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Ergon Energy and Energex – Network Distribution Resets 2015-2020

Thank you for the opportunity to make a submission in relation to the Australian Energy Regulator's (AER) review of the regulated network pricing proposals for 2015-20 put forward by Ergon and Energex and determination on network prices as required by the National Electricity Rules (NER).

Summary

CANEGROWERS seeks network distribution determinations from the AER for the Ergon Energy and Energex – Network Distribution Resets 2015-2020 that rigorously apply the NER. **The gaming of national electricity rules by Queensland's distributors must be stopped, if electricity price gouging endorsed by regulation is to be reined in**.

CANEGROWERS underlying concern is that the cost escalations in Ergon and Energex regulatory proposals, driven by inaccurate and vastly inflated forecasts of urban and industrial demand, are not reflective of the true costs of prudently and efficiently delivering electricity to consumers. Truly cost reflective tariffs would be lower, taking into account the need to write down the value of under used assets, the impact of the threat of competition from other energy sources and emerging technologies and the impact on of excessive price claims on electricity users.

To achieve this CANEGROWERS calls on the AER to closely scrutinise the separate regulatory proposals put forward by both Ergon and Energex and sharply reduce the regulatory revenue cap each has claimed. This can be done by **reducing**:

- the size of the highly inflated regulatory asset base each organisation has claimed to ensure Ergon and Energex do not receive a guaranteed return on past inefficient investments.
- the regulated (Weighted Average Cost of capital (WACC)) return calculation to reflect the actual cost of finance, not the contrived costs associated with the proposed departures from the AER Rate of Return Guideline.
- the levels of augmentation capex proposed by Ergon and Energex to levels that are consistent with flat/declining demand trends and recently reduced reliability standards.
- the excessive operating expenditure (Opex) claim to a level that is reflective of prudent and efficient operating costs.

It is important that the regulatory revenue cap be set at a level that provides performance incentives, encourages reductions in costs across the supply chain through both productivity gains and improved demand management, reflects declining network use and requires Ergon and Energex to bear the risk associated with their network investment decisions. Continuing

the current trajectory for electricity prices is unsustainable for agricultural irrigation users and many other sectors of the Australian economy.

Background

Sugarcane is Queensland's largest agricultural crop by volume and by value. Production is export focused. Prices for sugarcane are linked closely to the world determined raw sugar price. Of all agricultural commodities, the world sugar price is one of the most volatile.

In the highly competitive world sugar market, prices are not determined on a regulated cost reflective basis. Cane growers and the sugar millers they supply do not have an ability to pass cost increases onto final consumers. Unless offsetting productivity gains can be achieved, all input price increases flow directly to the growers' bottom line, reducing income and profitability throughout the industry. This exacerbates the effect of the downturn in commodity prices on producer incomes.

To enable electricity and water users to compete internationally, it is important that regulated prices are set at the level that would result from the forces of a competitive market. Such a price outcome would be consistent with the Australian Government's agricultural policy and the Queensland Government's long term vision for agriculture in the state. The current network charges, reflecting the behaviour of a monopoly supplier, are far higher than the prices a competitive market would deliver. Ernst Young[1] has found that network charges in Queensland have increased by 140% over the past fifteen years. In comparison, network prices in Victoria and South Australia have fallen over the same period.

This is flowing on to higher electricity prices at a network level. In August 2014 Carbon Market Economics (CME) found that the Ergon network tariffs that would apply to irrigators in Ergon's zones 1, 2 and 3 would have been significantly higher over 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, CME estimates that in 2014-15, prices of 17 to 18 c/kW hour for an Ergon tariff, compare with prices in the range of 10 to 15 c/kW hour for the southern networks.

The AER needs to be more than a rubber stamp

The most effective way to minimise the present systemic incentives for over-investment and establish efficient pricing boundaries, is for the AER to more rigorously apply the NER when determining revenue caps for Queensland's distribution network service providers (DNSP) Ergon and Energex. This requires the AER to independently assess network demand trends, efficient network costs and efficient network demand management strategies.

To contain capital cost structures and "gold-plating", the AER needs to be able to determine prices within a regulated framework that requires a rigorous assessment of the prudence and efficiency of investment in network structures and analysis of changing electricity market conditions (in terms of both electricity generation and consumption) and the cost of capital. This must take into account swings in demand such as those resulting from distributed power generation and the impact of disruptive new technologies that make demand forecasts based on historical trends obsolete.

Unless called to account by the AER, Ergon and Energex network proposals will require a smaller level of demand to carry a higher cost of supply, hastening the arrival and impact of disruptive alternative technologies.

[1] Ernst Young (2015), Network Pricing Trends – Queensland Perspective.

Productivity targets

Agricultural industries are required to increase their productivity every time input prices go up to remain economically viable in a fiercely competitive world market. Regulated price structures in the electricity sector should face the same downwards pressure on operating costs as other competitive industries. This productivity target should be administered by AER at the start of every five year price determination. This must also be an integral part of a more rigorous regulatory framework that covers both network and retail sectors.

Without effective market disciplines, Ergon and Energex operate in isolation of their users. The supply-side focus is not tempered by the demand side incentives to drive efficiency gains or deliver productivity improvements. The present network pricings framework means all cost increases, whether the result of changing user needs or new regulatory demands are passed through to consumers as higher network prices. Counterintuitively, higher cost structures deliver higher profits for DNSPs and their owners. The directors and officers of DNPs have a fiduciary responsibility to extract value for their shareholders. The Ergon revenue proposal, reportedly prepared at a cost of $6M, is designed to justify an increase in allowed revenue in 2015-16. This is in addition to the growth in allowed revenues of more than 50% that occurred over the five years to 2014-15, a period during which network use fell. In this environment, only the AER can say "enough is enough" and call the DNSPs to account.

1. **Demand forecasts**
   - Queensland's electricity market is changing rapidly. Driven by high prices consumers are switching to alternative energy sources, including off-grid electricity solutions to meet their energy needs. They are also turning to more energy efficient appliances and equipment. As acknowledged by Ergon and Energex, the impact of these changes, evident in energy use patterns during the 2010-15 period, is expected to accelerate during the forecast 2015-20 period.
   - At a national level 2014 electricity consumption was only 25% of what AEMO forecast 5 years ago. In Queensland, recent media reports have quoted Ergon's CEO as saying that by 2020 most domestic consumption will be supplied by solar cells.
   - Having acknowledged the overall impact of these changes and their own demand management programs on network demand, Ergon and Energex are more dismissive of the likely impact of change on peak demand.
   - It is difficult to forecast the impact of new technology. But, with network utilisation of less than 40%, there is a lot of spare capacity in both the Ergon and Energex networks and opportunity to manage the prospective change with the latest demand management techniques at much lower cost than either Ergon or Energex have proposed using current techniques.

   It is clear that the new technologies mean that forecasts based in large part on a continuation of past trends is likely to be flawed. The AER must challenge the level of forecast demand; both at an overall level, regionally and during peak periods, and require revised forecasts that reflect the likely disruptive impact of new technologies in a rapidly changing market. AER must also challenge the implied assumption in the Ergon and Energex proposals that existing demand management techniques will not change to meet new challenges.

2. **Regulated Asset Base (RAB) and proposed levels of capex**
   - The current and proposed RAB levels are too high. Ergon and Energex electricity networks have installed asset bases well in excess of requirements. Unless written down, this will lock in a guaranteed return on past inefficient investments and a

flawed asset valuation methodology which allows annual escalation provisions, ensuring excessive network prices remain well into the future.
    - As occurs in other sectors of the economy, major asset write-downs are required to ensure the size of the asset base reflects declining network demand.

- DNSPs, no longer required to follow "asset optimisation" rules, face few regulatory constraints on over-investing in their networks. The regulatory pricing framework encourages high asset valuations and enables the assets to be revalued upwards by CPI annually. There is no formal requirement to write down the value of underused or stranded assets.

- Electricity consumers in Queensland are already funding a significant level of "stranded assets" and inefficient past investments. The guaranteed returns these investments attract are driving around 70% of network prices[2].

- Although the AER has little ability to remedy past mistakes, it has the power to scrutinise proposed investments to ensure they are not repeated.
    - The risk of network investment decisions should be borne by the network owners, not be passed to users through a deeply flawed regulatory pricing framework.

If Queensland's unsustainable electricity prices are to be addressed, and to ensure Ergon and Energex do not receive a guaranteed return on past inefficient investments, the size of the highly inflated regulatory asset bases each organisation has claimed must be reduced.

3. Capital Expenditure (Capex)

- The levels of augmentation capex proposed by Ergon and Energex are inconsistent with flat/declining demand trends and recently reduced reliability standards.
    - Energex is proposing a 66% increase compared to its actual spend in the previous period.
    - Ergon is proposing a 23% increase compared to its actual spend in the previous period.

- These proposed expenditure levels are very high by historical standards and follow substantial replacement capex programs during the previous regulatory periods. The proposed levels of replacement capex appear to be significantly above underlying needs, given network use patterns and the emerging alternative electricity and energy alternatives.
    - One example illustration of Ergon's excessive capex claims is its ask for $17 million to relocate the Operations Control Centre. The claim, with no apparent offsetting efficiency gain of cost saving identified, calls into question Ergon's due diligence processes and is an example of the continuing "gold plating" of their network. Such a claim could only be made in a regulated price environment. In the commercial world, the costs of such decisions could not be foisted onto unsuspecting consumers. Such expenditure would be funded internally, from the savings and efficiency gains flowing from the capex decision.

- Australia's electricity distributors have a history of overestimating the levels of demand in their forecasts. With electricity prices at historically high levels, alternative supplies available and new and emerging technologies becoming

[2] Energy Users Association of Australia (2014), Submission to Senate Inquiry into the Performance and Management of Electricity Network Companies.

commercially viable, there is little to suggest that regulators can have confidence in the demand forecasts Ergon and Energex have developed for 2015-20.

- The evidence does not support Ergon and Energex claims regarding "ageing assets" and the need for replacement capex.

If Queensland's unsustainable electricity prices are to be addressed and the "gold plating" of networks stopped, the levels of augmentation capex proposed by Ergon and Energex must be adjusted to levels that are consistent with flat/declining demand trends and recently reduced reliability standards. Real world commercial disciplines must be imposed on Ergon and Energex capex proposals.

4. Operating Expenditure (Opex)

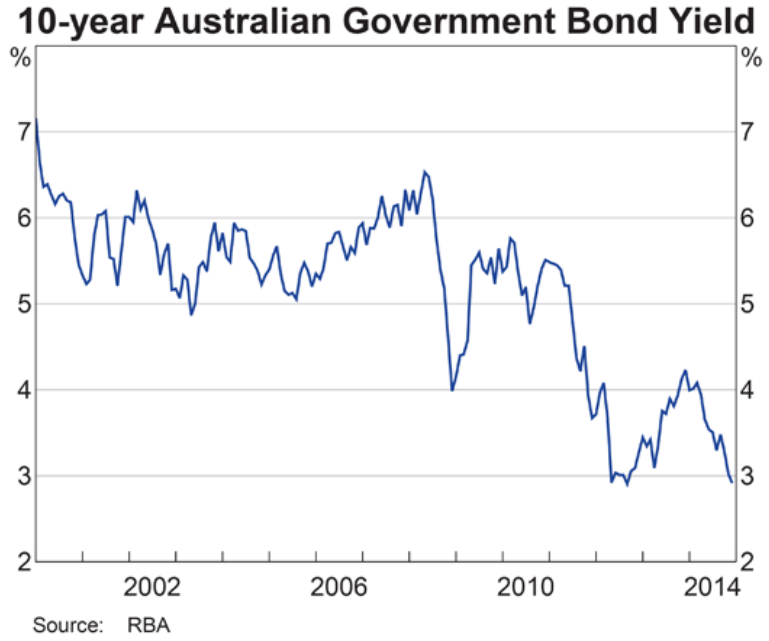
- We are concerned that the networks' past opex allowances were excessive and proposed opex levels are not reflective of prudent and efficient operating costs.
- Benchmarking is expected to determine significantly lower allowances for operating expenditure.
- Ergon's claim that because its network is dispersed with limited interconnectivity it cannot take advantage of the 'meshing' available to urban networks is hollow.
  - Ergon has a predominantly overhead network (more than 99% by length), 45% of which is single wire earth return (SWER). This is a much lower cost technology to install and maintain than other network options, such as underground. Ergon has the highest energy density (MWh sales per connection) in the NEM. Taken together, this would suggest Ergon should have lower average costs compared to networks that serve many smaller customers with lower average sales. Yet Ergon's cost per customer and unplanned outages are the highest in the NEM.
- The emergence of new technologies means that customers in regional and remote areas have increased access to new technologies and sources of power that can be supplied independently of the Ergon network. Unless it takes a new approach to network managements and customer supply, Ergon risks stranding assets and a declining customer base.

The excessive operating expenditure (Opex) claims must be reduced to a level that is reflective of prudent and efficient operating costs.

5. Return on Capital – Weighted Average Cost of Capital (WACC)

- Capital costs make up more than half of Ergon and Energex revenue requirements. In the case of Ergon, they account for 65% of the revenue requirement.
  - 47% – Return on capital (existing assets).
  - 11% – Return of capital (depreciation/existing assets).
  - 7% – Financing new capital investment.
- This means the calculated WACC is a key component of the regulated network charges Ergon's customers will face.
- The DNSP's proposed departures from the AER Rate of Return Guideline result in "artificially high" proposed WACCs. These departures, relying on creative financial workings, are designed to deliver the highest possible return on capital to take full advantage of the regulatory pricing framework.
- The regulated price framework provides a "guaranteed return" on the RAB. This means Ergon and Energex face much lower risk profile than they would if operating in a truly commercial environment. Their risk profile is largely unchanged since the 2010-15 reset.

- The key change that has occurred is that Ergon and Energex are operating in a sharply lower interest rate environment than they faced in 2009-10. The risk-free 10 year government bond rate has fallen from a level of around 5.5 in 2009-10 to currently less than 3%, a decline of more than 45% (Chart 1).



- Continuing global economic uncertainty and sharply lower commodity prices means the outlook is for a continuation of record low interest rates in Australia. This is reflected in minutes of the Reserve Bank of Australia's monthly Board meetings and statements made by its Governor after those meetings.

- The decline in WACC proposed by Ergon and Energex is less than two percentage points. This is inconsistent with the sharp reductions that have occurred in interest rates in an otherwise unchanged risk environment.

The regulated return calculation for should be more reflective of actual financing costs, not contrived WACC calculations designed to maximise the return Energex and Ergon receive on their regulated asset base.

6. Consumer engagement

- Ergon and Energex consumer engagement programs have been more extensive in the lead up to the preparation of their regulated network proposals. This appears to be a direct response to the AER's own customer engagement program and Consumer Challenge Panel processes.

- The workshops conducted by both Ergon and Energex provided insights into the DNSP's approach to the proposals being prepared for the AER. However, they were not designed to enable consumer representatives to critically analyse the issues and it is clear there is a strong focus on the needs of urban and industrial users, not on the needs of irrigated agriculture or the wider needs of Queensland's food and fibre producers.

- The AER's Consumer Challenge Panel identified many issues and flaws in Ergon and Energex regulatory proposals and provided a robust sounding board for consumers and was a much stronger avenue to developing consumer understanding than the Ergon and Energex processes.

CANEGROWERS urges the AER to pay close and careful attention to the issues raised in this submission and by the AER's own Consumer Challenge Panel and

challenge the assumptions and arguments put by Ergon and Energex in their regulatory pricing proposals.

Conclusion

CANEGROWERS underlying concern is that the cost escalations (driven by inaccurate and over inflated forecasts of urban and industrial demand) in Ergon and Energex regulatory proposals are not reflective of the true costs of prudently and efficiently delivering electricity across Queensland and to irrigated agricultural industries in particular. Truly cost reflective network revenue proposals would take account of changes in demand, the impact of new and emerging technologies on supply and demand patterns and the impact of network decisions on the international competitiveness of export oriented industries.

Rationality in regulated electricity pricing is needed. CANEGROWERS calls on the AER to closely scrutinise the separate regulatory proposals put forward by both Ergon and Energex and sharply reduce the regulatory revenue cap each has claimed.

Yours faithfully

Paul Schembri
CHAIRMAN