

28 August 2009

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



Dear Sir,

Energex and Ergon Energy Regulatory Determination Proposals for the period 2010-2015

Thank you for the opportunity to provide a submission on Energex and Ergon Energy's regulated revenue proposals for the period 2010-2015.

In this submission we outline our views on the merit of these proposals and on the adverse impacts the expenditure increases the proposals would have on energy users. We highlight the issue of the requirement under the National Electricity Rules to benchmark these energy businesses. We are seriously disappointed that the AER has not taken this requirement seriously and has stated that it doesn't intend to undertake benchmarking in assessing the proposals in question.

We trust that the AER will treat our concerns with the care and attention they deserve and we welcome open and frank discussion on this and other issues raised in our submission.

Yours sincerely

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Submission to the AER on Energex and Ergon Energy Regulatory Proposals for the period 2010-2015

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Executive Summary

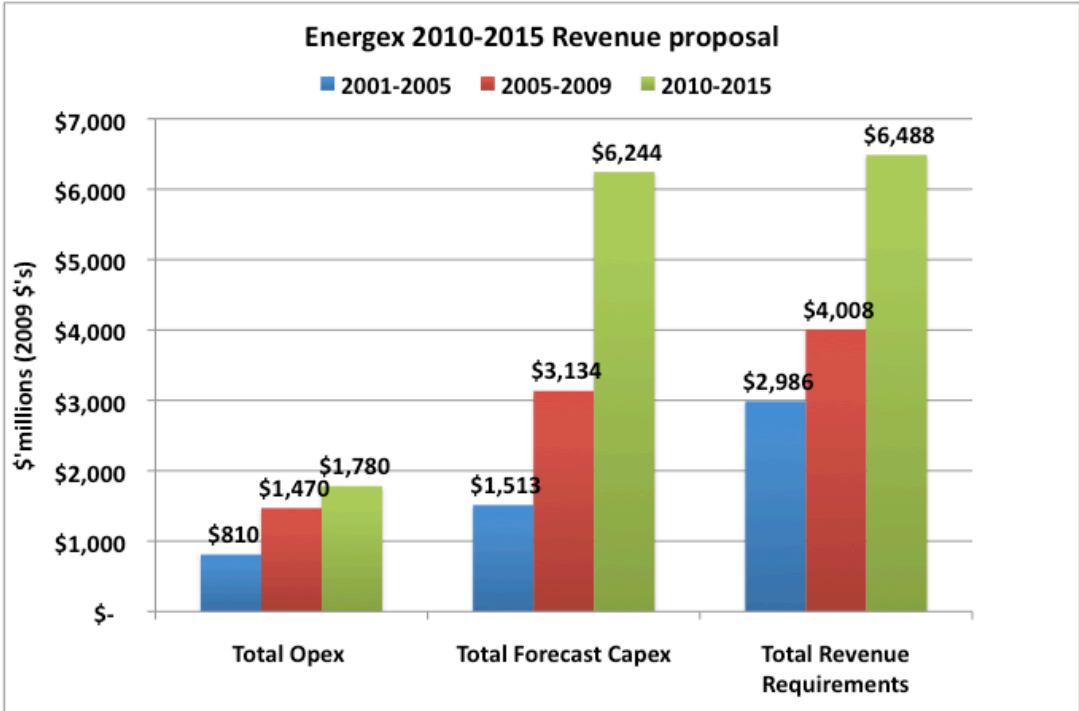
This document is the Energy Users Association of Australia (EUAA) submission to the AER on Energex and Ergon Energy’s regulated revenue proposals for the period 2010 to 2015. We welcome the opportunity the review affords, to provide this submission.

The EUAA is a non-profit organisation with over 100 members, many of them major electricity users in Queensland. These members will be significantly affected by the expenditure increases and resultant distribution charge increases as per the regulatory proposals recently submitted to the AER. Such increases come at a time of rising obligations on energy users to fund emissions reductions and renewable energy targets, and following the impact of the global financial crisis and world economic slowdown.

The EUAA recognises the significant effort Ergon Energy and Energex have gone to in putting together these proposals. Energex and Ergon have engaged with us in the past and have briefed or offered to brief us on these proposals.

However, these proposals mean that revenues in 2015 will be around 3.5 times higher than at the start of the 2000-2005 regulatory period. The compound annual growth rate (in constant currency) of expenditure of these businesses from 2000 to 2015 will have been 6.8% (for Energex) and 6.4% (for Ergon). This result is hard to reconcile with these distributors as mature technology utility businesses, rather than volatile commodity businesses subject to large fluctuations in demand and supply.

Figure E1: Energex opex, capex and revenue (\$m June 2009)



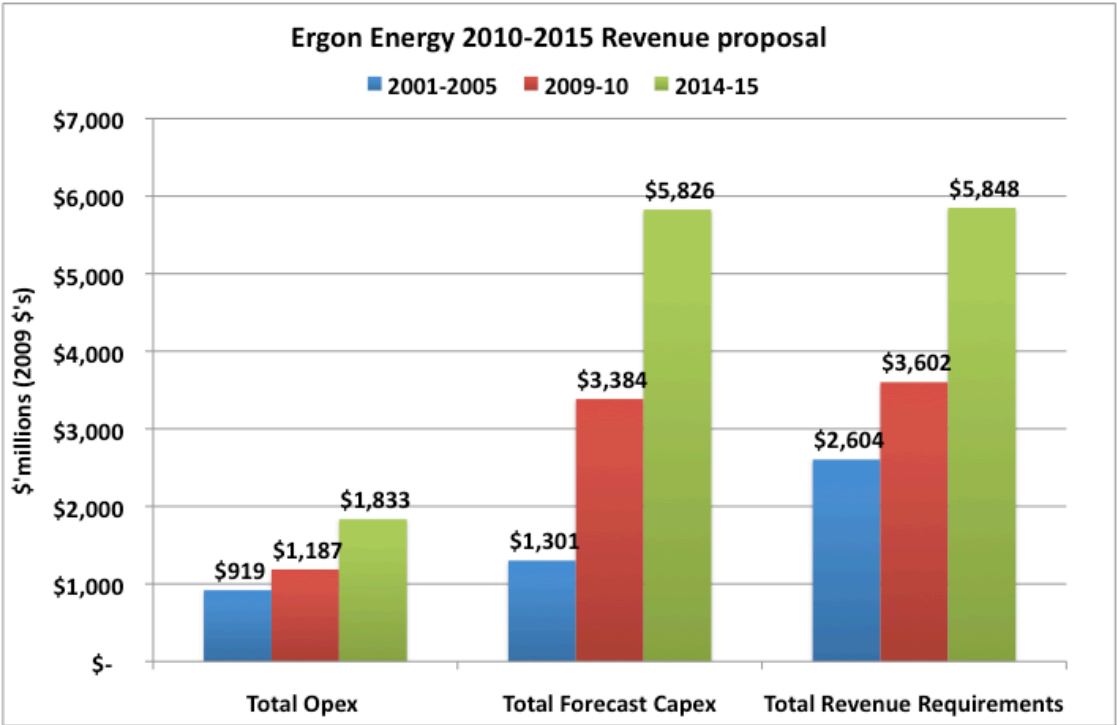
Energex provided data on distribution charges across different customer classes for the regulatory period and also said that in 2010-11 distribution charges would increase from an average \$4.20c/KWh to an average of \$5.27c/KWh. We calculate

this to be an increase of 25% in the first year and 10% in the subsequent years amounting to a compounded increase of 70% to 80% by 2015.

Ergon energy also provided indicative price increases for its various customer classes but did not give average indicative figures. Hence based on its standard access customer rates we calculated the 2010/11 increase is 30% followed by an average annual increase of 5-6% amounting to a 63% increase by 2015.

The root causes of such unexpectedly large increases in revenue are increases in capital expenditure and operating expenditure. This is illustrated in Figures E1 and E2 for Energex and Ergon Energy respectively.

Figure E2: Ergon Energy opex, capex and revenue (\$m June 2009)



Additionally Figures E3 and E4 show a major increase in the RAB and attendant increase in the regulated return on assets per customer.

Figure E3: Energex and Ergon RAB per Customer (\$m June 2009)

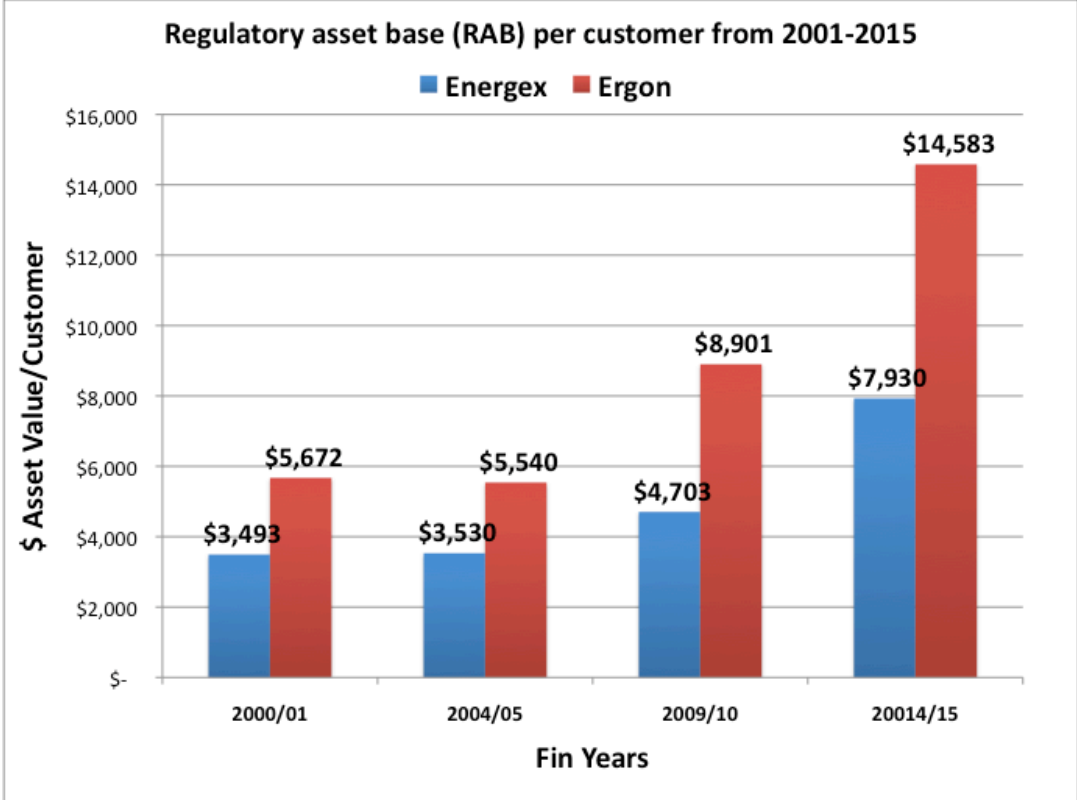
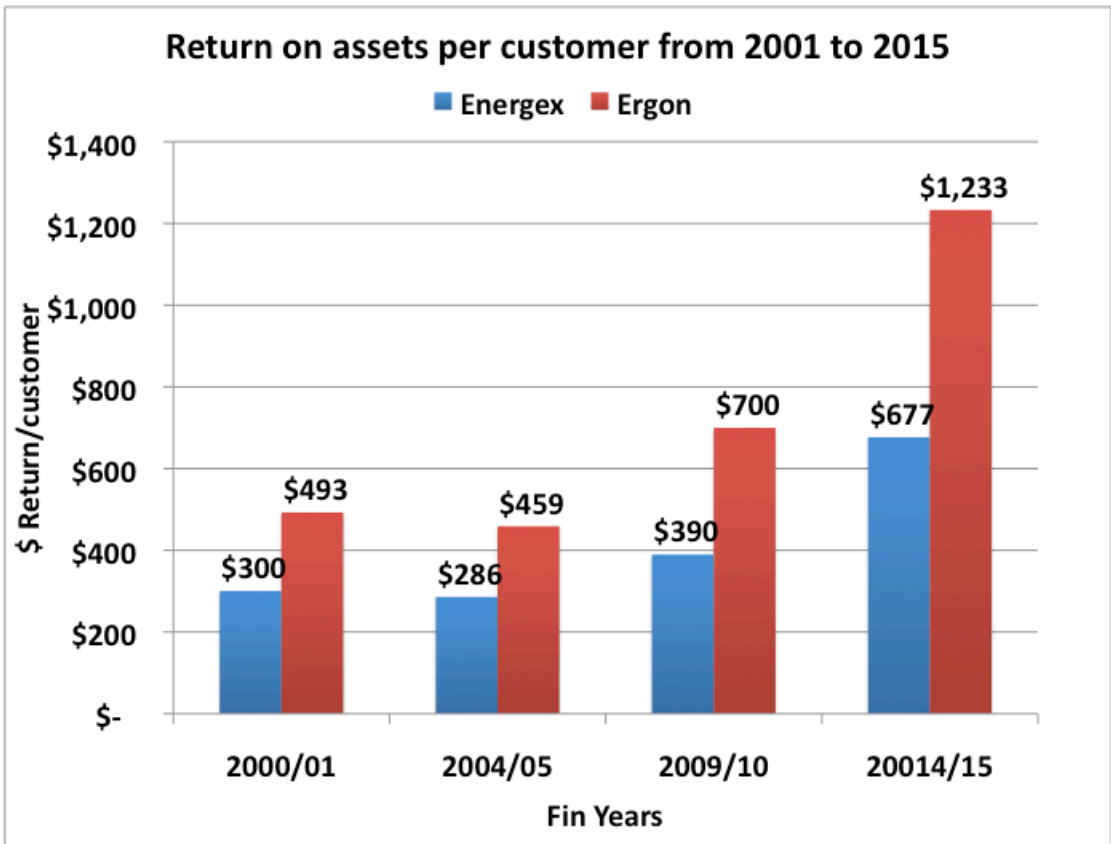


Figure E4: Return on assets per customer (\$m real June 2009)



The very large increase in the return on assets is likely to fund substantially higher dividend payments to the Queensland State Government. In addition to this, Energex and Ergon have projected income tax payments (which the Queensland Government will receive) rising from \$0m in 2010 to \$80m in 2015 (for Ergon) and rising from \$78m in 2010 to \$115m in 2015 (for Energex). Effectively electricity users in Queensland are being taxed via their electricity distribution charges. This is unacceptable to Queensland energy users. Such outcomes are inconsistent with the objectives of the National Electricity Market. We expect that the AER will take action to ensure that such outcomes are avoided.

Benchmarking can play a critically important role in identifying and quantifying inefficient expenditure. The National Electricity Rules require that the AER "must" have regard to benchmarking of the expenditure proposals of distributors compared to the expenditure of an efficient distributor under the Rules. This is one of the opex and capex factors to which the AER is required to have regard, in setting allowed capex and opex. The AER has called this benchmarking obligation a "long term proposition" and said that the AER only uses benchmarking "to test its bottom up detailed conclusions and not to set allowances". We consider that the AER is abrogating its obligations:

- Benchmarking is not "a proposition" in the Rules – it's a mandatory obligation.
- The AER does not have discretion in deciding which obligations it will implement and which not.
- In determining expenditure allowances there is no scope in this for the AER to use benchmarking only to "test its bottom-up detailed conclusions".

In deciding the regulated revenues for these businesses, the AER must properly implement this obligation using widely recognised techniques and methods in the application of benchmarks in the economic regulation of electricity networks. These techniques are, for example, used extensively by other regulators around the world and Australian energy users find it completely unacceptable that the AER is not developing recognised benchmarking techniques despite an explicit legal requirement for it to do so.

Finally we would like to emphasise that it is important that distributors are able to provide users with sufficient notice of tariff increases.

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1. Introduction

This document is the Energy Users Association of Australia (EUAA) submission to the AER on the regulatory proposals for the 2010/11 to 2014/15 regulatory period submitted by Energex and Ergon Energy.

The EUAA has over 100 members, many of them major electricity users in Queensland. These members will be significantly affected by the large expenditure and hence price increases proposed by Energex and Ergon. Our members' energy usage accounts for a significant proportion of Australia's industrial and commercial consumption of electricity and gas, and energy costs make up a significant part of their operating costs. In addition many of the EUAA's Queensland members are energy intensive users and electricity costs form a significant part of their input costs. Distribution charges typically make up around 40 per cent of their delivered costs of energy and this would increase under the proposals before the AER.

The Energy Users Association of Australia (EUAA) wishes to record its appreciation for the significant effort that both Energex and Ergon have put into the development of their proposals. We also wish to record that both Energex and Ergon have met with us (or propose to) to outline and discuss their proposals. We welcome this interaction and discussion.

The EUAA is very concerned about the size of the expenditure increases proposed and the impact they will have on distribution prices. The AER's recent decision on the regulated revenues for NSW distributors, suggest that the AER has been unable to ensure that only efficient expenditure is incurred by regulated network businesses. Energy users in NSW are paying a high price for this failure. This should also be of considerable concern to generators and retailers, who face the prospect of a weakened market as users curtail their use of power in the face of excessive network charges or seek to by-pass regulated networks and adopt distributed generation to avoid exorbitant network charges. It is urgent that the AER begins to regain control of the economic regulation of expenditure with these decisions, the ETSA decision and the forthcoming Victorian electricity distribution review.

We would also like to emphasise the importance of the need for ample notice of annual tariff increases, particularly before the start of the first year of the determination period, to enable users to incorporate changes into their lengthy budget processes.

There are three main sections to this submission:

- The first establishes the context of Energex and Ergon's expenditure proposals in light of their historic expenditure. It also examines the impact of their decisions on revenues, and regulated assets per customers, and the regulated return on assets that Energex and Ergon are asking energy users to fund.

- The second section sets out our view on benchmarking, and takes issue specifically with recent comments on this made by the Chair of the AER, Mr. Edwell on behalf of the AER.
- The third section identifies some specific issues on the applications by Energex and Ergon that we suggest the AER should consider further.

The appendix to this submission explains in detail why we think the so-called “benchmarking exercise” that the AER undertook in its recent decision on Transend is wholly unacceptable.

2. Energex and Ergon’s proposals in context

Energy users are unable to conduct a forensic evaluation of these proposals and therefore rely on the AER to protect them against inefficient expenditure. In this section we compare the components of the building blocks in these proposals to the previous determination by the Queensland Competition Authority. We express the total regulatory period opex, capex and revenues (in 2009 dollars) and also the Regulatory Asset Base (RAB) and return on capital in 2001/02, 2004/05, 2009/10, and 2014/15 also reported in 2009 dollars. We compared approved expenditures and revenues from past regulatory periods with the forecast expenditures and proposed revenue requirements from Energex and Ergon Energy for the 2010/11 to 2014/15 regulatory period. We strongly encourage the AER to do this analysis itself, and to present the results of this analysis in its draft and final decisions.

2.1. Opex, capex and revenue

Figures 1 and 2 show the operating expenditures, capital expenditures and revenue requirements over the previous, current and next regulatory period for Energex and Ergon respectively. They are summed into 5-year blocks after converting to constant 2009 dollars. While opex is forecast to double between the first and third period, the capex is forecast to go up around five times in both cases.

Figure1: Energex opex, capex and revenue (\$m June 2009)

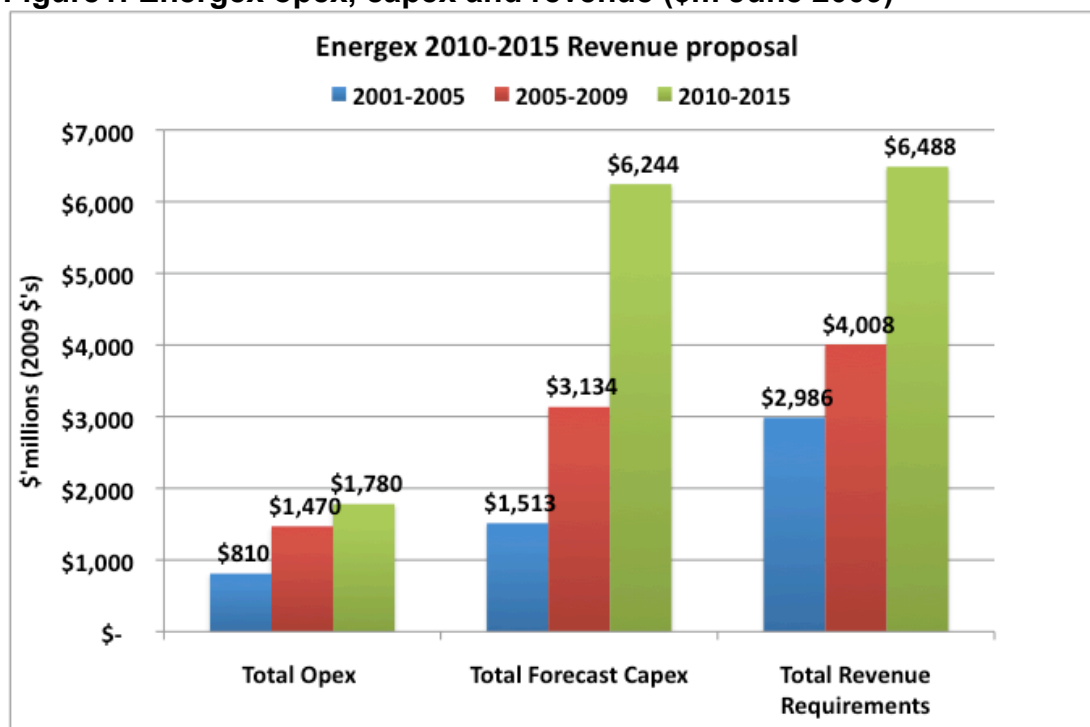
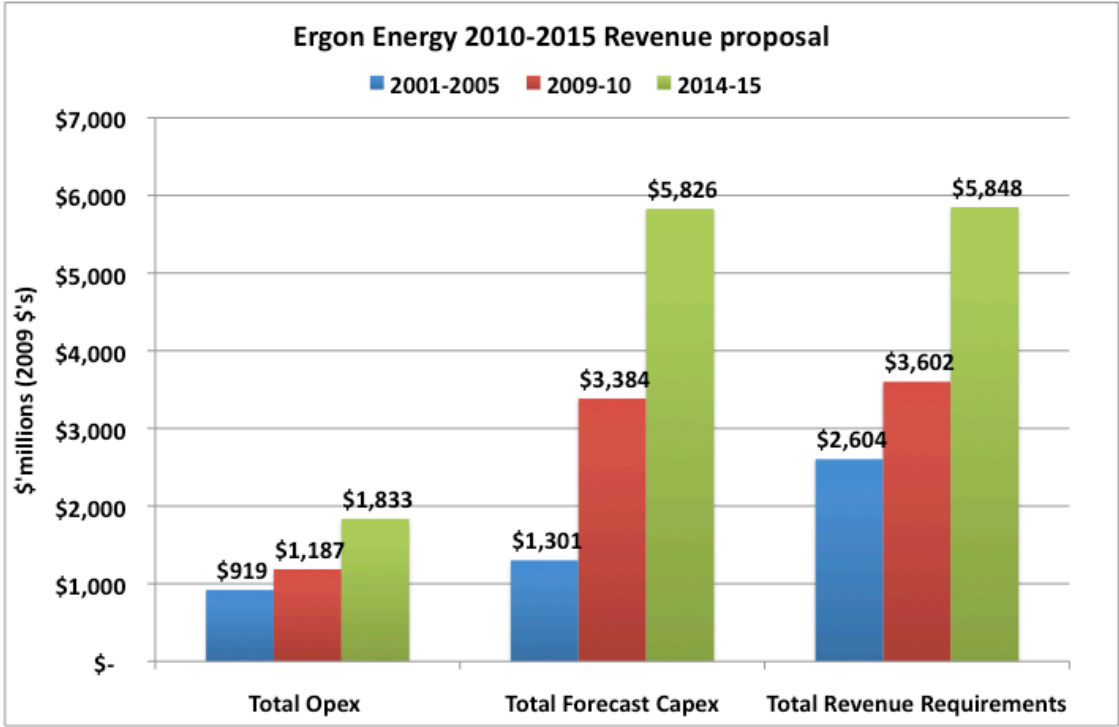


Figure 2: Ergon opex, capex and revenue (\$m June 2009)



2.2. Regulatory asset base and Return on Capital

High capital expenditures have led to large expansions in the Regulatory Asset Base (Figure 3) for both businesses, and regulated returns on the asset bases (Figure 4) below. Figure 3 shows that the regulatory asset base will be approximately three times higher in 2015 than it was in 2000.

Figure 3: Energex and Ergon Energy RAB per Customer (\$m real June 2009)

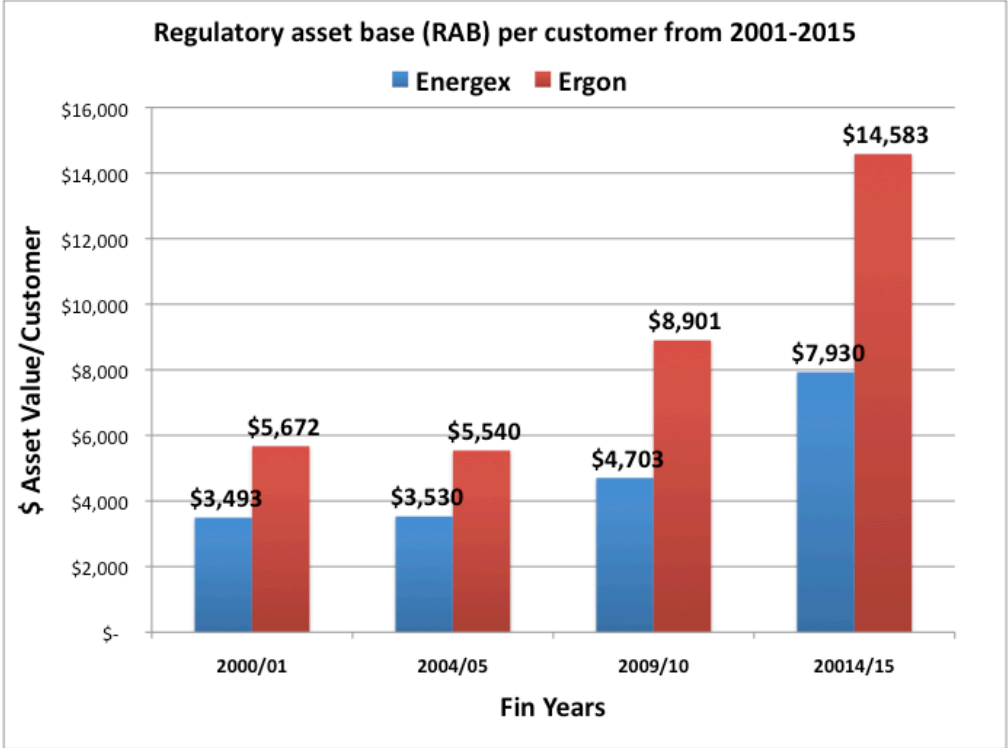
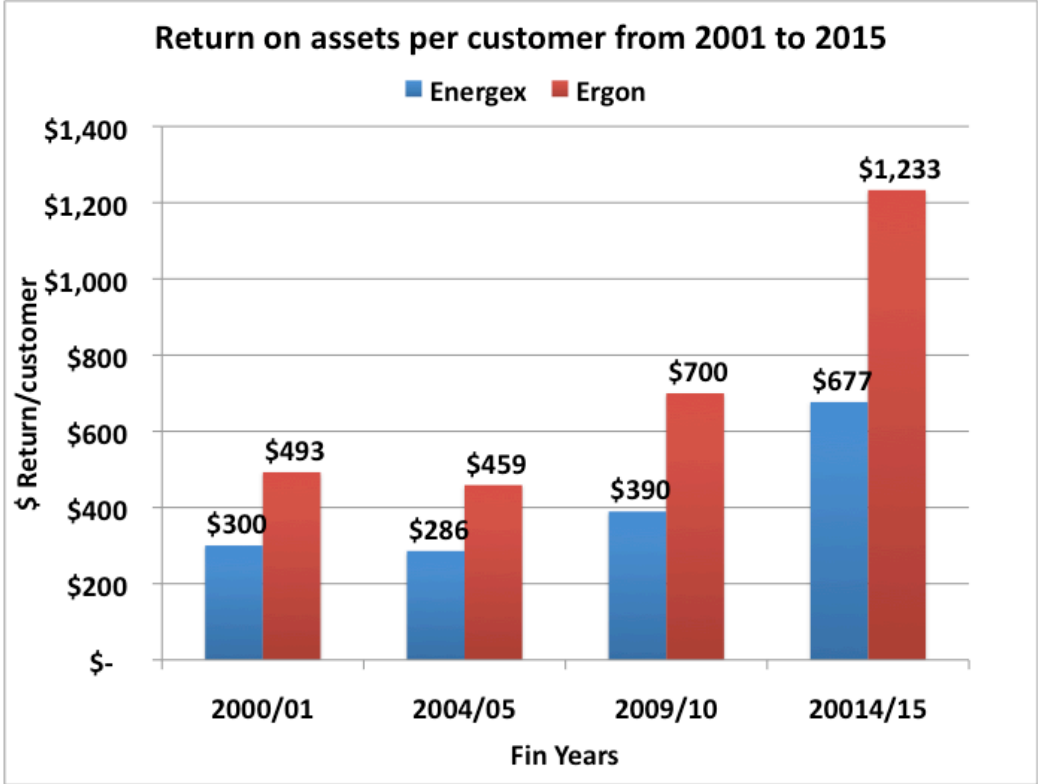


Figure 4: Energex and Ergon Energy Return on Assets per Customer (\$m real June 2009)



Moreover, the return on assets graph (Figure 4) shows that customers will be paying at least \$300 more every year in South East Queensland and \$700 or so more in the rest of Queensland than they were in 2000/01 as a contribution towards the dividends and corporate taxes flowing directly to the State Treasury from its two distribution businesses.

Potential Tariff Impacts

Both proposals gave some indicative numbers to give users some indication as to their impacts on electricity costs. However, these are very difficult to interpret and the AER needs to develop a standard template for providing such data. It would be a difficult task to users to gain much useful information from these numbers.

This is particularly important for the first year in the next regulatory period when the largest tariff increases are proposed.

The AER needs to work with the distribution businesses to provide users with sufficient notice of increases in tariffs for the next regulatory control period, including the 2010/11 financial year, is given for large companies to factor these increases into their budgetary planning. A common complaint from affected EUAA members is that large tariff increases are imposed without adequate notice. We note that some indication as to tariff increases is available from the time that distributors release their proposals and that these become ‘firmer’ when the draft determination is released.

AER should be using these opportunities to provide better and more advance notice of likely tariff changes resulting from its reviews.

The EUAA notes and welcomes comments by both Energex and Ergon at the public forum that they would be willing to work with customers and the EUAA to better inform them about the tariff impacts of their proposals and the AER draft determination through the course of this review. We also note their comments that they have already been engaging with customers on their proposals.

Whilst we see this as a useful and constructive approach which we would be happy to participate in and help facilitate with the two distributors, the AER has a broader regulatory responsibility and, in our view, this should include ensuring that customers are more engaged in the regulatory process, have information about regulatory proposals and their tariff impacts and obtain more notice of tariff changes. The current situation, where the participation of and information available to customers is very limited, is a cause for significant concern.

Indicative increases

Energex provided data on distribution charges across different customer classes for the regulatory period and also said that in 2010-11 distribution charges would increase from an average \$4.20c/KWh to an average of \$5.27c/KWh. We calculate this to be an increase of 25% in the first year and 10% in the subsequent years amounting to a compounded increase of 70% to 80% by 2015.

Ergon energy also provided indicative price increases for its various customer classes but did not give average indicative figures. Hence based on its standard access customer rates we calculated the 2010/11 increase is 30% followed by an average annual increase of 5-6% amounting to a 63% increase by 2015.

It is interesting to compare the increases with those proposed by ETSA in South Australia. A glaring difference is the relatively lower increase in the first year compared with the heavy front-loading of tariff increases in Queensland. The approach to “P_o” and “x” tariffs changes needs to be investigated further.

3. Benchmarking

3.1. What the Rules say

Under Clauses 6.5.6(e) (4) and 6.5.7(e) (4) of the National Electricity Rules, in making a decision on the operating and capital expenditure to be included in the calculation of the maximum allowed revenue, the AER is required (“must”) have regard to the benchmark operating expenditure/capital expenditure for an efficient transmission network service provider (TNSP) for the coming regulatory period.

3.2. Why benchmarking is important and its historical context in network regulation

As described above, the AER has a clear obligation under the Rules to have regard to benchmark efficient expenditures in making its decision. Therefore, it is not necessary for us to establish the rationale and policy justification for this. However, to communicate the significance of the AER’s failure to meet its benchmarking obligations, we will briefly establish the policy context to benchmarking in network utility regulation.

In 1993, the National Competition Policy Review undertaken by a Committee of Inquiry chaired by Prof. Fred Hilmer (the “Hilmer Review”) created the impetus for numerous micro-economic reforms that have followed over the last fifteen years. In their report, the Committee recommended a new competition policy regime focused on competition and the promotion of efficiency. In proposing approaches for the control of prices charged by monopolies, the Committee suggested:

“several potential bases, or benchmarks, which can be used to assess the appropriateness of a firm’s proposed price increases, including movements in the firm’s costs, movements in the general price level, and so-called “yardstick” competition, where the performance of comparable firms is used as a reference¹.”

The Bureau of Industry Economics in 1996 implemented these approaches in its comparative assessment of the efficiency of the Australian electricity industry in its International Benchmarking Report.²

The Australian Competition and Consumer Commission in a report to the Utility Regulators’ Forum in November 2000 noted that:

“Since the 1980s Australia has undertaken a major process of utility reform at both national and State levels. Increasing evidence — including from international benchmarking studies — of poor utility performance in key areas

¹ National Competition Policy Review, Committee of Inquiry, 1993. Available from the Australian Government Publishing Services, Canberra, page 279.

² Bureau of Industry Economics, 1996. “Electricity 1996, International Benchmarking Report”, AGPS, Canberra.

such as telecommunications, transport, water, gas and electricity led to the ensuing reform process in the organisational, management and ownership structures of utilities; and partially opened them up to competition. ³

From the time of its first decisions for the regulation of revenues of electricity transmission network service providers, the ACCC began to establish comparative information, although this was not always reflected in the decision on allowed revenues.

By 2004, in its “Statement of Principles for the Regulation of Transmission Services” the AER said

“To facilitate greater use of benchmarking data in determining the opex allowance to be included in a revenue cap, the ACCC intends to establish a working group by April 2005 to benchmark the performance of TNSPs and report by October 2006.” ⁴

The “Statement of Regulatory Principles” was subsequently superseded by the creation of the Australian Energy Markets Commission, which became responsible for writing the National Electricity Rules in 2006.

From the first proposed draft of the National Electricity Rules, the AEMC included a requirement that the AER have regard to benchmarking in its determination of the efficient levels of opex and capex to be included in the calculation of regulated revenues of the regulated businesses. This requirement was opposed by the Electricity Transmission Network Owners Forum (since renamed GridAustralia), who argued firstly that the results of benchmarking techniques should not be relied upon for setting transmission revenues and that if they were to be included they should be subject to certain requirements⁵.

The Energy Networks Association, in its submission to the AEMC recognised the value of benchmarking in helping regulators overcome information asymmetry but then suggested that benchmarking is not necessarily appropriate to regulated businesses.⁶

The Electricity Transmission Network Owners and Energy Networks Association suggested respectively that the AEMC should restrict the AER’s ability to use benchmark information⁷ unless it met specific criteria, and that the AER be required to place less weight on the results of benchmark studies in its determination of

³ Incentive regulation, benchmarking and utility performance, ACCC, November 2000.

⁴ Incentive regulation, benchmarking and utility performance, ACCC, November 2000.

⁵ “AEMC Review of the Electricity Transmission Revenue and Pricing Rules: Issues Paper on Revenue Requirements”, Submission by the Electricity Transmission Network Owners, November 2005, page 5.

⁶ Energy Networks Association submission to the AEMC Issues Paper on Revenue Requirements, November 2005. Page 7.

⁷ Submission by the Electricity Transmission Network Owners to the AEMC Review of the Electricity Transmission Revenue and Pricing Rules: Issues Paper on Revenue Requirements, November 2005, page 18-19

allowed revenues relative to the weight it should place on the regulated businesses' proposal.⁸

The AEMC rejected these arguments and set Rules that ensured that the AER "must" have regard to benchmark information as set out in Clauses 6A.6.6(e)4 and 6A.6.7(e)(4).

It is quite clear from this that the development and use of benchmarks in network economic regulation in Australia has had a long and secure basis in Australia's economic policy, particularly in the context of the pro-efficiency micro-economic reforms that stem from the Hilmer Review. It is also clear that the AEMC took the requirement to benchmark the expenditures of network businesses as a serious and important one – important enough to be specifically written into the NER. This is not surprising as, given the monopoly status enjoyed by energy networks, benchmarking is essential if consumers are to have confidence that they are not being forced to pay for inefficiencies in the businesses being regulated.

The requirement to benchmark network service providers in establishing regulated revenues or prices is common in other countries. Indeed, many other countries have developed and implemented rigorous benchmark methodologies. In particular, Britain, Norway, Sweden, Denmark, Holland, several Canadian Provinces and several US States have implemented benchmark approaches not just for the value they offer in providing information on efficient costs, but also for their used in establishing regulatory incentives. The value placed on such benchmark can be seen, for example, in Britain where legislation restricts the mergers of water monopolies in order to protect the industry regulator's ability to use benchmarks in its regulation of the prices charged by these businesses.⁹

Finally, it should be noted that while Australian transmission network service providers have continued to oppose the implementation of benchmarks for revenue regulation, many of these same business have used benchmarking approaches to compare themselves to their peers and obtain information on how to improve their own operations. For example, numerous electricity transmission network service providers around the world (including several in Australia) are represented in the International Transmission Operation and Maintenance Study. This is an annual study that began in 1994, to facilitate comparisons to be made between transmission network service providers around the world. The website representing this study explains that:

"Numerous companies have been part of the ITOMS™ study since 1994. Most of these companies have implemented performance improvement initiatives identified as a direct result of their participation. The consortium believes that there is a great value in both the consistent

⁸ Energy Networks Association submission to the AEMC Draft Rule and Rule Proposal Report, 24 March 2005, page 5.

⁹ Specifically, under the Enterprise Act of 2002, in reporting on the effects on the public interest of any merger referred under the Water Industry Act, the Competition Commission must have regard to whether the merger would prejudice the ability of the Director General of Water Services in carrying out his regulatory functions to make comparisons between different water enterprises

*source of relative performance information and the open sharing of idea, strategies, tactics and practices.*¹⁰

In several regulated revenue applications to the AER, transmission network service providers have quoted their own performance in comparison to their peers in the ITOMs study.

In summary, in establishing this policy context we wish to communicate the considerable importance accorded in Australia's regulatory policy debate and evolution, to benchmarks in the assessment of the regulated expenditures proposed by network service providers.

3.3. What the AER has said it will do

At the Public Forum on Energex's and Ergon Energy's regulatory proposals held in Brisbane on 3 August 2009, the Chair of the AER, Mr. Steve Edwell said that the AER is researching benchmarking but that it "is not there yet", that "the AER sees benchmarking as a longer term proposition" and that "the AER only uses benchmarking to test its bottom up detailed conclusions and not to set allowances".¹¹

We understand from this that Mr. Edwell has said that:

- That the AER does not consider that it is currently able to benchmark (the AER "is not there yet") but that in the "long term" benchmarking will be "a proposition";
- The AER will use its discretion in deciding whether or not to benchmark;
- If the AER does use benchmarks, it will only use these to test its bottom-up detailed conclusions, not to set expenditure allowances.

3.4. Our view of the AER's position

We wish to make clear that we unequivocally reject the AER's interpretation, as described by Mr. Edwell, of its benchmarking requirements. Specifically:

1. There is no provision in the Rules for the AER to decide whether benchmarking is a short term or long term proposition. Benchmarking is not described in the Rules as a proposition, and neither is any discretion given to the AER to decide when it sees fit to enforce the obligation.
2. The Rules are quite specific in instructing that the AER "must" have regard to benchmarks in setting allowed revenue. The AER is not allowed to ignore this responsibility and has no discretion in applying it, as Mr. Edwell has suggested it will.
3. Mr. Edwell's statement that benchmarking in the Rules will be used as a "test" of the AER's "detailed bottom-up conclusions" is entirely inconsistent with the specification of the AER's benchmarking obligations in the Rules. The Rules require the AER to have regard to the benchmark operating

¹⁰ http://www.umsgroup.com/ums_static/itoms.asp

¹¹ AER Minutes of "Queensland Public Forum on Energex's and Ergon Energy's regulatory proposals", Brisbane, 3 August 2009.

expenditure/capital expenditure of an efficient distribution network service provider (TNSP). This benchmarking stands alone and should be developed in accordance with the instruction of the Rules (the opex/capex of an efficient TNSP). The AER must then have regard to such benchmarking and explain how it had such regard. This activity stands on its own. There is no provision in the Rules for this activity to be used as a testing of “bottom-up detailed conclusions” or as a “high level sense check” as the AER described benchmarking in the Transend decision.

The requirements in the Rules on benchmarking are therefore quite specific: the AER is required to determine the benchmark opex/capex of an efficient TNSP for the coming regulatory period. “Efficiency” is a concept that involves the comparison of outputs and inputs. In an economic context applied to network service providers, efficiency would be established by comparing the outputs - such as a reliable transmission service - with inputs such as capital and operating expenditure.

There is no unique way to calculate efficiency or to develop benchmarks of efficiency. However, there are a number of well-established econometric and statistical techniques. The common goal of such techniques is to establish an objective comparison of the relationship between the outputs and inputs of comparable firms.

A challenge in such econometric analyses is to be able to objectively adjust for factors that affect the levels of outputs and inputs that the benchmarked firms can be expected to have little or no control over (exogenous factors), compared to those that the firm has significant control over (endogenous factors). In the case of distribution network businesses exogenous factors might include network topology and design, technology endowments, network density, climatology, and geography.

The challenge in adjusting for exogenous and endogenous factors is not unique to the application of benchmarking to distribution network service providers. In other industries, there are invariably several exogenous factors that need to be accounted for in developing fair comparisons.

We suggest that in determining the “benchmark expenditure of an efficient firm”, the AER is expected to develop a comparative analysis that uses established econometric and statistical techniques to develop systematic comparisons that take account of the exogenous and endogenous factors that affect a balanced comparison of one firm with another. This needs to be done to define the benchmark efficient opex and capex, against which the expenditure proposals of the Queensland distributors is to be compared. The evidence provided by this analysis then needs to be weighed (“had regard to”) by the AER in reaching its decision.

There is a substantial academic and practitioner literature in the field of the application of benchmarking to the economic regulation of network utilities, and we expect that the AER’s approach will reflect best practice as established in this literature. In particular, we expect the AER to closely examine the application of benchmarking in the UK, by its equivalent regulator, Ofgem. We are aware that Ofgem makes extensive use of benchmarking and has done so for many years.

4. Comments on specific issues

4.1. Service Target Performance Incentive Scheme

The EUAA welcomes the businesses' positive approach to the STPIS. This contrasts to the negative attitude of the NSW distributors during the recent AER review of their regulatory controls with the consequence that NSW energy users will have no such scheme in place until 2014/15 at the earliest, despite having to pay much higher network charges as a result of the AER's determination.

The EUAA also notes that the STPIS, whilst a welcome development, is still a scheme that has significant limitations for customers in that it focuses on only a few partial measures of distribution performance. For EUAA members and business customers more broadly, quality of supply tends to be an important factor in terms of their distribution services. In addition, our members would like to see an approach to service by the distributors that focuses more on their individual experiences and needs, including an ability to negotiate such matters through connection agreements.¹² This requirement was partly behind work that was undertaken for the EUAA by Evans & Peck, which examined the matter of connection agreements and made recommendations to improve them. This work was done in consultation with both Energex and Ergon. We would be happy to make the two reports that were produced, one of which relates specifically to Queensland, available to the AER upon request.

The AER has previously said that it "welcomes" negotiation (see comments by the Chair of the AER at the public forum on the NSW distribution review in 2008) in response to a EUAA comment about the desirability of more direct negotiation between customers and distributors on connection matters. However, as far as we are aware, little progress has been made on this so far and we would encourage the AER to do so in this review given the importance of larger customer load to the Queensland electricity system.

We find it disappointing that the AER has not sought to extend the STPIS and related distribution service issues into areas such as those raised above in this review and would urge them to carefully consider doing so.

4.2. Customer Participation in AER Regulatory Reviews

The EUAA wishes to draw to the attention of the AER some concerns it has about a lack of customer participation in AER regulatory reviews. Whilst bodies such as the EUAA have been regular participants in such reviews for more than 10 years, engagement with actual customers has been far more limited and problematic. As end users are the recipients of network services and are required to pay the regulated charges for such services, they ought to be seen as key participants and their engagement ought to be pro-actively sought. One of the costs of this not happening is that it is far more difficult for the regulator to determine what network

¹² The previous QCA review of Queensland distribution included some recommendations that were intended to encourage the Queensland distributors to consult with their customers on connection and service issues.

services customers are really willing to pay for and how much they are willing to pay. This is even more critical at a time like the present where the AER is regularly approving very large increases in expenditures by the businesses with very large increases in network tariffs as a consequence. In this regard, we note recent comments by Prof Stephen Littlechild, the foundation energy regulatory in the UK, at the ACCC/AER annual regulatory conference, also drawing attention to this challenge and presenting ideas on how regulators could seek to engage more with customers during regulatory reviews. We urge the AER to consider these matters carefully and develop ways to obtain greater customer involvement.

On a related matter, we also wish to draw the attention of the AER to concerns we have about the direction of energy consumer advocacy funding. Access to such funding has been a major means of ensuring better informed participation by groups such as the EUAA in regulatory reviews. Participation in such reviews is resource intensive, reflecting the complexity of the issues, regulatory approach and proposals. It would not be possible for the EUAA to participate at this level using only its own resources. However, the Advocacy Panel, which dispenses advocacy funding, has recently placed a limit on our annual funding which effectively halves its historical level. This is causing us to limit our advocacy effort by cutting back on areas of involvement and/or reducing our effort. This is inevitably affecting our participation in AER reviews. Given the consistent nature of the EUAA's involvement in regulatory resets and given the limited involvement of consumers, this must lead to a worse outcome for network regulation. Whilst our involvement in the Queensland distribution reviews has been funded, we have had to scale back on what we do and we wish to formally advise the AER that our involvement in other reviews is likely to be adversely affected by the situation.

4.3. Demand Management

The EUAA welcomes the fact that both Energex and Ergon are apparently seeking to promote demand management. However such demand management expenditure must be economically robust, and the AER needs to ensure that the benefit of such expenditure exceeds its cost before allowing for the inclusion of this expenditure in regulatory allowances.

4.4. Energex specific issues

1. Opex and capex has grown four times between 2001/2 and 2009/10. Of course this is much faster than growth in customer numbers and peak demand. The AER should carefully examine what has been achieved before contemplating further increases in expenditure.
2. The AER needs to examine in detail how Energex has ring-fenced its regulated and non-regulated businesses in terms of both expenditure and revenues, to ensure that the unregulated businesses are not being subsidised.
3. The demand growth projections were compiled in September 2008, which Energex said does not take account of the Global Financial Crisis. These demand growth projections need to be reexamined to take account of the GFC. In addition the AER needs to review historic demand growth, and Energex's claims on these rates of growth, to test the veracity of Energex's projections.

4. The \$132m sought for debt and equity raising seems quite unreasonable. Energex is owned by the Queensland Government, who arranges Energex's debt and provides Energex's equity. The AER should not allow any expenditure in this area unless there is clear demonstration that benefits will exceed costs.
5. Energex's arguments on expenditure to replace ageing assets do not appear to be supported by the asset age profile. For example, we can find no evidence of a bulge of assets nearing retirement. In fact, Energex appears to have one of the youngest networks of all distributors in Australia.
6. The AER's should assess carefully Energex's proposal regarding security and reliability standards and what expenditure is needed to meet these standards. This element of the proposal is responsible for a significant element of capex, some \$1.8bn over the regulatory control period and the AER must satisfy customers that it is reasonable and responsible. Contrary to popular belief, deterministic planning standards require considerable judgment and discretion in interpretation and in their application.
7. The demand management budget of around \$150m over five years will, it is stated, deliver a reduction in demand of around 140MW by the end of the fifth year. We welcome Energex's proposals on demand management and their supporting statements at the public forum but note a lack of specificity and detail around these aspects of their proposal. We note that most of the demand management budget is operating expenditure. If this expenditure is simply to defer demand growth then it is not likely that the benefits will exceed the costs. The AER needs to examine this in detail.
8. Generally, we consider that that Energex should provide more information to assess the benefits of its proposed expenditures. The AER must ensure a much higher level of cost/benefit analysis before considering the approval of the expenditure application.
9. Energex's proposed list of cost pass-throughs raises concerns for energy users. The allowed rates of return already compensate network businesses for assuming diversifiable market risks. The substantial list of pass-throughs proposed, while also allowing Energex to earn premium rates of return in its WACC, is unreasonable. We do not support pass-through as a matter of principal and believe that they will always be asymmetric in favour of the network businesses given their information advantages. Consequently, any cost reductions that emerge during a regulatory control period will almost certainly never be passed through.

4.5. Ergon Energy specific issues

1. We note Ergon claims commercial confidentiality in order not to publish key information. We do not see any reason why the data they claim is commercially confidential should not be made public. As businesses that enjoy regulated monopoly status, energy networks ought to make all information relevant to a regulatory review public unless it relates to transactions that involve customers in competitive industries and the information is commercially sensitive to competitors.
2. It is unclear what demand forecasts have been used, and the relationship between demand forecasts produced by Ergon and those produced for it by NIEIR. In addition, the basis of projections of customer numbers is not clear.

The impact of the GFC on demand and customer numbers should be examined in detail by the AER.

3. Ergon's separation of regulated and unregulated businesses is not clear, albeit that Ergon's proposals may be due to transitional arrangements. The AER must ensure that effective ring-fencing and separation is enforced, so that regulated customers are not paying for services provided to unregulated customers. This comment also relates specifically to customer contributions whether through gifted assets or some other pecuniary compensation. Gifted assets and customer capital contributions need to be properly accounted for so that customers are not paying twice.
4. Ergon does not appear to have undertaken any meaningful cost/benefit analysis to test that the claimed benefits of their proposed capex exceeds the costs incurred. We suggest that the AER has particular regard to the very significant expansion of asset replacement and corporation-initiated augmentation. We also query Ergon's emphasis on prudence as the criterion to be applied in assessing its expenditure claims. The National Electricity Objective, which under-pins the National Electricity Rules is an efficiency objective and this should be the focus of the AER's assessment.
5. Ergon Energy's demand management strategy is seeking approximately \$61m expenditure in non-network alternatives, and a further \$25m to trial smart meters. We welcome Ergon's proposals on demand management and their supporting statements at the public forum but note a lack of specificity and detail around these aspects of their proposal. The AER should only approve this expenditure if benefits exceed costs on the basis of a robust analysis.
6. We note the very significant expansion of expenditure on corporate property. The AER should investigate this carefully to determine its purpose, relevance and benefit.
7. Ergon does not appear to have benchmarked their expenditure claim against that of other similar distributors, although at the Public Forum they did allude to the fact that they had attempted to establish a benchmark exercise with other distributors but failed due to willingness by others to participate. We welcome Ergon's attempt and express our disappointment that it did not succeed due to the unwillingness of other distributors. Notwithstanding the absence of such benchmarking, we consider that Ergon needs to provide evidence to support its claims of efficient expenditure.
8. There is no evidence of the impact of productivity improvements in Ergon's claims for either opex or capex. However, all businesses should show continuous productivity improvement including network monopolies. The AER needs to delve further into this matter to determine the basis for further productivity improvements.
9. Ergon's proposed costs pass-throughs are inconsistent with the Rules and the basis of revenue cap regulation. The AER should not allow Ergon to pass through costs under any of these proposed categories. As stated above. The EUAA's position is that we do not support pass-through as a matter of principle and believe that they will always be asymmetric in favour of the network businesses given their information advantages. Consequently, any cost reductions that emerge during a regulatory control period will almost certainly never be passed through.

Appendix: Comment on the AER's benchmarking in the Transend decision

Whilst we acknowledge Mr. Edwell's recognition that the AER "is not there yet" in benchmarking, this candor has been lacking in previous AER decisions where the AER has claimed to have benchmarked expenditure, as required under the Rules. For the avoidance of doubt, we explain in this subsection why we think that the benchmarking that the AER undertook for the determination of regulated revenues for Transend – which the AER claimed met its Rules obligations - is wholly unsatisfactory.¹³ If a similar level of analysis is undertaken for the Queensland distributors, this will, in our opinion, fail to meet the benchmarking requirements in the Rules.

Specific errors of fact and reason in the AER's application of benchmarking of capex in the Transend decision are listed below:

1. The AER did not undertake a comparison for the relevant regulatory period (which begins on 1 July 2009 and ends on 30 June 2014). The analysis that the AER undertook was based on expenditure incurred by Transend and its peers in the 2006/7 year. The point of comparison, as required in the Rules, should have been with respect to Transend's proposed expenditure.
2. The AER failed to define the benchmark capex of an efficient TNSP.
3. The AER has not used a recognised benchmarking methodology. The AER simply calculated five ratios without justification for why those ratios were chosen, or how the selection and use of those ratios constitute a benchmark. Recognised benchmarking techniques¹⁴ can be classified as parametric or non-parametric. The former include Corrected Ordinary Least Squares and Stochastic Frontier Analysis, while the latter include Data Envelopment Analysis and Free Disposal Hull). These approaches exist in order to adjust for many differences that might explain the relative efficiency measure of different measures. The AER's ratio analysis makes no attempt to adjust for differences and hence fails to provide a meaningful comparison of the transmission network service providers included.
4. The AER's methodology is obviously flawed. For example two of the five capex ratios they use relate the total capital expenditure of a transmission network service provider to the number of substations (the first ratio) and to the length of the network (the second ratio). Such ratios provide meaningless information in the assessment of benchmark efficient capex. The former will vary amongst transmission network services based on the network typology, load density and substation size. The latter will vary based on the length of the network: for example the dense short network operated by Energy Australia around the city of Sydney bears no meaningful comparison to the long network in Tasmania operated by Transend. The AER even recognised these faults in its description of the ratios and yet persisted in including these ratios in its analysis.

¹³ We note also that the AER did not even attempt to benchmark expenditure in its TransGrid decisions or its decision for the New South Wales distributors.

¹⁴ Reference: Mehdi, F., Fetz, A., Fillipini, M. "Benchmarking and regulation in the electricity distribution sector", Centre for Energy Policy and Economics, Swiss Federal Institute of Technology.

5. The AER failed to identify the data used in its analysis. It said that the data used in its analysis is “sourced from publicly available regulatory determinations and AER regulatory reports”. It is not clear what regulatory reports have been referred to. It is also not clear that the AER has consistently stated all figures for the same financial year.
6. The AER has drawn factually incorrect conclusions from its own analysis. For example in explaining why Transend’s annual capital expenditure as proportion of average RAB value is higher than its peers, the AER said that this was because Transend’s capex values are on an “as commissioned” rather than “as incurred basis”. This is a factually incorrect conclusion and is inconsistent with the advice to the AER by its consultant Worley Parsons, that the difference between the recording of capital expenditure on an “as incurred” versus “as commissioned” basis is not material. The AER acknowledged and repeated this advice later in its own analysis.
7. The AER drew factually incorrect conclusions from its own analysis. For example, the AER concluded that based on a time-series analysis, Transend’s capital expenditure as a function of network length was in the middle of its peer group. This is not correct. After excluding Energy Australia from this ratio (based on the AER’s own conclusion that it is not comparable), Transend’s capital expenditure is either the second highest or highest for the four years for which the AER has presented data.
8. The AER made a misleading claim on the advice provided by its consultant, WorleyParsons. In particular, the AER claimed that based on its own analysis and that of WorleyParsons, Transend’s expenditure levels are similar to other TNSPs. In fact WorleyParsons reached no such conclusion. Instead WorleyParsons concluded that it was not possible to compare Transend to other TNSPs.
9. The AER drew conclusions from the analysis that are logically flawed. The AER claimed that Transend’s expenditure was similar to other TNSPs. Although they subsequently noted that in capex, Transend’s performance was “lower” than other TNSPs they noted that it would be difficult to assess Transend against other TNSPs due to the differing composition of its assets base relative to its peers”. By implication the AER have rejected their conclusion that the capital expenditure performance of Transend was worse than its peers, and decided instead that it is comparable to its peers, because it was difficult to assess Transend against other TNSPs. This is logically inconsistent: if the AER concludes that the performance is worse than its peers, but then says that comparisons are not possible, this provides no basis to conclude that performance is comparable.
10. The AER drew conclusions from the analysis that is not consistent with the results of the analysis. As noted in point 4 above, two of the AER’s five capex ratios do not, based on the AER’s own statements, provide data that is comparable. Of the remaining three-capex ratios, the AER made no claim that the results of those ratios were not fairly comparable. For all three of those ratios, Transend’s performance was worse, typically significantly so, than for any other TNSP. This suggests that it is not reasonable for the AER to conclude that Transend’s expenditure performance is comparable to its peers based on the results of its own analysis.

We also contend that the AER has failed to implement its obligation under the Rules to determine the benchmark opex of an efficient transmission network service provider. The specific errors of fact and reason are listed below:

1. The AER did not undertake a comparison for the relevant regulatory period (which begins on 1 July 2009 and ends on 30 June 2014). The analysis that the AER undertook was based on expenditure incurred by Transend and its peers in the 2006/7 year. The point of comparison, as required in the Rules should have been with respect to Transend's proposed expenditure
2. The AER failed to define the benchmark opex of an efficient TNSP.
3. The AER has not used a recognised benchmarking methodology. The AER simply calculated three ratios without justification for why those ratios were chosen, or how the selection and use of those ratios constitute a benchmark. Recognised benchmarking techniques¹⁵ can be classified as parametric or non-parametric. The former include Corrected Ordinary Least Squares and Stochastic Frontier Analysis, while the latter include Data Envelopment Analysis and Free Disposal Hull). These approaches exist in order to adjust for many differences that might explain the relative efficiency measure of different measures. The AER's ratio analysis makes no attempt to adjust for differences and hence fails to provide a meaningful comparison of the transmission network service providers it has included.
4. The AER's methodology is obviously flawed. For example one of the three opex ratios they used relates the total operating expenditure of a transmission network service provider to the number of substations. Such ratio provides meaningless information in the assessment of benchmark efficient capex. The value of this ratio will vary amongst different TNSPs based on the network typology, load density and substation size. Furthermore, the operation and maintenance of substations is only a small part of the business of operating a transmission network. It is clearly unreasonable to attempt to draw a meaningful comparison on the basis of the total operating expenditure of a business as a percentage of the number of assets of a certain type, where the number of those assets is likely to vary in different businesses for reasons that have nothing to do with the efficiency of those businesses.
5. The AER failed to identify the data used in its analysis. It said that the data used in its analysis is "sourced from publicly available regulatory determinations and AER regulatory reports". It is not clear what regulatory reports have been referred to. It is also not clear that the AER has consistently stated all figures for the same financial year.
6. The AER has drawn factually incorrect conclusions from its own analysis. For example, the ratio of the operating expenditure to the RAB shows Transend to be significantly worse than its peers. However the AER sought to diminish this evidence by noting that this ratio was calculated after the entry of Transend to the National Electricity Market when "*Transend was faced by higher costs resulting from the introduction of new functions and obligations*". This is an obviously flawed conclusion: all the other TNSPs in the comparison have already been part of the National Electricity Market. It follows that since Transend joined the NEM – and hence was now exposed to the same NEM-related costs of its peers – this would be reason to conclude that the results are now more comparable, not less.
7. The AER drew conclusions from its analyses that are not consistent with the results of its analysis. As noted in point 4 above, one of the AER's three opex ratios does not provide meaningful or comparable data. Of the remaining two opex ratios, after correcting for the error identified in point 6 above, Transend's opex performance is in fact worse than that of any of its peers. Therefore it is not reasonable for the AER to conclude that Transend's operating expenditure performance is comparable to its peers, based on the results of the AER's own analysis.

¹⁵ Reference: Mehdi, F., Fetz, A., Fillipini, M. "Benchmarking and regulation in the electricity distribution sector", Centre for Energy Policy and Economics, Swiss Federal Institute of Technology.