15 February 2010

Mr Mike Buckley
General Manager Network Regulation North
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Attention Mr Mike Buckley

Dear Mr Buckley

Queensland Draft Distribution Determination 2010-2015

Please find attached ENERGEX's response to the AER's Queensland Draft Distribution Determination submitted in accordance with Clause 6.10.2 (c) of the National Electricity Rules.

Please direct any queries relating to this submission and the appendices to either myself or to Ms Sue Lee. Ms Lee can be contacted by telephone on (07) 3223 1976.

Yours sincerely

Kevin Kehl
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ENERGEX

Submission on Draft Determination

for the period July 2010 – June 2015

February 2010

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1 Introduction

1.1 Background

In June 2009, ENERGEX submitted its *Regulatory Proposal* to the Australian Energy Regulator (AER) for the *2010-15 regulatory control period* in accordance with the requirements of the National Electricity Rules (the *Rules*).

On 30 November 2009, the AER published its draft distribution determination for the Queensland electricity distribution businesses (the draft determination).

In accordance with clause 6.10.3 of the *Rules*, ENERGEX submitted its *Revised Regulatory Proposal* (the RRP) to the AER on 13 January 2010. Where applicable, ENERGEX implemented the adjustments required by the AER's draft determination, or provided additional information and arguments to support its *Regulatory Proposal* for the AER's consideration. ENERGEX also advised the AER of its intention to provide further information on the input escalation and cost of capital issues in its response to the draft determination.

This is ENERGEX's submission in response to the AER's draft determination (the Response to Draft) in accordance with clauses 6.10.2(c) of the *Rules*.

1.2 Document structure

This submission contains additional information provided to support ENERGEX's *Revised Regulatory Proposal* and comments on other aspects of the draft determination as appropriate.

This submission covers the following key areas:

- input cost escalation;
- cost of capital;
- cost pass-through and self insurance arrangements; and
- other matters, including regulatory reporting and the annual revenue 'unders and overs' mechanism.

2 Input escalation

In its draft determination, in determining ENERGEX's operating and capital expenditure allowances, the AER substituted the input cost escalators used in the *Regulatory Proposal* on the grounds that they did not reasonably reflect the capital and operating expenditure criteria in the *Rules*.

For the purpose of the building block calculation, ENERGEX applied the AER's interim input escalation rates in its *Revised Regulatory Proposal*. However, given the significance of these escalation rates to the capital and operating expenditure forecasts, ENERGEX indicated its intention to provide further comment on these rates in its Response to Draft.

ENERGEX has subsequently engaged Sinclair Knight Merz (SKM) to assess the composition of its capital expenditure forecasts by materials components (for example, aluminium, copper, steel, oil and foreign exchange) and prepare updated forecasts. SKM's report is provided at Appendix 1. Further, ENERGEX also appointed PricewaterhouseCoopers (PwC) to prepare updated labour cost forecasts (including contractors), as well as to assess the reasonableness of the criticisms made by the AER of the modelling approach used by ENERGEX's consultant, KPMG, in preparing the forecasts for the *Regulatory Proposal*. PwC's report is provided at Appendix 2.[1]

ENERGEX notes that the real escalation rate forecasts and methodology presented in this chapter, if accepted by the AER, will need to be updated to reflect updated inflation, commodity, and exchange rate forecasts.

2.1 Criticisms of ENERGEX's modelling methodology

The main criticisms raised by the AER regarding the modelling methodology used in the *Regulatory Proposal* related to:

- the use of constant escalation rate forecasts in a volatile economic environment;
- doubts over the robustness of the models used by ENERGEX; and
- ENERGEX's failure to use the most recent data for modelling purposes.

[1] All of ENERGEX's input cost escalation forecasts in its Regulatory Proposal were prepared by KPMG. KPMG acquired Econtech who were engaged in work for the AER which resulted in KPMG not being able to perform any further input cost modelling work for ENERGEX for the *2010-15 regulatory control period* due to a potential conflict of interest.

2.1.1 Volatility and forecasting

The AER did not consider that ENERGEX's use of constant escalation rates for the forecasts of materials, construction and buildings and labour (including contractors) over the *2010-15 regulatory control period* were appropriate given the degree of volatility in the economic environment.

ENERGEX believes that it can be appropriate to propose a constant rate of escalation in circumstances where there is extreme uncertainty and volatility that render the use of data-based modelling methods inappropriate. Moreover, in the presence of a volatile and uncertain economic environment, a forecasting model is not necessarily reliable, accurate or robust merely because its forecasts demonstrate variability.

ENERGEX considers that the forecasting difficulties caused by the highly uncertain impact of the global financial crisis at the time ENERGEX was developing its *Regulatory Proposal* justified the use of constant escalation rates.

However, ENERGEX recognises that the improving and less volatile economic outlook allows greater confidence to be placed on the results of data-based methods and has prepared updated forecasts accordingly.

2.1.2 Statistical robustness of models

The AER indicated that it did not have insight into the statistical robustness of the KPMG models used to generate ENERGEX's materials and labour cost escalation forecasts for the *Regulatory Proposal*.

ENERGEX believes that the level of detail it provided in its *Regulatory Proposal* is consistent with the practices adopted by the AER and its consultants. In this regard, the AER places heavy weight on forecasts generated by its consultants' proprietary economic models, the statistical robustness of which is unknown by ENERGEX and other stakeholders.

Nevertheless, in recognition of the AER's criticism and to support ENERGEX's position in this submission, ENERGEX has used consultants whose methodology the AER has accepted (such as SKM's cost escalation weightings) or provided statistical diagnostics of the models (such as PwC's labour escalations).

2.1.3 Use of most recent data

In rejecting the proposed escalation forecasts in the *Regulatory Proposal*, the AER noted that certain aspects of KPMG's escalation rate forecasts did not use the latest available information.

ENERGEX regards rejection of any aspect of its escalation rate forecasts on these grounds to be inappropriate. The nature of the regulatory framework under the *Rules* is such that the AER will always benefit from access to more recent information than a DNSP given its draft determination will be prepared many months after a *Regulatory Proposal* is submitted. In

ENERGEX's view, the proposed escalation rates should be assessed solely on the basis of the soundness of the forecast methodologies adopted.

ENERGEX notes that the AER itself recognises elsewhere in its draft determination that the escalation rate forecasts will need to be updated at the time of its final determination.

2.2 Materials cost escalators

In recognition of the AER's general acceptance of the SKM methodology to forecast materials cost escalators for Ergon Energy (and conforms with the methodology accepted by the AER in the NSW decision), ENERGEX engaged SKM to derive updated forecasts for the *2010-15 regulatory control period*. ENERGEX notes the issues raised by the AER in the draft determination in relation to SKM's estimates for Ergon Energy. These issues have been addressed in formulating ENERGEX's material cost escalators, which are based on the most recent data available.

Using the SKM model the following escalators have been derived and applied:

- aluminium and copper;
- steel;
- crude oil;
- construction/civil works;
- exchange rate and inflation; and
- trade weighted index.

2.2.1 Commodity prices

SKM's commodity price forecasts are presented in its report at Appendix 1. The following sub-sections summarise some important issues in the development of the forecasts.

2.2.1.1 Aluminium and copper

In the draft determination, the AER raised concerns about SKM's continued use of economic forecasts despite the recent availability of futures contracts that cover the *2010-15 regulatory control period*. The AER considered cost escalators based on futures contract prices alone provided a more accurate indication of future materials costs.

ENERGEX's preferred approach is also to use commodity futures contract prices in preference to economic forecasts. However, this approach is contingent on the existence of an established liquid market for futures contracts. While the AER notes the existence of newly extended London Metals Exchange (LME) futures contracts, ENERGEX believes that the importance of longer dated contracts should not be overstated. As noted by SKM, these markets are currently illiquid and the 63 and 123 month prices are deemed by a quotations committee rather than derived through market/commercial negotiations.

In light of the market illiquidity for long dated contracts, ENERGEX considers SKM's methodology of using LME 3, 15 and 27 month futures contracts and interpolating to long-term economic consensus prices, more reasonably reflects the capital expenditure and operating expenditure criteria and objectives.

2.2.1.2 Steel

ENERGEX agrees with SKM that the LME steel futures market is still not sufficiently liquid to provide a robust price outlook.

As a result, SKM has estimated ENERGEX's steel price forecasts for the *2010-15 regulatory control period* using Consensus Economics steel price forecasts and the same methodology applied by SKM in estimating the cost escalators, which was accepted by the AER.

2.2.1.3 Crude oil

The AER noted its preference for a monthly average of New York Mercantile Exchange's (NYMEX) futures contract prices over observations from a single trading day. In estimating ENERGEX's forecast crude oil escalation factors for the *2010-15 regulatory control period*, SKM has used monthly averages of historical crude oil prices and NYMEX light crude oil futures contracts.

2.2.2 Commodity price weightings

ENERGEX's *Regulatory Proposal* did not include any cost weightings. In the draft determination, the AER noted that the forecast materials cost escalators could be made by calculating a composite of the escalator components, weighted by their actual contribution to ENERGEX's materials costs. In the absence of actual weightings, the AER proposed an average commodity cost weighting based on data for Energy Australia and Integral Energy.

In recognition of the AER's preferred approach, ENERGEX has engaged SKM to develop a cost allocation model to identify the underlying cost drivers of its capital expenditure program to determine the weightings applicable to ENERGEX.

Through the application of SKM's Cost Escalation model (the SKM model), ENERGEX has been able to identify the underlying cost drivers of its capital expenditure program. This has been achieved by mapping ENERGEX's data to the asset categories within the SKM model. SKM advised that the process of mapping the categories in the ENERGEX data base to asset categories within the SKM model was relatively straightforward.

ENERGEX's revised materials escalation weights are presented in Table 2.1

Table 2.1 Share of Total Materials Costs (%) – By commodity

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Aluminium	15.3	14.5	15.9	15.4	15.5	15.1	15.0
Copper	6.3	5.5	4.6	4.6	5.2	5.9	6.5
Steel	17.1	16.8	16.5	15.8	16.2	15.6	15.6
Oil	3.6	3.1	2.3	2.1	2.5	2.6	2.4

Source: SKM (2010) Weighting of ENERGEX Materials Cost Escalators. February. p 39.

2.2.3 Other materials

A large proportion of ENERGEX's costs under its capital expenditure program are associated with materials other than commodities, including manufacturing and construction costs, as well as inflation and exchange rate movements.

The approach taken by SKM with respect to local and imported manufacturing costs, with the associated treatment of inflation and exchange rate movements, reflects the AER's comments from the draft determination and/or more recent data.

SKM's approach to incorporating construction (including civil works) costs, which uses the most recent Construction Forecasting Council (CFC) engineering forecasts, is the same as that accepted by the AER in the draft determination for Ergon Energy.

The respective weightings for the other materials components in SKM's model are presented in Table 2.2.

Table 2.2 Share of Total Materials Costs (%) – Other Materials

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
MFr – Local (CPI)	31.3	29.4	28.9	27.8	29.4	29.0	28.2
Mtf – Import (TWI x CPI)	4.8	6.5	5.9	6.7	5.8	6.1	7.5
CPI	3.9	4.7	5.2	6.2	6.1	7.8	6.0
TWI	5.2	5.1	5.2	5.3	5.1	4.9	4.9
Civil Works	6.4	7.7	8.1	8.7	6.9	6.4	7.1
Oil (As proxy for Energy)	6.0	6.6	7.4	7.5	7.2	6.8	6.8

Source: SKM (2010) Weighting of ENERGEX Materials Cost Escalators. February. p 39.

2.2.4 Updated materials escalation forecasts

Table 2.3 compares ENERGEX's updated real materials cost escalators to those proposed by the AER in its draft determination. ENERGEX believes the real escalation rate forecasts determined by SKM reasonably meet the capital expenditure and operating expenditure criteria and objectives.

Table 2.3 AER and ENERGEX Materials Cost Escalation Rates (real, per cent)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
AER indicative rates	-2.38	0.02	2.18	1.59	0.29	-0.16	-0.32
ENERGEX revised escalation rates	-4.3	-3.0	10.5	5.3	-2.2	-3.6	-3.4

Source: SKM (2010) Weighting of ENERGEX Materials Cost Escalators. February. p 39.; AER (2009) Queensland Draft Distribution Determination 2010-11 to 2014-15: Draft Decision Appendices. November . p 579.

2.3 Construction and building escalators

The AER rejected ENERGEX's proposed construction and building escalation rates and substituted forecasts prepared by KPMG Econtech for the Constructing Forecasting Council (CFC). The AER did not consider that the sole use of ABS Engineering Construction Activity data was appropriate, with ABS Building Activity data also relevant.

ENERGEX notes the AER's reason for rejecting the construction and building escalation rates in the *Regulatory Proposal* and proposes to apply the latest CFC engineering construction forecasts for the purpose of both its construction and buildings real escalation rates. ENERGEX notes that the AER in its draft determination accepted Ergon Energy's use of the CFC forecasts for this dual purpose.

Table 2.4 compares the updated forecasts prepared by CFC to those proposed by the AER in its draft determination.

Table 2.4 Comparison of AER's and CFC's construction and buildings real escalation rates

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
AER	2.8	1.1	- 0.9	- 0.2	1.0	0.0	-1.5
CFC updated	1.8	1.6	- 0.9	0.6	2.1	1.4	- 0.4

Source: SKM, Weighting of ENERGEX Materials Cost Escalators, p xxxviii.

2.4 Labour cost escalators

The AER rejected the labour cost escalation forecasts in the *Regulatory Proposal* and substituted forecasts generated by Access Economics' macroeconomic model.

ENERGEX's main concerns relate to:

- the nature of Access Economics macroeconomic model;
- the base year adjustments made by the AER; and
- the AER's use of different escalation rates for ENERGEX's internal labour and external contractors.

2.4.1 Nature of Access Economics' forecasts

The AER commissioned Access Economics (Access) to prepare labour cost forecasts for the electricity supply sector across all NEM jurisdictions. ENERGEX has concerns with the AER's continued use of Access' labour cost forecasts for this purpose, given Access appears to place insufficient weight on the specific circumstances facing electricity supply entities in favour of the outputs of its general macro-economic model. In this regard, ENERGEX notes the criticisms made about the construction and outputs of an earlier version of the Access model used in the context of Powerlink's 2007-08 to 2011-12 revenue determination.[2]

In ENERGEX's view, the main weaknesses of the Access' model are as follows:

(1) The labour cost forecasts are one of the outputs of a recently re-designed propriety macroeconomic model of the Australian economy, with no information available on the accounting identities and behavioural equations used in the model. Access' accompanying report only contains a relatively high level discussion of the structure of the model. Consequently, ENERGEX does not know the predictive performance of the re-designed model.

(2) The main driver of forecast labour cost movements in the model appears to be cyclical factors, reflected in a rapid flow-through of the weakening in national and state economic growth in 2009 (as measured by output) into utilities wages growth. However, PwC's modelling indicates that the business cycle does not appear to be significant in explaining the variability in wages relating to the electricity gas and water (EGW) sector. PwC also notes that the Access' model does not appear to appropriately account for the surge in employment in the EGW sector in 2008-09. Based on its analysis of Queensland and South-East Queensland employment data, PwC concludes that one would not expect to see the level of wage volatility in the Queensland region as is displayed in Access' model.[3]

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2 Source: Synergies, Powerlink, *Review of Wage Growth Forecasts*, Appendix C to Powerlink's Response to AER Draft Decision, February 2007.

3 Source: Synergies, *op cit*, page 17.

Synergies' report to Powerlink also noted that it was difficult to find modern references or empirical findings that point to the same strength in cyclical factors as suggested in Access' earlier version of its model.

Moreover, the output effect in Access' model is compounded by the dampening effect of competition (relative wage) factors relating to the mining and construction sectors in the model. In contrast, the institutional influences on wage rates (such as EBAs, unions and wage tribunals) that could mitigate and slow the cyclical impact appear to be given little weight in the development of the forecasts.

(3) The strong impact of cyclical factors in the model result in Access forecasting that real wages growth in the Utilities sector will be lower than for all industries for around half of the forecast period up to 2017-18. Synergies work for Powerlink noted that labour market evidence suggested it is difficult to envisage real wages growth for a higher skill group such as Utilities workers slipping behind any lower skilled group for any length of time.[4]

(4) There is superficial analysis of labour supply factors affecting the Utilities sector in the Access accompanying report. For example, the report includes discussion on student participation in university engineering courses to support its conclusion that supply side developments will favour weaker wage gains over the next year and a half. ENERGEX notes that student participation in engineering courses will have no material effect on the resourcing and delivery of its expenditure program over this period.

Further, Access argues that an assessment of overall demand and supply outlook for workers in the Utilities sector is that skill shortages are temporary and do not drive permanent wedges in wage relativities. In contrast, Synergies work for Powerlink raises strong doubts about this argument and identifies academic papers to the contrary.[5]

(5) The specification of the labour productivity component of the wage forecasting model is not clear, including what measure of Utilities' sector output is used (e.g. annual peak MW per hour worked, annual MWh per hour worked). Consequently it is impossible to assess the appropriateness of the output measure used and the labour productivity estimates that are derived with their resulting impact on labour cost rates.

4 Source: Synergies, *op cit*, pages 26-30.

5 Source: Synergies, *op cit*, pages 26-30.

(6) It is not clear how the model is taking into account the labour market and wage effects of the significantly increased investment and operating and maintenance programs facing DNSP's across Australia over the next five years (at least). In this regard, the following quote from the Access report summarising the effect of the weakening in the economy in 2009 on the utilities sector, in particular, referring to 'weakness' in the Utilities sector, seems to be directly contrary to the available evidence in Queensland[6]:

> *In the utilities section itself the past year saw a surge in electricity output (up 11 per cent) which may not be maintained. Structurally warm winters are hurting electricity demand at the same time as scorching summers are adding to it, raising the peak load problem already facing a sector with more than enough on its plate as regulatory certainty over the Emission Trading Scheme holds back much needed investment in new capacity. With business demand expected to weaken further from here, we see the sector suffering some short term weakness before recovering to its usual growth rate, averaging a little below that in the wider Australian economy.*

It is not clear to ENERGEX which DNSP in the NEM is holding back on 'much needed investment in new capacity'. If anything, Access' view appears to relate to the electricity generation rather than the distribution sector.

Moreover, ENERGEX finds it difficult to sustain the argument that there will be any weakness in the Utilities sector in Queensland, or other NEM jurisdictions, over the next 5 years given the forecast network expenditure and the need to resource that expenditure. The Access model seems to be driven by an undisclosed measure of electricity supply output, which has limited relation, at best, to the practical realities of attracting and retaining sufficient labour resources to deliver ENERGEX's extensive network expenditure program required to meet its obligations in relation to reliability and security targets.

2.4.2 Base year adjustments for real escalation rate forecasts

ENERGEX does not understand the AER's adjustment made for the impact of the ENERGEX Union Collective Agreement (EUCA), which reflects nominal wage increases of 4.5 per cent for 2008-09, 2009-10 and 2010-11, in its real labour escalation rates.

After converting these nominal wage increases into real terms (using KPMG Econtech's inflation forecasts) in 2008-09 and 2009-10, the AER applies the real wage increase implied under EUCA for one quarter of the year and uses Access' forecasts for the remainder of the year. In 2010-11, the real increase under EUCA is applied for half the financial year and Access' forecasts used for the remainder of the year. Using this mix of actual and forecast data, the AER constructs a labour cost index and derives annual real escalation rates by comparing the yearly average of the index for each quarter with that in the preceding year.

6 Source: Access Economics, *Forecast growth in labour costs*, September 2009, page ix.

The effect of the AER's modelling approach is that the real escalation rates for 2009-10 and 2010-11 are less than the real increases implied by the EUCA for both general and specialist internal labour as derived by PwC and indicated in Table 2.5.

Table 2.5 Comparison of AER's and PwC's EBA real escalation rates

	2008-09	2009-10	2010-11
AER	- 0.1	2.6	0.7
PwC	1.3	2.6	1.5

Source: PwC, ENERGEX, Response to AER draft determination

PwC's updated forecasts use the RBA's inflation forecast rather than the KPMG Econtech inflation forecast as used by the AER. ENERGEX believes that a consistent source for inflation forecasts should be used in the distribution determination.

The AER appears to have discounted the real wage increases implied by the EUCA in 2008-09 and 2010-11 solely to preserve ENERGEX's (and Ergon Energy's) incentive to actively pursue efficient and competitive wages outcomes over the *2010-15 regulatory control period*.[7]

In terms of this incentive issue, ENERGEX notes the significant duration over which the EUCA was negotiated, including employee industrial action on a number of occasions. It is not clear to ENERGEX whether the AER had regard to the length or intensity of these negotiations in rejecting the forecasts in the *Regulatory Proposal*.

In particular, ENERGEX does not believe that the AER considered either the efficiency or prudency of the actual real wage increases or levels implied by the EUCA as it is required to do when applying the capital and operating expenditure criteria under the *Rules*. In other words, the AER must assess any wage agreement negotiated by a DNSP on its merits having regard to the circumstances applying at the time of negotiation, as well as any associated efficiency trade-offs, rather than presuming that its cost is inefficient and so must be discounted to preserve DNSPs' wage bargaining incentives. It appears to ENERGEX that the AER is inappropriately establishing a test that DNSPs can never meet such that the AER will always discount an actual or forecast wage increase negotiated by a DNSP on incentive grounds even if it could be demonstrated to be efficient or prudent.

In summary, in ENERGEX's view, the basis upon which the AER made adjustments to the EUCA do not reasonably reflect the capital expenditure and operating expenditure criteria in the *Rules*. As a result, ENERGEX proposes that the forecasts developed by PwC, as indicated in Table 2.5 above, should be used for the purpose of developing real labour cost escalation forecasts for the *2010-15 regulatory control period*.

[7] Source: AER, *Queensland draft distribution determination 2010-11 to 2014-15*, Appendices, page 609.

2.4.3 Contractors

The AER decided in its draft determination, that given external contractors are not entitled to benefit from the EUCA paid to ENERGEX's internal labour, cost escalation rates for contractors should not reflect the EUCA increases.

As a result, it appears that the AER has applied some form of adjustment to the Access' labour cost escalation forecasts but has not revealed the basis of the adjustment in its draft determination. There also appears to be an assumption that because of the short term weakness in the mining and construction sectors in Queensland, external contractors will face less demand for their services which will be reflected in weaker wages growth.

In ENERGEX's view, unless the AER has access to disaggregated actual labour cost data on the Queensland electricity supply sector and/or a detailed understanding of the dynamics of labour supply conditions in this market it is not clear on what grounds it can make this adjustment. Moreover, ENERGEX cannot find any specific analysis in Access' report to support different labour cost escalation rates being applied to ENERGEX's internal labour and external contractors (Access also did not make any such differentiation in its forecasts).[8] Consequently, it appears that the adjustment mechanism applied is arbitrary and does not reasonably reflect the capital expenditure and operating expenditure criteria and objectives.

ENERGEX submits that its internal labour and external contractors, particularly specialist electrical labour, form a labour market pool capable of working on the multitude of projects in ENERGEX's significant expenditure program. ENERGEX notes that large elements of its expenditure program are already being delivered by electrical contractors, including the substantial new sub-division and vegetation management programs. As a result, it could be expected that any wage increases enjoyed by ENERGEX internal labour will have an impact on external contractor wages and vice versa, which is reflected in an observed tendency for increases in the respective wages rates to be aligned. The generally public nature of the outcomes of ENERGEX's wage bargaining agreements, reflecting the existing institutional framework in Queensland, facilitates this alignment. PwC's report at Appendix 2 discusses the complementary nature of ENERGEX's internal labour and contractors further.

Consequently, the updated forecasts prepared by PwC apply the same labour escalation rate for internal labour and contractors over the *2010-15 regulatory control period*. However, consistent with the draft determination, these forecasts use different proportions of specialist and general labour for internal labour compared to external contractors.

[8] The AER in its draft determination cross-references page 68 in Access' report to suggest there is evidence that these two labour categories have historically exhibited some wage growth differentials. However, ENERGEX cannot identify this evidence on the relevant page.

2.4.4 AER and ENERGEX's updated labour cost escalation rates

Table 2.6 provides a summary of the AER's draft determination and ENERGEX's proposed updated labour escalation forecasts.

Table 2.6 Comparison of AER's and PwC's labour escalation rates

Escalation rates	2008-09	2009-10	2010-11	2011-12	2012-13	2103-14	2014-15
AER – Internal Labour	-0.03	2.51	0.69	0.57	1.20	1.56	1.54
PwC – Internal Labour	3.4	1.7	2.5	0.9	0.8	0.7	0.6
AER – Contractors	0.77	1.38	0.14	0.58	1.17	1.54	1.53
PwC – Contractors	3.4	1.7	2.5	1.1	1.0	0.8	0.7

Source: PwC Response to AER draft determination, February 2009.

3 Cost of Capital

There are three key aspects of the AER's Draft Decision that ENERGEX wishes to respond to in this chapter, being:

- the nominal risk-free rate and the reasonableness of the return on equity;
- the debt margin; and
- inflation.

3.1 Nominal risk free rate and the return on equity

As part of its *Regulatory Proposal*, ENERGEX submitted a report prepared by SFG Consulting that questioned the reasonableness of the resulting cost of equity if the *Statement of Regulatory Intent* (SoRI) parameters are applied. In its Draft Determination, the AER indicated that it had identified a number of deficiencies in SFG's analysis.

ENERGEX considers that the AER's dismissal of this analysis is unreasonable. SFG's analysis was based on the parameters set out in the SoRI *as they are*, with the risk-free rate and debt margin estimated based on the requirements of the NER using market data at the time the analysis was undertaken. SFG has identified a number of significant concerns with some of the statements and assumptions made by the AER, which are set out in the report, *Response to Aspects of the Draft Determination*. This report is provided at Appendix 3. The analysis was undertaken by SFG just prior to the submission of ENERGEX's *Revised Regulatory Proposal*. The AER has noted that during this period, the cost of debt was at an historical high and the risk-free rate was very low. The AER considers that SFG should have used a long-run historical average risk-free rate as this "would be more reflective of the nominal risk-free rate during a normal year".[9]

The AER's comments suggest that had ENERGEX's WACC been set over that time, some adjustment may have been made. The AER has previously rejected submissions that some form of adjustment may have been required over this period given the abnormally low risk-free rate (for example, via the convenience yield). However, it is now suggesting that SFG should have made some adjustment for the purpose of its analysis as this would have arrived at an estimate for a more 'normal' year.

As Commonwealth Government bond yields have increased since the analysis was undertaken, ENERGEX did not propose any form of adjustment to the risk-free rate in its *Revised Regulatory Proposal*. However, ENERGEX remains fundamentally concerned regarding the risk of further economic shocks occurring between now and the AER's final determination, resulting in abnormal market conditions.

9 Australian Energy Regulator (2009).

If a business had its WACC reset over the same period in which SFG's analysis was undertaken, it would have locked in an outcome that the AER is now suggesting was a function of abnormal market conditions. The issues the AER has raised with SFG's analysis has merely highlighted the concerns facing regulated businesses, including ENERGEX, that face having a reset occur over such a period, with a WACC outcome locked in for a subsequent 5 year period.

ENERGEX therefore requests that it has the opportunity to review this matter with the AER if any further major economic shocks are experienced that have the potential to impact its reset period. This concern relates not only to this review, but to future *regulatory control periods*.

3.2 Debt risk premium

The issues involved in reliably estimating the debt margin following the global financial crisis are now well recognised. In its *Regulatory Proposal*, ENERGEX proposed the application of an average of Bloomberg and CBA Spectrum. For the purpose of the Draft Determination, the AER determined that it would apply CBA Spectrum and ENERGEX indicated that it is willing to accept this in its *Revised Regulatory Proposal*.

There are two matters arising from the Draft Determination that have not yet been responded to, which are:

- how to estimate a 10 year BBB+ Bloomberg yield, which has not yet been addressed by the AER; and
- the method that the AER currently uses to test the alternative data sources available.

Consistent with its position in the *Regulatory Proposal*, ENERGEX submits that the average of the CBA Spectrum and Bloomberg should be adopted. ENERGEX has obtained advice from Synergies Economic Consulting (Synergies) in relation to these two matters. Its advice is provided at Appendix 4. In summary, Synergies has recommended the following:

- that an average of two methods be used to estimate the 10 year BBB+ Bloomberg yield, being extrapolation from the Bloomberg BBB 7 year yield based on:
  - the difference between the Bloomberg 7 and 10 year AAA yields; and
  - the difference between Bloomberg 5 and 7 year yields;
- that some further refinements could be made to the AER's method used to test the alternative data sources in order to minimise the subjectivity in the analysis.

ENERGEX also reiterates its assumption that any alternative method that might be developed by the AER will not be applied in the Final Determination, and if this is contemplated, requests that it has the opportunity to respond to any such proposal.

3.3 Inflation

In the Draft Determination, the AER flagged that consideration may be given to changing from its use of RBA inflation forecasts to estimate expected inflation prior to the Final Determination. This in turn has been prompted by the re-commencement of the Commonwealth Government's issuance of indexed bonds. ENERGEX asked Synergies to consider any issues arising from this for ENERGEX and its response is provided at Appendix 4.

The AER has already flagged that given the liquidity issues in this market, an inflation estimate derived from yields on indexed Commonwealth Government Securities (CGS) may be unreliable. Synergies' analysis reiterates these concerns and sets out why the data may not be credible. If the AER proposes to revert to using this market data, it will therefore need to be able to establish that the data is credible and reliable.

There is no one universally accepted test to determine if the market data is credible. However, there are predictors of credible data that can be referenced, being transaction time (market efficiency), volume and bid-ask spreads. Examination of these factors provides an insight into the credibility of the data and hence whether the data can be used to provide the 'best estimates of forecast inflation' as required under Clause 6.4.2(b)(1) of the NER.

ENERGEX reiterates that if the AER does propose to change the method it will use to forecast expected inflation prior to the Final Determination, it has the opportunity to respond to this prior to implementation.

3.4 Gamma

As set out in the *Revised Regulatory Proposal*, ENERGEX intends to continue to depart from the AER's value for gamma, which is 0.65. The AER's decision in relation to gamma is arguably the most contentious aspect of the SoRI, and continues to be so. Significant concerns have been raised regarding all of the key inputs relied upon by the AER, including the assumed distribution or payout rate and its assumed range for the value of franking credits (theta), which was derived from two studies. ENERGEX has further evidence to submit in relation to each of these areas, which is summarised below.

3.4.1 Payout rate

ENERGEX continues to question the appropriateness of the AER's assumption of a payout rate of 100 per cent. Reference is made to the attached report by SFG for further evidence as to why the most appropriate rate is 71 per cent (this report is provided at Appendix 3). One of the things shown by SFG is that the Officer (1994) WACC framework does not assume full distribution of free cashflows. The AER has previously relied upon this assumption in its assessment.

In further support of this position, ENERGEX also refers to evidence submitted by ETSA Utilities, in the form of a report by Professor Officer.[10] Officer explains why he disagrees with the AER's assumptions that the time value loss where credits are retained is not material and that all credits are eventually distributed. He concludes that the most appropriate payout rate is around 70 per cent.

3.4.2 Value of theta: analysis based on tax statistics

In the Draft Determination the AER rejected analysis undertaken by Synergies, which questioned the reliability of the tax statistics analysis the AER had relied upon (being the Handley and Maheswaran (2008) study). For the purpose of this response, ENERGEX asked Synergies to review and respond to the criticisms that have been made. This response is provided at Appendix 4.

Synergies addresses the key issues raised regarding its analysis, including showing that:

- it does not suffer from double counting;
- the estimates produced were not 'implausibly low'; and
- the use of tax statistics to estimate the payout rate, but not value theta, is not inconsistent.

In relation to the last point, it notes that this treatment is consistent with the Monkhouse definition, which requires the payout ratio to be derived using face values and for theta to be estimated using market values. Synergies confirmed that without access to Handley and Maheswaran's data, it is unable to reconcile their results with its own study or understand where the source of the differences might lie. Synergies taxation study was transparent and robust, however, it cannot be used to value theta, nor has it ever purported to do so.

Reference is also made to the attached report by SFG (refer Appendix 3) which highlights issues with the propositions supporting the AER's use of average redemption rates to estimate theta. It shows the advantages of using observable market prices to estimate theta, which is consistent with the approach used to estimate all other WACC parameters.

3.4.3 Value of franking credits

As part of its review of the SoRI outcomes in relation to gamma, SFG provided an updated estimate of the value of franking credits based on the methodology applied by Beggs and Skeels (2006), which was also relied upon by the AER. This report was submitted with ENERGEX's *Revised Regulatory Proposal* as new evidence supporting its continued departure from the AER's preferred value for gamma of 0.65. This report is also provided at Appendix 5.

[10] Source: Professor R. Officer (2009), *Estimating the Distribution Rate of Imputation Tax Credits: Questions Raised by ETSA's Advisers*, 23 June.

SFG's analysis concluded the following:

(1) If the Beggs and Skeels variation of the methodology is the most appropriate and if only post-2000 data should be used, an estimate using an updated data set should be preferred to that reported by Beggs and Skeels (2006);

(2) Professor Skeels states that the best such estimate of theta is currently 0.23; and

(3) *All dividend drop-off estimates of theta are conditional on the particular value of cash dividends that is adopted.*[11]

ENERGEX also refers to evidence submitted by ETSA Utilities, being a report by Skeels.[12] This report provides more detail in relation to Skeels' review of SFG's updated analysis. As outlined above, Skeels concluded that SFG's estimate of 0.23 is the most accurate currently available estimate.

Based on the above evidence, ENERGEX questions how the AER can continue to consider that the Beggs and Skeels 2006 study (which is now somewhat dated), can represent the best estimate of the value of theta that is currently available, particularly given clause 6.5.3(e)(1) of the *Rules* requires that the rate of return is:

> *...a forward looking rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in providing standard control service …*

3.4.4 Conclusion

ENERGEX has therefore submitted that SFG's estimate of theta is an appropriate and reasonable estimate based on current market data and this has been acknowledged by a co-author of one of the key studies relied upon by the AER. This new study provides further support for ENERGEX's proposed value for gamma of 0.2 (and the position previously put by the Joint Industry Associations), even if a 100 per cent distribution rate is assumed (noting that ENERGEX believes the appropriate value to be around 0.7). This position is further supported by a number of other reputable Australian studies that have already been submitted to the AER.

At minimum, it raises serious questions as to how it can be considered reasonable to continue to exclude values below 0.5 from the bounds of a reasonable range. Significant concerns have been raised regarding the two studies that the AER has relied upon in supporting its decision to move from the established precedent of 0.5. ENERGEX does not consider that either of these papers represent persuasive evidence for such a departure. However, it does consider that reputable Australian market-based studies have shown that the value of gamma is likely to be below 0.5.

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11 Source: SFG Consulting (2009), *Gamma: Further Evidence to Support Departure from the AER's Statement of Regulatory Intent*, Report Prepared for ENERGEX and Ergon Energy, December, page 4.

12 Source: C. Skeels (2009), *A Review of the SFG Dividend Drop-off Study*, 28 August.

3.5 Hedging costs

In a supplement to its *Regulatory Proposal*, ENERGEX proposed to include the costs of hedging the interest rate risk on the additional borrowings that it will need to undertake during the *regulatory control period* as part of its significant capital expenditure program. ENERGEX submitted reports by Synergies and SFG in support of this proposal.

The AER rejected ENERGEX's submission. Fundamental to this decision was its rejection of ENERGEX's proposal to treat the costs as operating expenditure and to instead assume that they should be treated as part of the WACC. The AER's assessment of the merits of the proposal then solely focused on the treatment of this claim as a cost of capital issue.

ENERGEX has a number of concerns with the AER's decision. These concerns are supported by information provided in the accompanying report by SFG, Response to Aspects of the Draft Determination, which is provided at Appendix 3.

The AER argues that hedging costs should not be considered as operating expenditure:

> *...as they refer not to the costs of entering into an exchange but rather the costs to transfer risk to another party for the duration of the regulatory control period.*[13]

It also claims that costs must be submitted in the building block proposal to be included in forecast operating expenditure. It stated that "it would appear problematic" for these costs to be estimated over the same averaging period as the risk-free rate and debt margin (although it does not say why), and that:

> *The NER appears to require that operating expenditure be based on forecasts for the relevant regulatory control period, not that previous to it.*[14]

ENERGEX does not consider that the AER's reasons for dismissing its categorisation of the claim are reasonable. If regard is given to clause 6.5.2 of the NER, ENERGEX considers that the costs of hedging its future interest rate exposure are part of "the efficient costs of achieving the operating expenditure objective" and it has already submitted detailed arguments to show why this would be the case.

If the costs are defined as they are by the AER, which is "the costs to transfer risk to another party", ENERGEX questions how these costs are any different from insurance, which are included as part of operating expenditure, not the cost of capital. SFG states:

> *In this respect, the cash cost of hedging interest rate risk is similar to any other form of insurance – it is prudent for a firm to eliminate exposure to certain risks by paying an insurance premium in relation to it.*[15]

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13 Source: *Australian Energy Regulator (2009)*, page 182.

14 Source: *Australian Energy Regulator (2009)*, page 182.

15 Source: SFG Consulting (2009), *Response to Aspects of the Draft Determination*, Report prepared for ENERGEX and Ergon Energy, page 3.

ENERGEX also considers that its proposal to estimate the costs over the averaging period was a reasonable one. It does not understand why this is "problematic". It is also not aware of any provision in the NER which precludes forecasting costs using information prior to the end of the *current regulatory control period*, noting that the market data that is used to estimate the hedging costs is a forward-looking estimate of the actual costs that a business would incur if it wanted to hedge risk over the next *regulatory control period*. It is not possible to see how these costs could have been estimated – or approved for inclusion by a regulator – after the *regulatory control period* has commenced.

ENERGEX considers that even if it could be reasonably argued that compensation could otherwise be provided via an increment to the cost of capital, it is at least equally reasonable, if not preferable, to treat this as operating expenditure. ENERGEX considers that its proposed treatment is reasonable and should not have been discarded in favour of the AER's preferred view.

As submitted in the attached report by SFG, there are concerns with a number of statements made by the AER in rejecting the analysis previously submitted. For example, SFG had shown how the business could be exposed to the risk of a credit rating downgrade if interest rates moved materially (and adversely) during the *regulatory control period*. The AER has assumed that because ENERGEX has relatively stable cashflows, its credit rating is unlikely to be changed even with lower cashflow coverage and higher gearing. The AER does not present any evidence for this statement, which is considered speculative.

In conclusion, ENERGEX has not re-submitted its claim for hedging costs because it does not have any new evidence. However, for the reasons set out above, ENERGEX does not agree with the way in which the AER has arrived at its decision. ENERGEX submits that hedging costs are proper, prudent and efficient costs incurred by DNSPs that is currently not compensated for in the WACC and therefore ought to be an operating expenditure allowance or specifically adjusted for in the WACC.

4 Pass-through and self insurance arrangements

The elements of the AER's draft determination in relation to ENERGEX's proposed cost pass-through and self insurance arrangements are closely linked. The main implication of the AER's draft determination is that ENERGEX will have material unmitigated risk exposures in relation to significant atypical storm events and retailer credit losses over the *2010-15 regulatory control period* because of the level at which the threshold for general cost pass-through events will apply.

4.1 Mitigating significant storm event risk

Significant storm events are one of the major exogenous events that each summer impacts adversely on ENERGEX's network and must be managed to ensure reliable electricity supply.

Recognising the need to manage this risk exposure, ENERGEX's *Regulatory Proposal* incorporated a proposal to self insure for 'storm catastrophe' losses. These losses represent network damage caused by atypical storm events that cause damage beyond that normally expected (and so are not covered by forecast emergency operating expenditure) but are not of a size that meets the threshold for general cost pass-through events. A $9.1 million actuarial-estimated 'storm catastrophe' loss estimate was proposed for the *2010-15 regulatory control period*.

The AER raised a number of concerns about the way the 'storm catastrophe' loss estimates were developed by insurance actuary, Finity Consulting Ltd, and rejected the proposed loss estimate entirely. ENERGEX maintains its position that these loss estimates were developed in a robust manner and meet all relevant Australian actuarial and insurance standards. In this regard, it does not appear that the AER subjected the loss estimates to assessment by an actuarial expert.

However, of greater significance to ENERGEX is the AER's apparent new position that if a commercial insurance company is unwilling to take on a specific risk associated with damage to a distribution network, it is not prudent for network service providers to self insure for that risk.[16] ENERGEX notes that it was not provided with any indication prior to the submittal of its *Regulatory Proposal* of this new position, which represents a material change in regulatory precedent.

[16] Source: AER, *Queensland draft distribution determination 2010-11 to 2014-15, draft decision – appendices*, pages 701-702

As a result, ENERGEX incurred costs and time engaging an actuarial expert to develop loss estimates for a risk exposure that the AER has now proposed should not be self insured by DNSPs. This is notwithstanding, the AER previously approved self insured loss estimates for risk exposures of transmission network service providers (TNSPs) that commercial insurers have not always been prepared to insure, including substation and tower structure damage.

In developing its *Regulatory Proposal*, ENERGEX believed that it met all AER self insurance requirements applying at the time. However, due to the AER's change in these requirements, ENERGEX believes there is merit in a set of guidelines on self insurance being developed in consultation with stakeholders, to provide clarity around the role of self insurance and the assessment process to be applied by the AER. This would also facilitate a nationally consistent approach to self insurance being applied by the AER across DNSPs and TNSPs. In contrast to the AER, ENERGEX believes that self insurance has an ongoing role in managing the risks facing its network because of the cycles in commercial insurance markets which means that not all network risks are insurable all of the time.

The AER also stated in its Draft Determination that events affecting key income generating assets are better dealt with through the cost pass-through mechanism.[17] However, the AER's draft decision on the threshold level for general cost pass-through events has resulted in ENERGEX now facing an unmitigated risk exposure in relation to atypical significant storm events, which will increase over the course of the *2010-15 regulatory control period*. Therefore in its *Revised Regulatory Proposal*, ENERGEX proposed that storm events causing significant losses should be classified as a specific nominated pass-through event. The specific nominated event approach would ensure ENERGEX is able to recover the efficient costs of addressing atypical adverse storm events without putting the funding of its capital and operating expenditure programs under undue pressure.

4.2 Retailer credit risk

Through the sale of ENERGEX's retail business and the introduction of full retail competition (FRC) in 2007, ENERGEX's exposure to retailer credit risk has increased significantly. In order to mitigate this exposure, ENERGEX proposed a total self insurance premium of $0.4 million over the next *regulatory control period*. Any costs over $5 million relating to a failure by a retailer to pass on the distribution use of system (DUOS) charges recovered from customers to ENERGEX should be treated as a general nominated pass-through event. The self insurance premium was based on an independent actuarial assessment conducted by Finity Consulting Ltd.

In the draft determination, the AER noted that it did not accept ENERGEX's proposal that self insurance was the best approach to mitigate this risk exposure.

[17] Source: AER, *op cit*, page 701.

By definition a competitive market is characterised by participants entering and exiting the market. Market and legislative factors as well as business specific issues can influence the level of market activity. Through measures such as licensing and prudential requirements for participation in the wholesale energy market, the National Electricity Market (NEM) is relatively stable. However it is widely recognised that retailer failure has and will continue to occur. Similarly changes in Government policy, such as the proposed implementation of the Carbon Pollution Reduction Scheme (CPRS), may have a significant impact on the financial stability of electricity retailers and mean that robust retailer of last resort arrangements are required.[18]

As noted by the AER with reference to Finity's report, the losses from retailer credit are highly uncertain. Default is a rare event, and it is possible that there will not be any defaults in the next *regulatory control period*. However, the losses from a single default could easily exceed independent actuarial estimates. Despite this unpredictability, it would be difficult for a prudent DNSP to not take steps to mitigate its exposure to these events. Especially given there have been two retailer failures in Queensland in the past 3 years.

ENERGEX's exposure to retailer failure is a function of the competitiveness of the south east Queensland electricity market and corporate structure of participating retailers. ENERGEX's financial exposure to the market exit of Energy One in June 2007, was limited by the fact that FRC was yet to commence and Energy One exercised its legislative rights to exit the market, that is it was not suspended from operation by a third party. However, the recent failure of Jackgreen (International) Pty Ltd is a completely different situation.

Jackgreen supplied electricity to about 17,500 customers throughout Queensland, most of which were located in south east Queensland. There is limited, if any, scope to recover the outstanding payments, as noted in the Age:[19]

> *An administrator from PKF said these unsecured creditors [including Integral, Origin Energy, AGL, Country Energy and ENERGEX] faced an uphill battle in reclaiming funds from Jackgreen, as they were lower in the queue than secured financiers and employees.*

Based on initial estimates, ENERGEX is likely to incur a significant loss through the failure of Jackgreen (International) Pty Ltd given the modest recovery prospects. Based on the draft determination, if this was to occur during the *regulatory control period*, ENERGEX would:

- incur the full financial impact of this event as it not permitted to self insure; and
- not meet the general event pass-through threshold of 1 per cent of annual regulated revenue ($11.6 million in the first year of the regulatory determination).

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18 Source: AEMC (2009), *Review of Energy Market Frameworks in Light of Climate Change Policies: Final Report*. September.

19 Source: Yeates C (2010), *Jackgreen funds unlikely to reach power companies,* January 4.

The AER notes there are a number of alternative methods to self insurance that are available. However, ENERGEX does not believe these represent a comparable approach to self insurance and would not necessarily represent a prudent response to the risk of retailer failure, as discussed below.

4.2.1 Obtain commercial insurance

Credit risk insurance allows a DNSP to protect its business from the failure of a retailer to pay for distribution services. This is a credible risk mitigation tool for DNSPs, however as noted by the Allen Consulting Group, in recent years there has been a hardening of the market for credit insurance coverage. This has resulted in a reduction in the number of underwriters offering these products.[20]

> *Reasons given for this by market participants included corporate concerns as more capital market transactions are backed by insurance and high profile international corporate failures such as Enron and World-Com inc, both of whom made use of credit enhancement mechanisms.*

As noted in ENERGEX's *Regulatory Proposal*, there has been substantial thinning in this market to the extent that ENERGEX is yet to find insurance for this risk exposure. Therefore, this is not a reliable alternative to self insurance.

4.2.2 Request additional security from retailers

ENERGEX agrees that it would be desirable to request additional security from retailers. However, due to the terms and conditions contained in the deemed Standard Coordination Agreement on credit support, there are a number of limitations with this approach. For example, it:

- underestimates the administrative difficulty associated with negotiating such an outcome with retailers; and
- is not effective in a dynamic market characterised by a competitive retail sector and increasing demand for energy.

4.2.3 Apply for a general cost pass-through

In accordance with the general pass-through threshold proposed in the draft determination, ENERGEX would only be permitted to recover losses greater than $11.6 million in the event of a retailer failure (in the first year of the *regulatory control period*). ENERGEX believes this threshold is too high and is greater than the 'moderate losses' viewed by the AER to be acceptable.

[20] Source: Allen Consulting Group (2006), *Review of Retailer DUoS Credit Support Arrangements*, January, page 13.

As noted in the *Revised Regulatory Proposal*, ENERGEX seeks to include retailer failure as a specific nominated pass-through event. ENERGEX submits that a retailer failure meets the AER's criteria for a nominated event.

ENERGEX proposes that a retailer failure event for the purpose of pass-through arrangement be defined as follows:

> *The incurring of costs (default payment) by ENERGEX during the course of the 2010-15 regulatory control period due to a retailer failure. A retailer failure event is an event when the Australian Energy Market Operator Limited (AEMO) has issued a suspension notice to a retailer under clause 3.15.21(f) of the Rules.*

4.3 Threshold for general cost pass-through events

In its *Regulatory Proposal*, ENERGEX proposed an alternative pass-through threshold of 1 per cent of average annual revenue or a fixed amount of $5 million, whichever is the lower, to apply to general nominated pass-through events.

In the draft determination, the AER rejected ENERGEX's alternative proposal on the basis that:

- the threshold must treat small, medium and large DNSPs fairly;
- it does not accept that a percentage threshold should be capped by a fixed amount; and
- a business with larger annual revenue requirements has a greater capacity to respond to an unexpected event without compromising service delivery.

Although the AER argues that pass-through thresholds should treat DNSPs fairly, this principle does not appear to hold for general nominated pass-through events. As shown in Table 4.1 below, larger DNSPs such as ENERGEX will not be treated equitably under the AER's proposed approach. For example, in the final year of the *regulatory control period*, ENERGEX will need to incur costs in excess of $16.9 million for a single event before it can seek a cost pass-through, such as a significant unforeseen major storm.

Table 4.1 Comparative Threshold Levels for Electricity Distribution Entities (1% of ARR) ($ million)

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
ActewAGL	1.34	1.47	1.59	1.72	1.82	
Country Energy	9.38	10.80	11.12	12.19	13.22	
Energy Australia	12.31	14.05	15.70	17.50	18.87	
Integral Energy	8.10	8.43	8.99	9.47	9.86	
ENERGEX		11.66	12.89	14.30	15.75	16.99
Ergon Energy		10.90	11.80	12.79	13.79	14.36
ETSA		6.10	6.59	7.08	7.60	8.11

Source: AER (2009) Australian Capital Territory Distribution Determination 2009-10 to 2013-14: Final Decision. April. p xxvi; AER (2009) New South Wales Distribution Determination 2009-10 to 2013-14: Final Decision. April. p xlvii-xlix; AER (2009) Queensland Draft Distribution Determination 2010-11 to 2014-15: Draft Decision. November. p xxxix – xi; AER (2009) South Australia Draft Determination 2010-11 to 2014-15. November. p xxx.

ENERGEX is particularly concerned that the AER believes businesses with larger annual revenue requirements (ARR) have a greater capacity to respond to unexpected events. This approach fails to recognise that the size of the ARR is fundamentally a function of a DNSPs licence conditions (including minimum reliability standards, geographic area and customer density). Hence, a large asset base or capital expenditure program is not a direct reflection of a DNSP's capacity to re-allocate funds to manage unexpected major adverse events.

ENERGEX's capital expenditure program is driven by demand growth on its network and the requirements to meet security, reliability and compliance obligations, leading to the rapid growth in the regulatory asset base. In these instances there is pressure on ENERGEX to:

- meet consumer needs while maintaining standards across the network; and
- manage the risks associated with deviations between forecast and actual maximum demand.

There are significant risks for ENERGEX in this environment as any deviation, where actual demand is materially higher than forecast, results in ENERGEX having to fund the additional expenditure. This puts pressure on ENERGEX's ability to fund the capital and operating expenditure program deemed efficient by the AER and means it is less able to re-allocate costs to manage unforeseen major events.

Most importantly, a DNSP's forecasts of efficient capital and operating expenditure include an allowance for foreseeable events, not unforeseeable or unpredictable events, such as extraordinary storms or bushfires. Therefore, irrespective of the size of the DNSP, its ARR reflects expenditure (capital and operating) the AER has deemed to be efficient i.e. there is no allowance to fund atypical adverse events. As noted in section 4.1, the AER has rejected the use of self insurance to assist manage such risk exposures in favour of the pass-though mechanism being the sole mitigation mechanism.

Expenditure on general unforeseen events is predominately operating expenditure. In recognition of this relationship, ENERGEX believes the pass-through threshold for general events should be proportionate to a DNSP's annual operating expenditure and 2 per cent is the appropriate materiality threshold.

This approach addresses each of the AER's criticisms of the general pass-through threshold outlined in ENERGEX's *Regulatory Proposal*. Specifically, it treats DNSPs fairly because it is not distorted by large capital expenditure programs and/or large regulatory asset bases. It can also be seen from Table 2.3 that use of operating expenditure as the basis of the pass-through threshold provides a more stable threshold level for all DNSPs over the *regulatory control period* reflecting the relatively greater stability of operating compared to capital expenditure. It also meets the AER's requirement that a percentage threshold should not be capped by a fixed amount.

Under this scenario, the threshold for a general nominated pass-through event for ENERGEX would fall to between around $6.4 and $7.2 million (see Table 4.2 below) over the *2010 2015 regulatory control period*, based on the AAR in the AER's draft determination.

Table 4.2 Comparative Thresholds – 2% Operating Expenditure ($)

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
ActewAGL	1.22	1.35	1.48	1.62	1.71	
Country Energy	8.11	8.48	8.86	9.22	9.56	
Energy Australia	9.66	10.12	10.62	11.09	11.41	
Integral Energy	6.0	6.30	6.55	6.79	6.94	
ENERGEX		6.42	6.56	6.84	7.15	7.19
Ergon Energy		6.57	6.70	6.55	6.47	6.23
ETSA		3.85	4.09	4.34	4.65	4.89

Source: AER (2009) Australian Capital Territory Distribution Determination 2009-10 to 2013-14: Final Decision. April. p xxvi; AER (2009) New South Wales Distribution Determination 2009-10 to 2013-14: Final Decision. April. p xlvii-xlix; AER (2009) Queensland Draft Distribution Determination 2010-11 to 2014-15: Draft Decision. November. p xxxix – xi; AER (2009) South Australia Draft Determination 2010-11 to 2014-15. November. p xxx.

ENERGEX considers such a threshold level to be material for general pass-through events and addresses the AER's concerns in relation to treating small, medium and large DNSPs fairly and is not capped by a fixed amount.

4.4 Self insurance reporting arrangements

The AER in its draft determination substituted ENERGEX's proposed self insurance allowance for below deductible public liability losses of $6.5 million over the *2010-15 regulatory control period* with an allowance of $38,000. In its *Revised Regulatory Proposal*, ENERGEX rejected the basis of the AER's loss estimate and re-submitted the $6.5 million loss estimate from its *Regulatory Proposal*.

The AER's draft determination (Appendix Q) also proposed a set of onerous reporting requirements in relation to the occurrence of self insurance events that will cost substantially more to administer than the allowance provided for the expected losses.

The reporting requirement is that when a self insurance event occurs, the following information should be reported to the AER as soon as reasonably practicable:

- the nature of the event;
- the total cost of the event, identifying:
  - costs that are provided for by external funding such as insurance or where the cost is paid for by third parties;
  - costs that are covered by self insurance;
  - costs to be passed through;
  - other costs, for example, costs that do not relate to the regulated assets;
- independently verifiable information/reports to justify the estimated total cost of the event and funding components of the total cost that were used to cover the loss.

These reporting requirements will impose a significant burden on ENERGEX to administer. This is because ENERGEX annually processes hundreds (and in some years, over one thousand) below deductible public liability claims each of which would appear to need to be reported to the AER.

Given information on the number and cost of ENERGEX's historical small and large public liability claims was presented to the AER in the *Regulatory Proposal* (in Appendix F of Finity's self insurance report), ENERGEX does not understand how such an onerous and administratively costly reporting obligation could be proposed.

The administrative cost to ENERGEX of complying with this obligation, if imposed, would far exceed any efficiency benefits that would be delivered by the associated regulatory reporting framework. As a result, ENERGEX proposes that the self insurance reporting requirements in the draft determination be simplified and less onerous.

This position is based on the assumption that the AER will approve ENERGEX's proposed forecast below deductible public liability losses of $6.5 million (or a reasonable amount). However, if the AER intends to maintain its draft determination position regarding these losses, ENERGEX does not wish to have any self insured loss amount recognised in the Final Determination given the associated reporting cost will far exceed the $38,000 estimate proposed by the AER.

5 Other matters

The AER's draft determination provides a high level summary of the reporting requirements that will apply to ENERGEX over the next *regulatory control period*. While the AER's draft determination provides some guidance on the AER's expectations, further clarification is required to ensure an effective transition from legacy reporting frameworks.

ENERGEX also has comments on the following matters raised in the AER's draft decision:

- negotiated distribution service criteria;
- annual revenue 'unders and overs' mechanism; and
- feed in tariffs.

5.1 Regulatory reporting

In ENERGEX's view, regulatory reporting arrangements should only be imposed on DNSPs if they are reasonably necessary for the AER to carry out its regulatory functions, including monitoring compliance with the distribution determination.

The provision of information is not a costless exercise. To ensure regulatory reporting provides a net benefit, the regulatory reporting framework (e.g. guidelines, reporting templates) should:

- be clearly articulated, including the timelines for submitting reports and reporting framework, prior to the commencement of the new *regulatory control period*;
- provide sufficient time for the DNSP to develop, implement and test internal reporting arrangements;
- be supported by a commitment to regulatory consistency and predictability as unforeseen changes in the reporting framework can have a material impact on a DNSPs administrative costs; and
- be consistent with the National Electricity Law (NEL) and *Rules* regulatory framework. ENERGEX does not believe that simply 'rolling over' the QCA regulatory reporting arrangements is appropriate given DNSPs are now operating under a new framework.

5.1.1 Annual reporting

Chapter 4 of the draft determination provides the AER's interpretation of the requirements of clause 11.14.5 of the *Rules*. Clause 11.14.15 stipulates that the ring-fencing guidelines in force in a participating jurisdiction immediately before the AER's assumption of regulatory responsibility continues in force in that jurisdiction until they are amended, revoked or replaced. Furthermore, references to the Queensland Competition Authority (QCA) in the ring-fencing guidelines are to be read as references to the AER.

The QCA's Final Determination - Electricity Distribution: Ring-fencing Guidelines September 2000 (Ring-fencing Guidelines) are currently the relevant ring-fencing guidelines. The AER specifically cites clause 2 of the Ring-fencing Guidelines which provides (upon substituting 'AER' for 'QCA'):

…a DNSP must:

(1) if the AER has published general accounting guidelines for DNSPs which apply to the accounts being prepared, comply with those guidelines; or

(2) if the AER has not published such guidelines, comply with guidelines prepared by the DNSP and approved by the AER, or if there are no such guidelines, comply with such guidelines (if any) as the AER advises the DNSP apply to that DNSP from time to time.

The AER has not published general accounting guidelines for DNSPs nor has it approved guidelines prepared by ENERGEX. As such, the AER's draft decision provides that the Reporting Guidelines[21] approved by the QCA will continue to apply.

The AER also imposes additional annual reporting obligations (beyond those in the Ring-Fencing Guidelines and Reporting Guidelines) in other parts of the draft determination, including Chapters 12 (STPIS), 13 (EBSS) and 14 (DMIS). These additional obligations are summarised in Appendix Q of the Draft Determination.

ENERGEX acknowledges that the AER draft determination:

- has determined that the Reporting Guidelines will continue to apply due to the operation of clause 11.14.5 of the *Rules*; and
- sets out additional reporting requirements beyond those in the Ring-Fencing Guidelines and Reporting Guidelines.

ENERGEX considers it important that reporting requirements only be imposed on ENERGEX to the extent they are reasonably necessary for the AER to carry out its regulatory functions and therefore do not impose an undue compliance burden on ENERGEX. ENERGEX notes that the current Reporting Guidelines were developed by the QCA to allow it to perform its functions and were consistent with the applicable cost allocation guidelines. ENERGEX believes that reporting guidelines applicable from 1 July 2010 should reflect the regulatory framework under the NEL and *Rules*. ENERGEX considers that relevant and targeted regulatory reporting requirements are in the interests of the AER, customers and the DNSP.

In regards to the additional reporting requirements in Appendix Q of the draft determination, ENERGEX notes that a number of expected requirements are yet to be clearly defined, for example "information relating to standard small customer metering". In addition, it is unclear which telephone answering parameter (GOS or ASA) ENERGEX will be required to report. The AER's draft decision notes PB's advice regarding GOS, but does not appear to conclude

[21] For clarity, ENERGEX interprets the Reporting Guidelines to include the QCA's *Electricity Distribution*: *Regulatory Reporting Templates June 2008*.

on the matter. ENERGEX reiterates that it considers ASA to be the more appropriate measure.

The AER currently intends to collect the information listed in Appendix Q through a separate Regulatory Information Instrument at or around the time that annual ring fencing compliance reports are submitted. ENERGEX believes that an efficient approach would be to incorporate this information collection process into existing annual reporting requirements and processes where they can be defined.

ENERGEX is reviewing the proposed reporting requirements included in the draft determination and will seek to engage further with the AER on this issue prior to the commencement of the next *regulatory control period*.

5.1.2 Ring-fencing guidelines

To facilitate the transition to the AER's regulatory framework, ENERGEX seeks the AER's confirmation of the interpretation and application of words and phrases in the Ring-Fencing Guidelines from 1 July 2010, as outlined in Table 5.1. These interpretations would continue to apply until updated Ring-Fencing Guidelines are implemented.

Table 5.1 Interpretation and application Ring-Fencing Guidelines from 1 July 2010

Clause	Word or Phase	Interpretation from 1 July 2010
1(c)	"prescribed distribution services"	"classified services"
1(d)	"establish and maintain a separate consolidated set of accounts in respect of the entire business of the DNSP, including establishing and maintaining a separate set of accounts of excluded services provided by the DNSP".	"establish and maintain separate set of accounts in respect of *Standard Control Services*, *Alternative Control Services* and Negotiable Services provided by the DNSP".
1(e)	"is generally consistent with the objectives of the National Electricity Code"	This condition is no longer relevant and therefore not enforceable.
1(h)	"or Code participant"	This condition is no longer relevant and therefore not enforceable.
3	"prescribed distribution services"	"*Standard Control Services*"
20	"Any breach of these requirements may be reported to NECA, with potential civil penalties where a breach is determined to have occurred."	This statement is no longer relevant and therefore not enforceable.

5.2 Negotiated distribution service criteria

The AER has proposed negotiated distribution service criteria to guide the provision of these services over the *2010-15 regulatory control period*.

ENERGEX does not intend to provide any negotiated distribution services over this period and has no comment to make on the AER's proposed criteria.

5.3 Annual revenue under and overs mechanism

ENERGEX believes the Maximum Allowed Revenue (MAR) formula for the first year of the *regulatory control period* should be consistent with the formula for subsequent years.

$MAR_t = AR_t \pm S_t \pm C_t \pm$ transitional $\pm$ pass-through

This formula allows for the recognition of adjustments for *current regulatory control period* over / under recoveries of Capital Contributions and Tax, and remains consistent for each year of the *regulatory control period*. In year 1 the S_t (STPIS factor) and pass-through values would be zero.

ENERGEX notes that the draft determination sets out in Table 16.10 the annual revenue requirements which represent the revenue to be earned as Distribution Use of System (DUOS) charges to customers and incorporates reductions relating to forecast revenue earned as Capital Contributions, and from assets used in providing alternate control services. The expected revenues in Table 16.10, being the smoothed annual revenue requirement represents the Allowed Revenue (AR) in the MAR formula discussed in Chapter 4.

Following on from above, ENERGEX understands that the revenue cap referred to in Section 4.7 of the Draft Determination relates to the revenue allowed to be recovered through DUOS charges to customers. The Capital Contributions revenue cap for each year of the *regulatory control period* is represented by the forecast Capital Contributions used in the Post Tax Revenue Model (PTRM).

5.3.1 Change in CPI

ENERGEX proposes that the change in the Consumer Price Index (ΔCPI) used to determine subsequent years AR, should be the annual percentage change in the ABS Consumer Price Index All Group, Weighted Average of Eight Capital Cities from December in year t-2 to December in year t-1.

The use of the March in year t-2 to March in year t-1 percentage change as outlined in the draft determination would not provide sufficient time for ENERGEX to prepare and submit its annual Pricing Proposal by the end of April as the publication of the official March CPI index is normally due in the fourth week in April.

Please note that this proposal does not apply to the CPI calculation to be used in the Roll Forward Model, which will continue to use the March t-2 to March t-1 percentage change to align with ENERGEX's statutory and current regulatory approach.

5.3.2 Distribution use of system unders and overs account

ENERGEX wishes to highlight that the DUOS unders and overs account calculation included in Appendix D of the draft determination does not adequately allow for the operation of the agreed tolerance limits set out in Chapter 4 of the draft determination. Where ENERGEX has an under or over recovery greater than two percent, the adjustment to revenue may span two or more years. The interest charge calculation on the opening balance in year t-2 does not take into consideration that the excess of the agreed tolerance limit may be cleared in year t or later.

ENERGEX suggests substituting Table 5.2 for the calculation of the DUOS unders and overs account as it considers the extension of time to adjust for unders and overs beyond the two percent tolerance limit. The table also allows easier identification of any under or over recovery relating to prior years, distinct from the respective current year. When year t becomes 'year t-2 actual' in subsequent years it can include over or under recoveries relating to both prior and current regulatory years, which needs to be distinguished in order to determine the correct current year over / under recovery.

In Table 5.2, a one year interest charge is applied to the Remaining Prior Years Balance in year t, reflecting the additional interest charge beyond the two years interest originally charged. This interest charge can continue to be applied to the Remaining Prior Years Balance for as long as it takes to clear any under or over recovery beyond the initial two years.

Table 5.2 Example calculation of DUOS unders and overs account ($,000)

	year t-2 (actual)	year t (forecast)
Revenue from DUOS charges	31,000	34,397
Prior years under/over recovery adjustments	-	603
MAR for the relevant year	30,000	35,000
Under/over recovery for regulatory year	**1,000**	**-**
DUOS Overs & Unders Account		
Nominal WACC	9.70%	9.70%
Opening Balance	-	1,203
Prior years under/over recovery adjustments	-	-603
Remaining Prior Year Balance	-	600
Interest on Remaining Prior Year Balance	-	58
Closing Balance with respect to prior years	**-**	**658**
Under/over recovery for regulatory year	1,000	-
Interest on under/over recovery for regulatory year	203	-
Under / Over recovery for current regulatory year	**1,203**	**-**

5.3.3 Transmission use of system unders and overs account

ENERGEX also suggests substituting the following Table for the calculation of the TUOS unders and overs account as it allows easier identification of any under or over recovery relating to prior years, distinct from the respective current year. When year t becomes 'year t-2 actual' in subsequent years it can include over or under recoveries relating to both prior and current regulatory years, which needs to be distinguished in order to determine the correct current year over / under recovery. ENERGEX has recently corresponded with the Queensland Competition Authority, who agreed that ENERGEX's approach of separately identifying prior period adjustments is appropriate.

Table 5.3 Example calculation of TUOS unders and overs account ($,000)

	year t-2 (actual)	year t (forecast)
Revenue from TUOS charges	6,000	8,797
Prior years under/over recovery adjustments	-	1,203
Transmission charges to be paid to TNSP's	5,000	10,000
Avoided TUOS payments		
Inter – DNSP payments		
Total transmission related payments	5,000	10,000
Under/over recovery for regulatory year	**1,000**	**-**
TUOS Overs & Unders Account		
Nominal WACC	9.70%	9.70%
Opening Balance	-	1,203
Prior years under/over recovery adjustments	-	-1,203
Under/over recovery for regulatory year	1,000	-
Interest on under/over recovery for regulatory year	203	-
Closing Balance	**1,203**	**-**

5.4 Feed-in tariffs

ENERGEX notes that ETSA Utilities has recently submitted a Rule change request to the Australian Energy Market Commission (AEMC). The Rule change request seeks to provide a mechanism for DNSPs to recover payments made under photovoltaic feed-in schemes and climate change funds. If approved the new mechanism would allow DNSPs to recover payments made under these schemes through an explicit provision in the DNSP's pricing proposals.

ENERGEX accepts the AER's specified cost pass-through feed-in tariff arrangement for the *2010-15 regulatory control period* as decided in the AER's draft determination. However, ENERGEX seeks clarification from the AER on the impact any Rule change will have on the operation of this defined pass-through event over the 2010-15 period. ENERGEX's view on this matter is outlined in its submission to the AEMC.