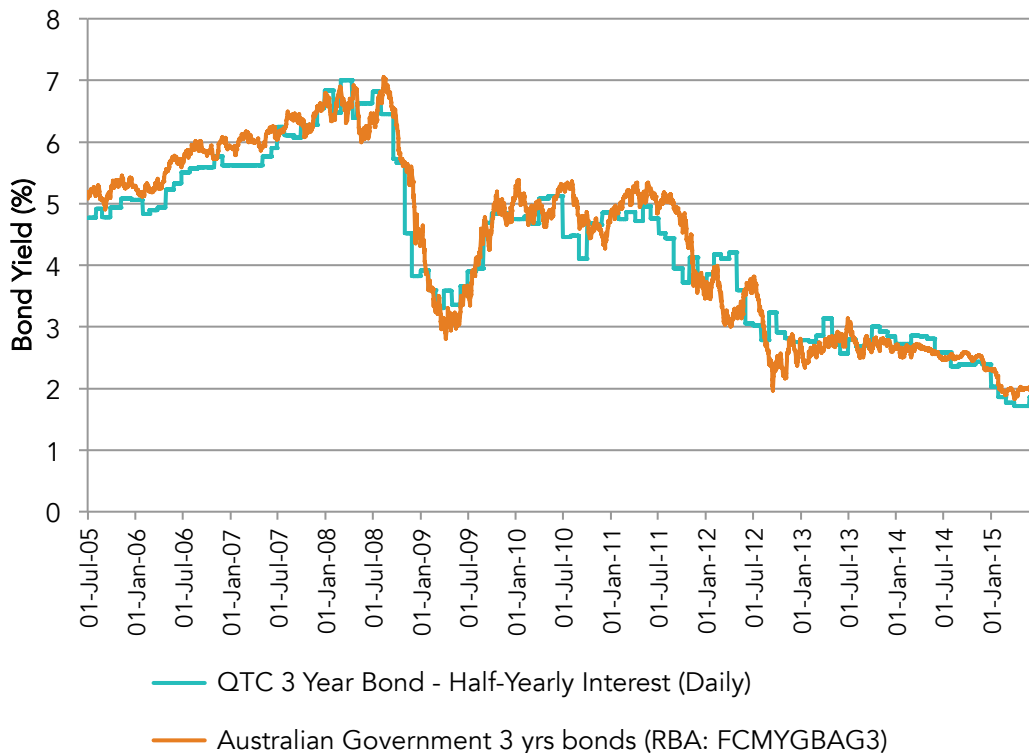
All of the additional revenue Energex and Ergon Energy are allowed to collect from electricity consumers through the inflated WACC, in excess of the Queensland Government’s actual financing costs, is directly transferred to the Queensland Government through corporate dividends and “competitive neutrality fee” payments.

Paying higher electricity prices to increase revenue to the Queensland Government is not in the short- or long-run interests of consumers and should not be facilitated by the AER.

Real Cost of QTC Debt

Data collected on QTC and the Australian Government’s respective 3-year bond rates show that there is not a significant yield premium (deficit) on Queensland’s bond rate, compared to the rate of the Commonwealth.

QTC and Australian Government Bond Yield



The Alliance supports the AER's trailing-average approach to calculating debt.

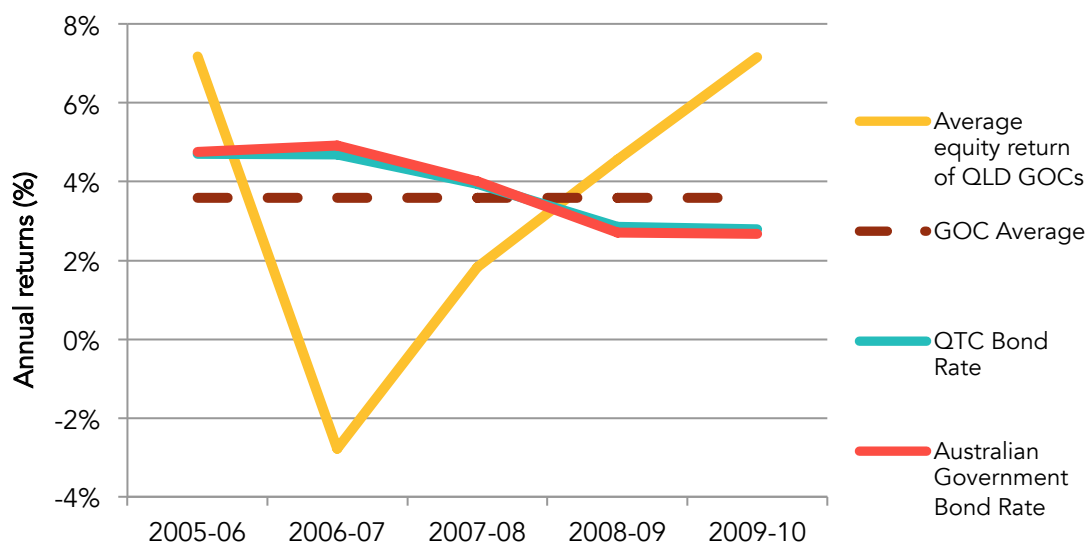
As the cost of debt has fallen significantly since the last Regulatory Decision in 2010, the AER must ensure that Energex and Ergon Energy's consumers realize the full benefit of reduced borrowing costs to the Queensland Government, through lower electricity prices.

Cost of Equity for GOCs

The AER calculates a regulated return on equity as a part of its Regulatory Reset process. The regulated return on equity is designed to provide a rate of return that an ordinary shareholder would require for them to continue investing in the company.

Analysis conducted by the Alliance shows that the average returns on equity for Queensland's non-network GOCs is below the QTC bond rate. This demonstrates that government investment in non-AER regulated GOCs is often for a non-commercial, public good outcome (such as the provision of port, water and electricity generation infrastructure for economic and social development).

Low equity returns from GOCs



The GOCs included in the Alliance's analysis include:

- SunWater
- Stanwell
- CS Energy
- Ports North
- Gladstone Ports
- North Queensland Bulk Ports
- Port of Townsville

The Alliance analysis shows returns to equity to the Queensland Government are lower than the cost of debt. However, to ensure that the Queensland Government does not face a disincentive to invest in Energex and Ergon Energy where necessary, the Alliance suggests the AER should peg returns to equity with the Risk Free Rate.

Alliance Proposed WACC & Return on Assets

The Alliance has developed alternate WACC and ROA allowances for the AER to adopt in its Final Decision. A detailed overview of the Alliance’s review of Energex and Ergon Energy’s WACC and ROA has been included in the appendix.

| Alliance WACC | 2015-20 |
|----------------------------------|----------------|
| Real financing costs only | |
| Cost of Debt | 2.13% |
| Cost of Equity | 2.55% |
| Gearing | 60% |
| WACC | 2.81% |

| Alliance ROA | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
|--|----------------|----------------|----------------|----------------|----------------|
| Efficient ROA only (\$million, nominal) | | | | | |
| Ergon Energy | 305 | 316 | 325 | 333 | 340 |
| Energex | 340 | 352 | 363 | 374 | 382 |

A detailed overview of the Alliance’s review of Energex and Ergon Energy’s WACC and ROA has been included in the appendix.

INCENTIVE SCHEMES

The Alliance does not support the application of any of the AER's Incentive Schemes for the next Regulatory Control Period.

STPIS

The Alliance does not support the application of the Service Target Performance Incentive Scheme (STPIS). Electricity consumers in Queensland are already paying significantly higher electricity prices due to the mandated N-1 network planning criteria, which was introduced state-wide following severe storms in South East Queensland in 2004.

As a result of the N-1 criteria, Energex and Ergon Energy are meeting and exceeding their STPIS targets through its legal obligations, not through innovative network management. Rewarding Energex and Ergon Energy for meeting legislative levels of service through additional incentive payments (paid through higher electricity prices) is not in the short- or long-run interests of consumers.

The Alliance calls on the AER to revoke the \$13.5million and \$30.22 million in STPIS payments Energex and Ergon Energy are seeking to recover in the next Regulatory Control Period. Further, the Alliance calls on Energex to forego the \$64.3 million in STPIS payments it has already recovered through higher network prices for Queensland consumers.

EBSS and CESS

The Alliance calls on the AER to NOT APPLY the CESS and EBSS incentive schemes to Energex and Ergon Energy in the next Regulatory Control Period. In their current format, the CESS and EBSS do not provide the appropriate incentives for Energex or Ergon Energy to invest in and operate their networks efficiently, nor does it protect consumers from inefficient expenditure.

For example, if the EBSS and CESS are to be applied, electricity consumers will still be required to pay for 30% of any inefficient expenditure incurred by Energex or Ergon Energy. This is not in the short- or long-run interest of consumers. In a competitive environment, any business would not be able to pass on 30% of their inefficient costs to consumers – the inefficient cost is borne by the business.

The Alliance firmly believes that the AER should be setting only the efficient levels of expenditure through the Regulatory Reset. If the AER is setting efficient expenditure (at the efficient frontier), Energex and Ergon Energy would have no scope to further reduce their capital or operational expenditure to gain from the EBSS or CESS.

Further, The Alliance calls on the AER to revoke the \$130.1 million of EBSS payments Ergon Energy is seeking and the \$38 million Energex is seeking to recover in the next Regulatory Control Period.

CORPORATE TAX ALLOWANCE

The Alliance does recognize that the AER is bound by the National Electricity Rules and must determine at corporate tax allowance for both Energex and Ergon Energy.

Based on substantial reductions in WACC and OPEX proposed by the Alliance, the AER's PTRM calculates that both Energex and Ergon Energy would not have a corporate tax liability in the next Regulatory Control Period.

ADDITIONAL AMOUNTS

Energex

The Alliance has identified \$505 million in unexplained Revenue Adjustments and Additional expenditure in the AER's Preliminary Decision on Energex's Regulatory Proposal for 2015 to 2020.

If the AER cannot explain the benefits of this expenditure to consumers in its Final Decision, it should not be included in Energex's total revenue allowance.

Ergon Energy

The Alliance has identified \$286 million in unexplained Carryover and Additional expenditure in the AER's Preliminary Decision on Ergon Energy's Regulatory Proposal for 2015 to 2020.

If the AER cannot explain the benefits of this expenditure to consumers in its Final Decision, it should not be included in Ergon Energy's total revenue allowance.

Alliance Proposed Additional Amounts

The Alliance proposes that only the cost of the Solar Bonus Scheme be included as an additional expenditure item for both Energex and Ergon Energy in the next Regulatory Control Period. All other additional, carry-over and revenue increments should not be to be passed on to consumers.

| Alliance Additional | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 |
|---|----------------|----------------|----------------|----------------|----------------|
| Efficient Additional only (\$million, nominal) | | | | | |
| Ergon Energy | 245 | 231 | 105 | 102 | 99 |
| Energex | 452 | 421 | 182 | 174 | 167 |

A detailed overview of the Alliance's review of Energex and Ergon Energy's additional amounts has been included in the appendix.

OTHER ISSUES

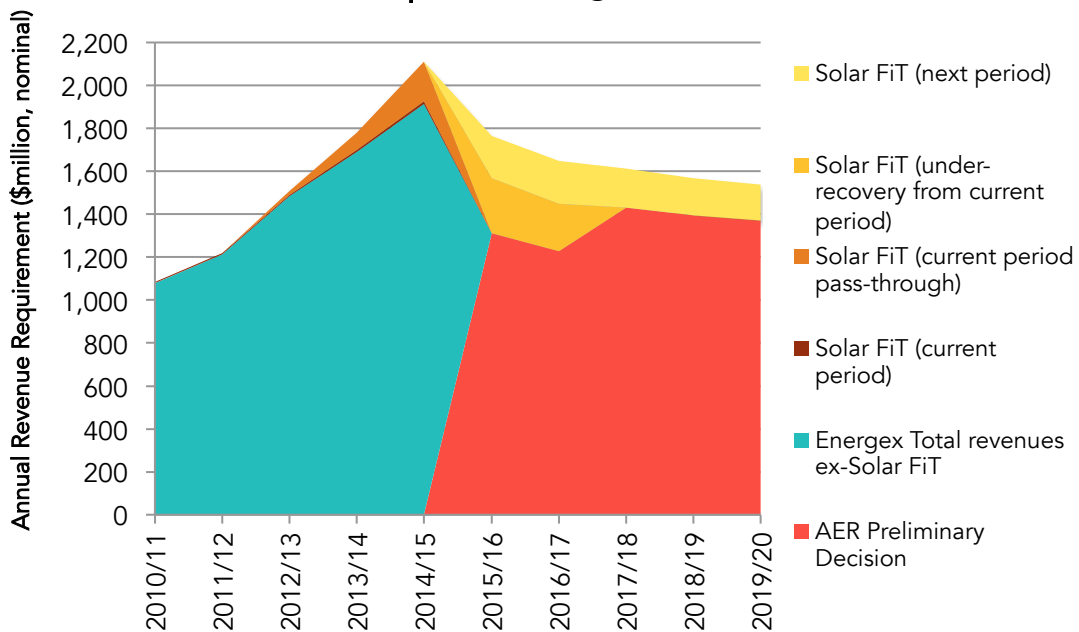
The Alliance understands that the National Electricity Rules limit the AER’s ability to proactively remove all inefficient costs from Energex and Ergon Energy’s Regulatory Proposals. In light of this, the Alliance calls on Energex, Ergon Energy and the Queensland Government, to remove the unnecessary costs outlined below in order to provide substantial price relief for consumers.

44c Solar FiT (Solar Bonus Scheme)

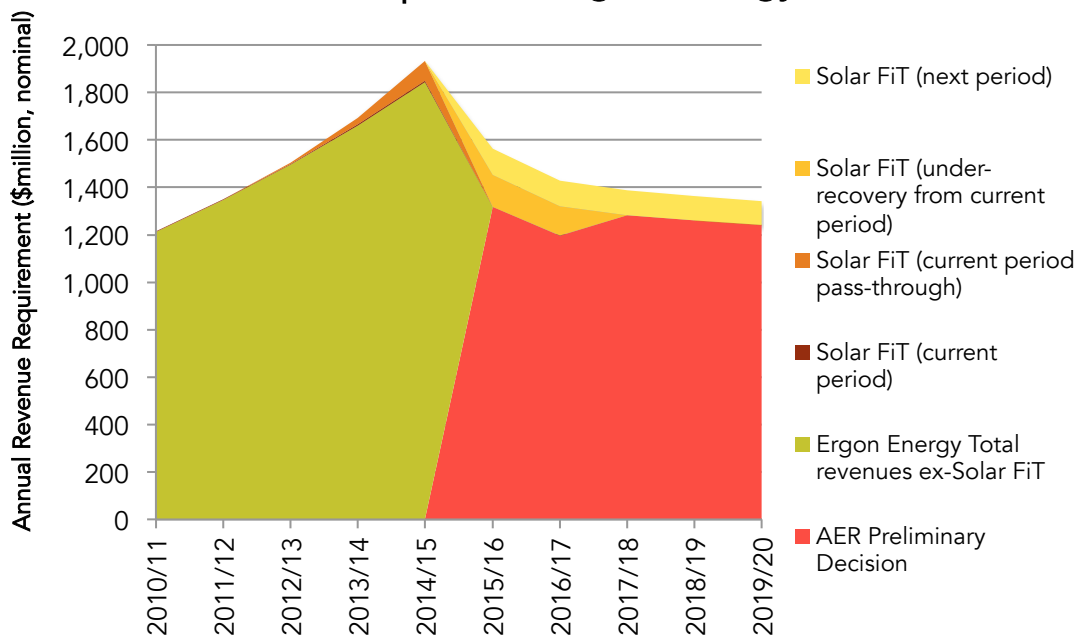
The legacy cost of the 44c Solar FiT will significantly increase the price of electricity for electricity consumers over the next Regulatory Control Period. For the financial years 2015-16 and 2016-17, the impact of the 44c Solar FiT is more than doubled, due to recovery of previously unrecovered Solar FiT payments from the past five years.

The Alliance estimates that Queensland electricity consumers will pay more than \$2.18 billion in Solar FiT payments over the next five years, through higher electricity prices.

44c Solar FiT impact Energex Revenue



44c Solar FiT impact on Ergon Energy Revenue



Per average customer, the Alliance calculates that the cost of the 44c Solar Fit over the next five years amounts to:

- \$630 per household
- \$2,080 per small business
- \$14,375 per irrigator (Ergon Energy)
- \$1,214,125 per industrial customer (Ergon Energy)

The Alliance calls on the Queensland Government to remove the cost of the 44c Solar FiT from Energex and Ergon Energy's network charges and fund the legacy of the program through consolidated revenue.

Corporate Tax Payments

Energex and Ergon Energy pay an effective corporate tax rate of 30% on profits. As Energex and Ergon Energy are Government Owned Corporations (GOCs), the Commonwealth Government does not collect the tax they pay as all tax receipts from GOCs are transferred back to the Queensland Government.

Based on Energex and Ergon Energy's Regulatory Proposals, the Alliance estimates that Queensland electricity consumers will pay more than \$1.223 billion in unnecessary corporate tax payments over the next five years, through higher electricity prices.

Per average customer, the Alliance calculates that the cost of corporate tax payments proposed by Energex and Ergon Energy, over the next five years amounts to:

- \$270 per household
- \$360 per small business
- \$11,405 per irrigator (Ergon Energy)
- \$963,735 per industrial customer (Ergon Energy)

The Alliance believes that the impact of this corporate tax transfer artificially increases the price of electricity and must stop. The Alliance calls on the Queensland Government to forego the revenue from corporate tax payments to lower electricity prices for Queenslanders.

Network “Gold Plating”

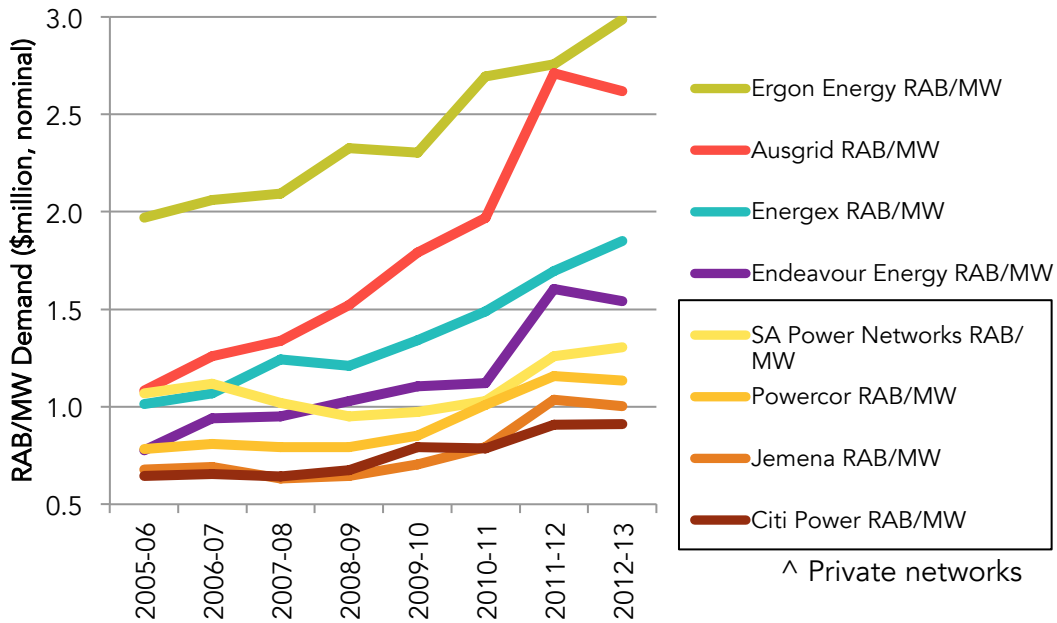
Network “Gold Plating” is a term used to explain deliberate overinvestment in the electricity network, which included investment with the aim of increasing the size of the Regulated Asset Base (RAB) to increase returns to shareholders. Gold plating includes both actual and regulatory inflation of the RAB.

Based on network RIN information over the past decade, it appears privately owned networks have not materially increased the size of their asset base, relative to the amount of coincident demand across the network. Based on this information, it is possible to infer that GOC networks have an incentive to “gold plate” their networks, where privately owned networks do not.

The Alliance understands that the key driver for unnecessarily expanding the RAB is the difference between the AER “private benchmark efficient” financing costs and each network’s actual financing costs.

The Alliance also notes the impact of regulatory gold plating on the price of electricity. The Alliance defines regulatory gold plating as deliberate manipulation of the National Electricity Rules to allow for indexation of the RAB to inflation, which acts to constantly increase the value of the RAB over time.

Gold Plating in GOC networks



The Alliance estimates that Queensland electricity consumers have paid over \$3.5 billion in inflated electricity prices due to gold plating over the past decade. Based on the AER's Preliminary Decision, the Alliance expects consumers will pay an additional \$3.9 billion due to network gold plating over the next five years, through higher electricity prices.

Per average customer, the Alliance calculates that the cost of gold plating from the AER's Preliminary Decision (assuming no change in the AER's WACC) over the next five years amounts to:

- \$885 per household
- \$2,920 per small business
- \$32,190 per irrigator (Ergon Energy)
- \$2.7 million per industrial customer (Ergon Energy)

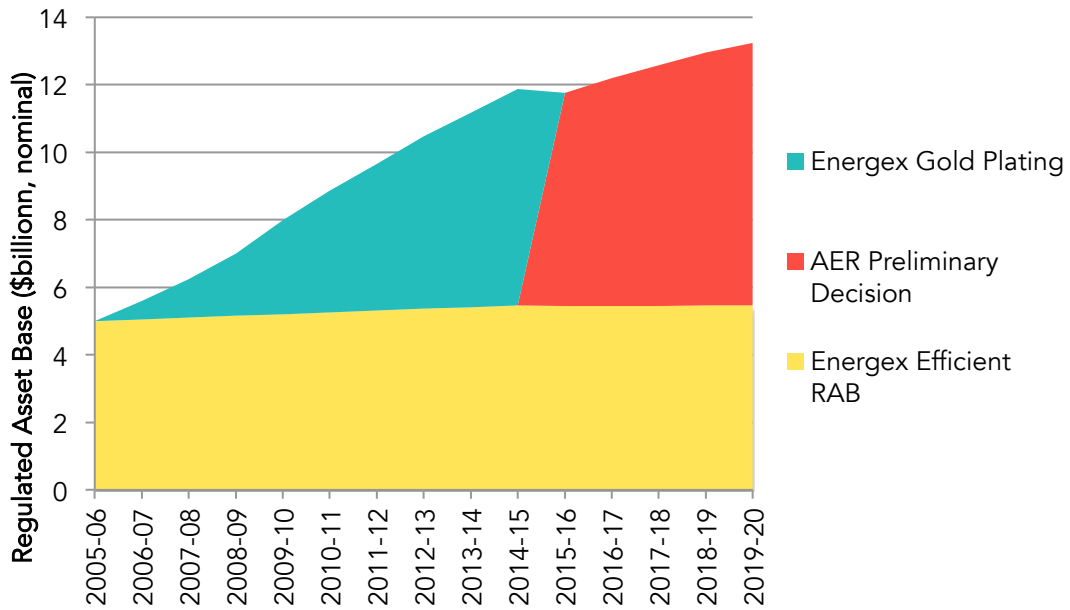
The Alliance believes that both Energex and Ergon Energy's RABs are too high and are causing increased prices. The Alliance calls on the Queensland Government to reduce the size of Energex and Ergon Energy's RABs, to a normalized level rather than the Gold Plated standard, to lower electricity prices for Queenslanders.

Energex and Ergon Energy's Optimised RABs

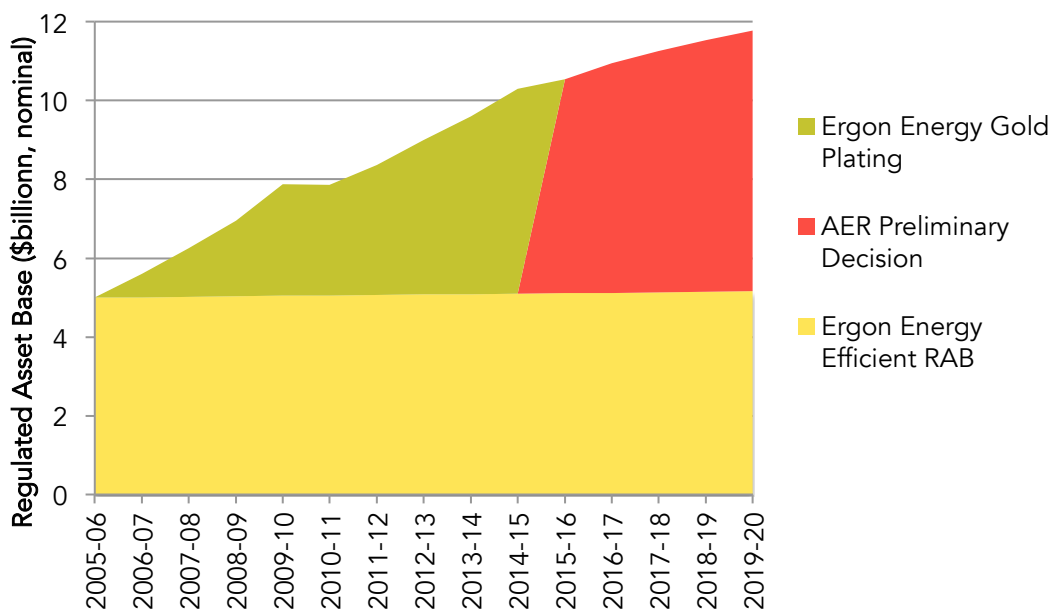
The Alliance has calculated an efficient value for Energex and Ergon Energy's RABs to isolate the impact of over-investment in the network and to quantify the impost gold plating imposes on electricity prices.

Assuming a prudent and efficient operator would have maintained a RAB/MW value of \$1.23 million/MW Demand over the past decade for Energex and \$1.96 million/MW Demand for Ergon Energy, Energex and Ergon Energy's RABs could have only grown to cater for slightly increased peak demand.

Energex Gold Plating



Ergon Energy Gold Plating



APPENDIX LIST

- Appendix 1. Annual Revenue Requirement & Price Generator
- Appendix 2. Proposed Forecasts
- Appendix 3. Proposed OPEX
- Appendix 4. Proposed WACC & Return on Assets
- Appendix 5. Proposed Depreciation
- Appendix 6. Proposed Additional Amounts
- Appendix 7. Proposed Tax Allowance
- Appendix 8. Proposed Other Issues

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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