SUBMISSION

Australian Energy Regulator

Energex and Ergon Regulatory Proposals 2015-2020 and Issues Paper

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Thank you for the opportunity for the Electrical Trades Union of Australia (ETU) to provide comments to the Australian Energy Regulator (AER) on Energex distribution regulatory proposal and the QLD electricity distribution issue paper for the 2015-20 period.

The ETU is the Electrical, Energy and Services Division of the Communications, Electrical, Electronic, Energy, Information, Postal, Plumbing and Allied Services Union of Australia (CEPU). The ETU represents approximately 65,000 electrical and electronic workers across the country and the CEPU as a whole represents approximately 100,000 workers nationally, making us one of the largest trade unions in Australia.

Access to affordable, sustainable energy is a cornerstone of today's modern way of living; however, we have seen the cost of electricity increasing unceasingly, posing significant financial burdens on private consumers and businesses. It is vital that electricity is correctly and fairly priced whilst maintaining a secure supply through robust networks. We believe these aims are not mutually exclusive.

Over recent years we have seen electricity prices increase by large, unsustainable amounts to the point where it has become the most significant cost of living expenses for private consumers, and one of the largest ongoing expenses for businesses. The hyper-inflation of electricity prices has sparked significant regulatory and policy reform as regulators and governments have reacted.

While prices have sky-rocketed, transmission and distribution network companies have enjoyed huge increases to revenues and profits despite the fact that the National Electricity Market and the energy sector are one of the most heavily regulated industries in the country.

The biggest contributor, in our view, to high electricity prices has been the ineffective regulatory environment within the NEM that has resulted in network businesses being able to consistently achieve profits that are far in excess of those allowed for in AER determinations.

Linked to that is the role that forecast modelling by agencies such as the AER, AEMO and AEMC play in decisions of network businesses, generators and new entrants. The current oversupply of electricity, along with perceived over investment in networks can be linked back to demand projections from NEM governance bodies that were wildly inaccurate. Coupled with a regulatory environment that did allow for appropriate adjustments, it has contributed significantly to the price outcome problems that are currently besetting energy regulators and governments.

While it is not possible to accurately predict the future, important data such as demand projections should not be totally wrong, and there needs to be sufficient flexibility in the regulatory process to allow adjustments that protect consumers from having to foot the bill of bad investment decisions via bloated AER determinations.

Much has been made of network costs as the main culprit of steep increases to residential electricity prices. In particular, the term 'gold plated' networks was coined in reference to publically owned transmission and distribution network businesses that (allegedly) overinvested in network capital expenditure in comparison to private networks. This has led to a barrage of calls from various industry sectors that those remaining public electricity networks, such as those in Queensland and New South Wales, should be privatised.

We also note the contents of the AER Distribution and Transmission Annual Benchmarking Report 2014.

We do not agree that privatisation of the energy sector is the best way forward, not least of which is because privatisation does not lead to lower retail energy prices. In fact, the energy sector policies that delivered hyper-inflation of consumer electricity prices were largely a result of national competition based reforms that trumpeted privatisation. Advocates for privatisation of government owned energy infrastructure on the basis that it will driving increased market competition that will eventually be of benefit to consumers. Continuing to pursue this failed and outdated ideology is not warranted. Evidence drawn from other jurisdictions clearly shows that privatisation leads to high electricity prices as private companies profit gouge and maximise returns to shareholders.

Regulated Asset Bases (RAB)

As highlighted in both regulatory proposals, it has become apparent that electricity demand has declined and has significantly decoupled from economic growth. This has been driven, in part, by consumers reducing their consumption

in response to the dramatic increases in network prices. Furthermore, consumers are finding solar and other self-generating electricity more cost effective which is also a key factor in the decline of energy being delivered by the networks. However, one of the main planning tools for network businesses in considering their future capital works needs, and indeed, a main planning tool of regulators, is future demand projections. Any objective analysis of projected demand against actual over the last 5 years shows a large disparity.

What precipitates is the "death spiral".[1] The demand continues to decline and the burden to pay for maintaining the networks will be placed on consumers until consumers can no longer afford to stay connected to the network. Australian energy consumers are already funding a significant level of "stranded assets". The Public Interest Advocacy Centre reported that a realistic value of NSW electricity networks is around $13 billion, rather than its current $22 billion valuation.

The reality is that the RABs, the valuation of the electricity networks' past investments, are grossly inflated due to unnecessary and inefficient investments, and a flawed valuation methodology. To address Australia's unsustainable electricity prices it is imperative that RABs are re-valued to more appropriate levels.

[1] The Energy Market Death Spiral - Rethinking Customer Hardship, Paul Simshauser and Tim Nelson , 2012 <http://aglblog.com.au/wp-content/uploads/2012/07/No-31-Death-Spiral1.pdf>

The current system distorts incentives for the efficient allocation of capital. The government owners of the DNSPs, like Energex and Ergon, can borrow at the risk-free rate, overspend on infrastructure and receive a much higher rate of return. The AER has a duty to ensure that the DNSPs are adequately financed for opex and capex.

Departure from Guidelines – WACC

A good estimate of the rate of return is necessary to promote efficient prices in the long term interest of consumers. If the rate of return is set too low, the network business may not be able to attract sufficient funds to be able to make the required investments in the network and reliability may decline. On the flip side, if the rate of return is set too high, the network business may seek to spend too much and consumers will pay inefficiently high prices.

Energex regulatory proposal highlights the importance of considering alternative models that have a relevant and accurate role to play in estimating the return on equity.

The method of calculating the WACC is crucial to producing fair network price determinations that are in the long term interests of consumers. Reflecting upon Energex reasoning in departing from the guidelines, we believe that there is room for significant further progress to benefit consumers at the regulator's discretion when calculating the WACC.

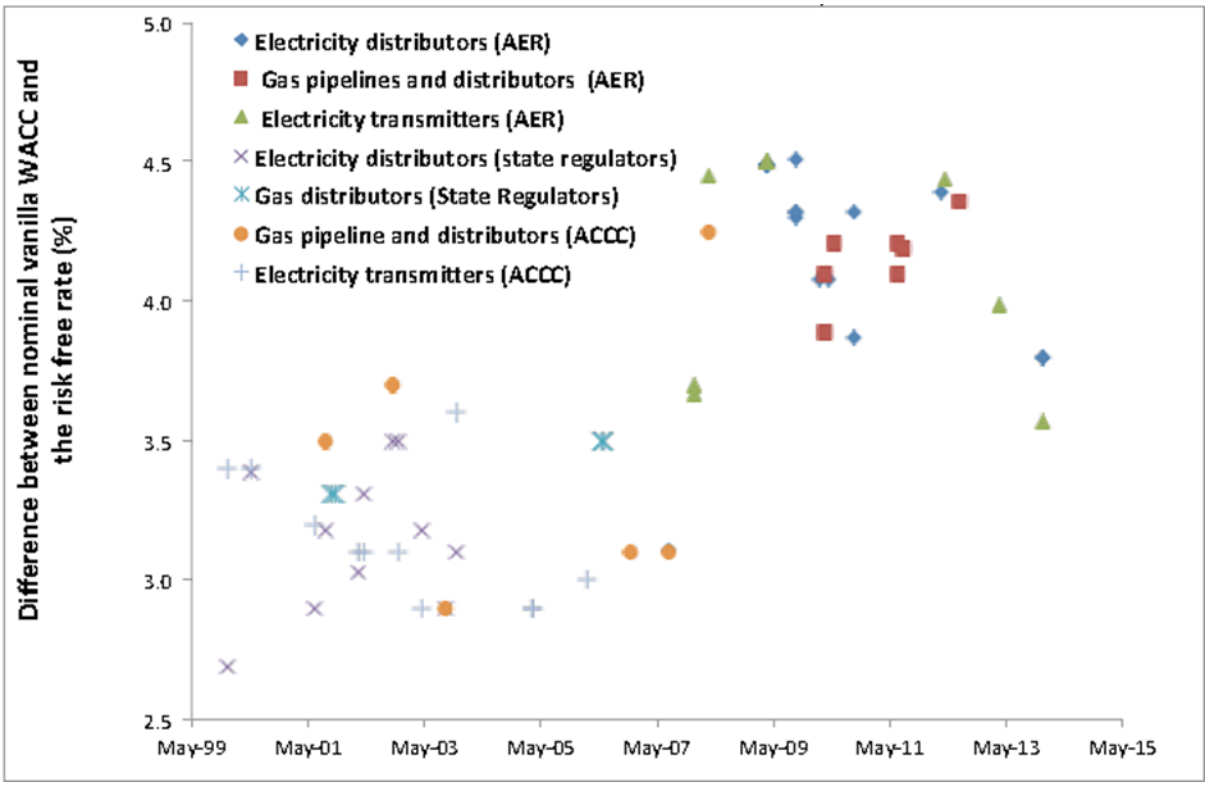
The ETU recommends that the AER review and apply some of the advice and criticisms on approaches to WACC determinations by the AER Consumer Challenge Panel.[2]

We submit that it is critical that outcomes under the AER's Rate of Return Guideline are compared with the reality of financing low-risk businesses such as regulated monopolies with guaranteed revenues. ETU believes that conservative application of Rate of Return Guidelines leads the AER to build conservative assumptions about the constituent components upon one another. This results in a final WACC that is higher than what is likely to be the actual cost faced by the networks.

The ETU believes that the trade-off between flexibility and uncertainty in the WACC should be further assessed, particularly within the context of comparable risk in the private sector. Where the interest rates fall, networks are able to refinance their borrowing to a lower-cost option. However, consumers/customers have been unable to reap the benefit through lower prices.
A report by the AER Consumer Challenge Panel (Figure 1) highlighted how the AER consistently set higher WACC than any other Australian state regulators or ACCC.

[2] AER Consumer Challenge Panel: Smelling the roses and escaping the rabbit holes: the value of looking at actual outcomes in deciding WACC, July 2014

Figure 1 Nominal Vanilla WACC less risk free rate



(Source – AER Consumer Challenge Panel)

Energex has provided reasoning's to depart from the Rate of Return guidelines provided. These reasoning merely gravitate towards methodological difficulties utilising regression analysis to determine a benchmark credit rating. Other concerns include the averaging approach illustrating Energex's lack of confidence in the AER regression analysis and to some degree advocates against AER methodologies.

It is essential that the AER should have regard to actual market and comparative regulatory information in exercising its discretion when determining the regulatory WACC. However, it is quintessential for the AER to carry out extensive and deep investigation into Energex's proposal.

Equity Modelling

Energex have rejected the AER approach to developing the cost of equity observing that the AER approach and current parameter would result in a cost of equity of well below the other relevant financial models highlighted in the regulatory proposal. Energex proposes a return of equity of 10.5%, which is based on a risk free rate of 3.63 per cent, a market risk premium of 7.57% and an equity beta based on both local and international equity betas.

What Energex has provided in their proposal (including reference to the SFG report) regurgitates the same arguments put forward by networks in the extensive discussions on how to develop a model for setting the cost of equity. That the debate on the use of the other models has been has and conclusions drawn is effectively overlooked. The arguments provided to justify the use of the other models do not introduce new information which might otherwise lead to a variation in the AER assessment made in the development of its guidelines.

<u>Forecast Data Modelling</u>

Much has also been made recently of the oversupply of generation in the National Electricity Market, and while that is certainly a consideration when it comes to the long term security of supply of our generation sector, the latest

Bureau of Resources and Energy Economics data confirms that final energy consumption (energy consumed by end-use sectors excluding energy used in conversion activities such as electricity generation) actually rose by 2 per cent in 2012–13.

One reason there is an oversupply of generation capacity is a result of the ongoing pendulum effect of swinging between too much generation capacity and too little, because of the reluctance of the free market to commercially invest in new generation until there is a period of projected shortage, at which point the market delivers a glut a new capacity as investors rush to build new capacity, which is the current point in the cycle.

Central to this is the role that forecast modelling by agencies such as the AER, AEMO and AEMC play in decisions of network businesses, generators and new entrants.

The current oversupply of electricity, along with perceived over investment in networks can be linked back to demand projections from NEM governance bodies that were wildly inaccurate. Coupled with a regulatory environment that did allow for appropriate adjustments, it has contributed significantly to the problems that are currently besetting energy regulators and governments.

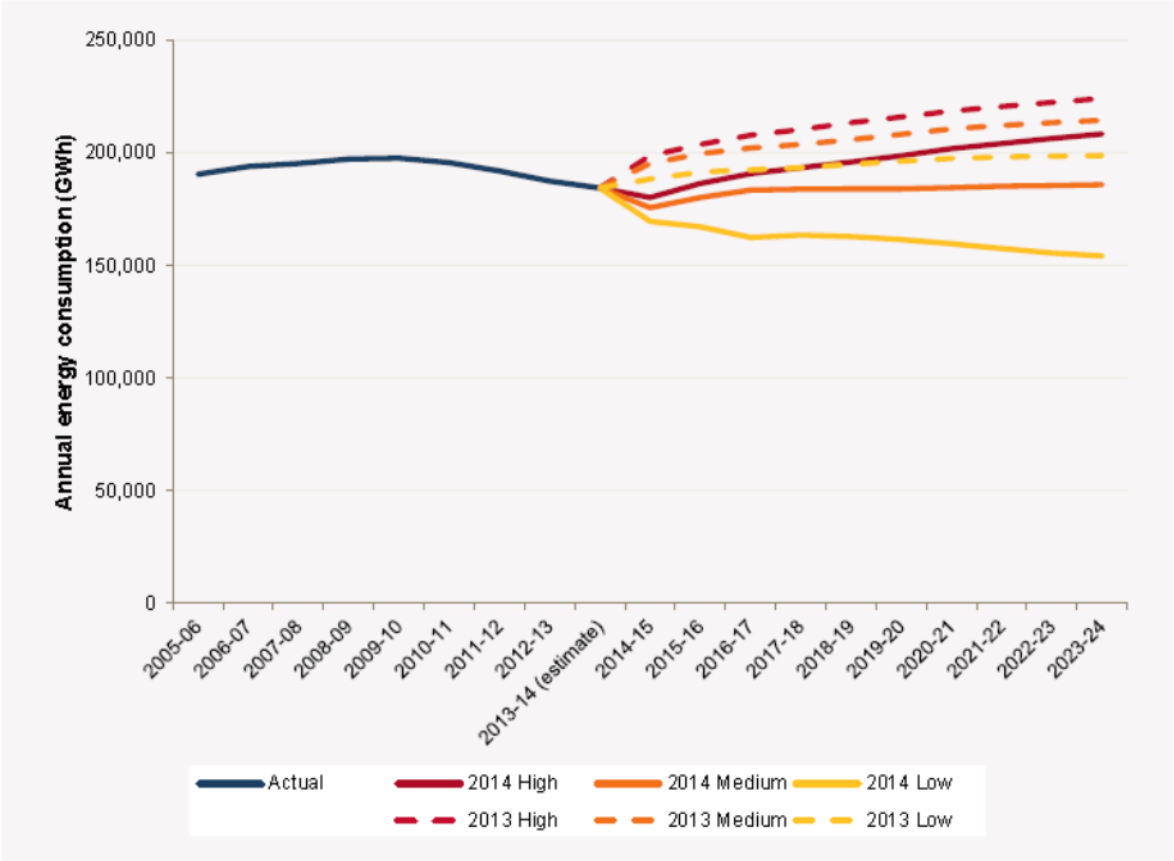
Compare the data in the tables below, taken from the Australian Energy Market Operator (AEMO) Electricity Statement of Opportunity 2010 and 2014 respectively.

Figure 2 – 2010 ESOO NEM Projections

Financial year	Actual	Medium growth	High growth	Low growth
2004/05	186,246			
2005/06	191,598			
2006/07	194,107			
2007/08	195,376			
2008/09	197,187			
2009/10 (estimate)	198,055			
2010/11		205,034	208,081	202,215
2011/12		211,405	217,566	204,929
2012/13		216,623	225,197	207,510
2013/14		220,167	231,613	209,570
2014/15		224,961	239,732	212,139
2015/16		230,248	249,022	214,903
2016/17		234,455	256,070	216,615
2017/18		237,935	261,925	218,923
2018/19		241,661	273,780	220,691
2019/20		246,584	281,915	224,000
Average annual growth	1.2%	2.1%	3.4%	1.1%

(Source – AEMO 2010)

Figure 3 – 2014 ESOO NEM Projections



(Source – AEMO 2014)

The difference between the projected demand is stark, and sobering particularly when you consider how influential the ESOO data is for NEM forward planning of both regulators and participants alike.

While it is not possible to accurately predict the future, and sole responsibility does not lime with the AER, AEMO or AEMC, important data such as demand

projections should not be so dramatically wrong, and there need to be sufficient flexibility in the regulatory process to allow adjustments that protect consumers from having to foot the bill of bad investment decisions via bloated AER determinations.

We urge the AER to fully interrogate both Energex and Ergon's proposals and to use the discretion that has been afforded by the recent NEM rule changes to ensure that the draft determinations reflect a sustainable balance between consumer relief, safe and secure networks, and prudent pass through costs that represent good value for consumers and network businesses alike.