Supporting Documentation

Our Journey to the Best Possible Price

To ensure we manage the distribution network efficiently, Ergon Energy is regulated under the National Electricity Rules (NER) by a national regulator, the Australian Energy Regulator (AER). It is the AER's role to set the amount of money we're allowed to collect for the use of our electricity network. These network charges make up approximately half of the retail 'price' of electricity in Queensland.

To assist the AER in making the decisions it needs in determining our revenue allowance for 2015 to 2020, we have provided them with our future investment plans as a Regulatory Proposal. After considering our proposal and public submissions, the AER will publish a draft Distribution Determination. This will be available for further consultation in May 2015.

We have engaged with our customers to help inform our proposal and are confident, with the AER's support, that our investment plans will enable us to deliver the best outcome for regional Queensland into the future.

How to read our Regulatory Proposal

Ergon Energy's Regulatory Proposal is presented in a number of documents to make it easier for our different stakeholders to access the information they need.

The document, An Overview Our Regulatory Proposal, provides the context for the proposal and an overview of the price impacts and the broader customer benefits, along with the highlights of how we plan to deliver them. The overview document is supported by a number of documents.

One of the supporting documents is this document, **Our Journey to the Best Possible Price**. It details the measures we have taken and those we plan to take over the coming regulatory control period to achieve significant efficiency improvements, and improve the affordability of electricity for our customers.

The document, Ergon Energy Regulatory Proposal 2015 to 2020, fully addresses the regulatory requirements of the proposal for the AER.

These and a suite of other documents are available at www.ergon.com.au/futureinvestment.

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1. Introduction

The regulatory control period 2010-15 has been one of disruptive change for Ergon Energy in terms of the evolution of electricity market conditions in Queensland and the implementation of major reforms to jurisdictional and national energy regulatory frameworks. As a result of these changes many of the business drivers and assumptions present at the time of setting the 2010-15 Distribution Determination have materially changed.

It became apparent to us early on in the regulatory control period 2010-15 that a number of these developments represented or created permanent changes in our operating environment. We therefore sought to understand more fully the impact of these changes, the challenges and opportunities they presented and our customers' expectations.

Extensive customer engagement has revealed an increasing gap between our customers' expectations about the quality of the electricity service they receive and the price they must pay for it. However, the majority of our customers are generally satisfied with current levels of electricity supply reliability and expect it to be maintained. The price/affordability dimension is now clearly one of our customers' key concerns when evaluating the electricity service they receive.

Given these changes in expectations and market conditions Ergon Energy focused sharply on the efficiency and effectiveness of its operations, while ensuring our service performance and employee and community safety was not compromised. We are continuing to take action to improve the affordability of electricity for our customers. Achieving this will require a focus on continuous improvement in Ergon Energy's operational effectiveness and efficiency over a number of years.

The expectations of our shareholder, the Queensland Government, during the regulatory control period 2010-15 also supported an increased focus on efficiency in service delivery. In 2012 the Queensland Government established an Interdepartmental Committee on Electricity Sector Reform (IDC) to scrutinise cost pressures on electricity prices – specifically network costs, electricity supply and retail competition.[1]

This paper has been prepared by Ergon Energy to explain the measures we have taken and those we plan to take over the regulatory control period 2015-20 to achieve significant efficiency improvements. The common objective for each of the measures is to improve the affordability of electricity for our customers, while not compromising safety and reliability.

1 www.dews.qld.gov.au/__data/assets/pdf_file/0009/78543/idc-report.pdf

2. Ergon Energy and our customers

2.1 Regulatory Proposal process

The needs of our customers, now and in the long term, are central to what we do. We endeavour to meet these needs within the boundaries of our regulatory and legislative obligations. These obligations extend from regulated standards for network performance and safety, to how customers are connected and charged.

At a high level, Ergon Energy must ensure it:

- invests prudently and efficiently
- operates the network safely
- provides a safe workplace for its employees
- is environmentally responsible
- complies with all applicable regulatory and legislative obligations.

A summary of our regulatory and legislative obligations is provided in supporting document *01.01.01 – (Revised) Legislative and Regulatory Obligations and Policy Requirements*.

The preparation and submission of our revised Regulatory Proposal represents a key stage in the regulatory process, as it assists the AER in making a series of decisions that ultimately lead to it determining the revenue Ergon Energy is allowed to earn and the prices we may ultimately charge customers. The AER also determines some of the terms and conditions associated with the services we provide.

2.1.1 Our ongoing conversation with customers

We recognise that electricity – access to, timeliness of connections, reliability of supply, and/or price – is integral to the competitiveness of Queensland's small, medium and large businesses and the quality of life for all Queenslanders.

The ability to meet the expectations of our customers is central to our success as a business and to achieving our vison of becoming a 'high-performance, customer-driven energy business', Ergon Energy has been a long standing advocate of effective community engagement.

We actively engage at the grass roots level to identify infrastructure solutions that address community expectations but also meet our legislative, regulatory and corporate objectives. We also conduct periodic surveys to ensure we have a balanced and longitudinal perspective of our customers' expectations and consumption behaviour. This information provides a basis for our network plans (including our demand management plan) and the services we provide.

Ergon Energy took the initiative to establish the Customer Council in 2011; constituting a group of representatives from Ergon Energy and nine peak organisations across regional Queensland involved in the community service, environmental and business sectors. The Customer Council allows these organisations to inform and influence Ergon Energy's business decisions and, in turn, facilitate wider community consultation and information provision to their constituent groups.

Over the course of 2013, 2014 and 2015 we supplemented these engagement activities with activities directly targeted at developing the context of the Regulatory Proposal. We explored ours customers' views on key issues and to build the capacity of the community to understand the key issues addressed in the Regulatory Proposal.

The customer research we have conducted in 2015 provided strong support for the direction taken in our Regulatory Proposal and validated the approach Ergon Energy took towards balancing peace of mind, choice and control for the best possible price. Ergon Energy asked Synergies Economic Consulting to review the efficiency implications of these findings. In summary, those results indicated that customers place a high value on supply reliability, and are willing to forgo further decreases in charges (beyond those we have already proposed) in order to forestall reduced reliability, quality or safety of the network, deterioration in general service levels and increases in supply outages.[2]

We understand the level of concern in the community about rising electricity prices. Residential consumers have told us they want prices to stabilise and business customers want to see immediate price relief.

We also understand that our customers still want the peace of mind that comes from having a safe, dependable electricity service. However, as a result of the investment efforts of the past 10 years to improve the reliability of the network, most consumers are happy with the quality of supply and are no longer willing to pay more for further service improvements. However, for some areas within the network, reliability remains a key priority.

At the same time our customers are increasingly seeking greater choice and control around their energy supply solutions.

Based on the insights gained (refer to the supporting document *Informing Our Plans, Our Engagement Program* for further details) we have refreshed our service commitments to regional Queensland. These commitments have guided our future investment plans.

Figure 1: Our service commitments

[2] Synergies (2015), *Further Analysis of Ergon's Efficiency*.

CHOICE AND CONTROL

5. **We're looking to the future – and evolving the network to best support customer choice in economic electricity supply solutions.**
6. **We'll make it easier for you to contact us, whether by phone, Facebook, or Twitter, and provide you with the information you need, when and how you need it.**
7. **We'll play our part in powering the economy by making it easier to connect to the network.**

FOR THE BEST POSSIBLE PRICE

8. **After reducing charges for the use of our network in 2015-16, we're targeting to keep charges overall at 2014-15 levels for the remaining four years out to 2020.**

One of the key challenges facing Ergon Energy is how to balance our regulatory and legislative obligations with customer expectations.

While price is a key issue, it is essential that any measures taken to reduce costs (either capital or operational) are in the long term interests of consumers. History has shown us the adverse impacts associated with failing to get this balance right. Typically, network failures in the short term leading to rising electricity prices in the medium term are due to the need to invest in the network. Our customers have expressly stated they do not want either of these outcomes to occur, and reaffirmed this view again in 2015 as part of customer service work undertaken after the AER released its Preliminary Determination in April 2015.

2.1.2 Our network footprint

Our network footprint also plays a significant role in how we meet the needs of our customers and the costs incurred in doing so. The unique characteristics of our network and how it performs relative to our peers is summarised in the supporting document, *How Ergon Energy Compares*. Further information on benchmarking of Distribution Network Service Providers (DNSPs) undertaken by Ergon Energy and our advisers, as well as the AER's benchmarking results is contained in our submission on the AER's Issues Paper, our cross-submissions on the New South Wales and Australian Capital Territory network service providers reset processes and additional reports from Huegin and PwC that are contained in our revised Regulatory Proposal and associated response documents.

3. The affordability tipping point

3.1 Initial drivers

Up until mid-2000 Queenslanders enjoyed relatively stable and low retail electricity prices. This was largely a function of the regulatory and policy processes in place at the time.

From early 2000, Ergon Energy was investing heavily on new and replacement assets in the network. This was in response to an aging network, population growth and in an effort to meet our customers' changing expectations around reliability and quality of supply driven by the uptake of lifestyle appliances.[3] Additional network investment was required from 2004 to meet the higher reliability standards introduced in response to the Electricity Distribution Service Delivery (EDSD) Review.

To achieve the higher reliability standards each of the Queensland DNSPs had to undertake a number of measures. For Ergon Energy, this meant the obligation to achieve N-1 security on bulk supply substations and large zone substations (5MVA and above) and subtransmission feeders. Steps also needed to be taken to improve network planning processes, improve maintenance programs and to better communicate with customers on network outages. While it was acknowledged by the EDSD Review Panel at the time that these recommendations would result in significant capital and operating expenditure, the impact of these reforms on price was not fully understood.

Since 2007, electricity affordability has become a key issue of concern for our customers. A key contributor to rising electricity prices has been changes in the policy environment for setting retail prices (i.e. the introduction of full retail competition and Benchmark Retail Cost Index (BRCI)). As a result, the full cost of the capital investment programs undertaken by the DNSPs to address the EDSD Review's recommendations, was passed through to customers. This had a significant impact on retail prices with various reports indicating:

- network costs generally represent approximately 47% of a typical residential retail bill[4]
- between 2007-08 and 2012-13 network costs (distribution and transmission) grew by more than 100%.[5]

Recent policy changes such as the one-off effects of moving to the N + R framework (for setting regulated retail prices[6]) and renewable energy policies (e.g. Solar Bonus Scheme) have also contributed to higher electricity prices.

Although already recognised as an issue in Ergon Energy's strategic planning horizons for some years, by 2010 'affordability' had clearly become the issue of greatest concern to stakeholders, with 'reliability and security of electricity supply' and 'disaster management' ranked 4th and 6th, respectively[7]. This change in drivers was noted by the Electricity Network Capital Program Review (ENCAP) Panel:[8]

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3 Ergon Energy 2007 Annual Report 2006-07 p 19.

4 QCA 2014 Electricity pricing from 1 July 2014 – updated 24 July 2014: Factsheet.

5 Queensland Government 2013 Independent Committee on Electricity Sector Reform: Report to Government, May, p 25.

6 Notified prices for 2012-13 were the first set of retail tariffs that had been determined on the basis of the N+R methodology.

7 Ergon Energy. 2010. Annual Stakeholder Report 2009-10. p 2.

8 Electricity Network Capital Program Review 2011: Detailed Report of the Independent Panel. November. p 8.

The 2004 Review was driven by consumer issues around security and reliability of supply. What became increasingly clear to the Panel … was that affordability has become a more important issue to consumers. As part of its consultation, the Panel met with Queensland consumer groups … which confirmed the prominence of affordability as an issue for consumers and enhanced the Panel's understanding of the trade-offs consumers may seek between increased security, reliability and price outcomes.

3.2 Circumstances impacting affordability further

At the time of the AER's 2010-15 Distribution Determination, the key drivers for Ergon Energy were expected to be continued growth in peak demand driven by economic and population growth in regional Queensland, continued investment to meet increasing reliability obligations and reasonable customer expectations for the safety, quality and reliability of their power supply. Further, our customers had just started to develop an interest in energy supply alternatives, both to procure and use electricity.

These key drivers framed expectations for demand over the regulatory control period 2010-15 and forecast expenditure (capital and operating and maintenance). The AER's consultant forecast maximum demand and energy consumption to grow on average by 3.4% and 3.0% p.a. respectively. The AER determined that over $6.9 billion ($2009-10) in total expenditure needed to be invested in or spent maintaining the distribution network over the regulatory control period.

Within 12-18 months of the regulatory control period 2010-15 many of these drivers and assumptions had materially changed due to one or more of the following factors acting independently or collectively:

- The price impact of the reliability standards introduced by the Queensland Government following the EDSD Review had a greater impact on network prices than initially anticipated at the time the standards were introduced. Since the EDSD Review, reports indicate that annual capital expenditure on the Queensland network has essentially doubled.[9]
- Weaker global economic conditions. While both Queensland and the rest of Australia have experienced slower economic growth in recent years, the moderation in growth has been more pronounced in Queensland. The effect of severe weather events in 2010-11, which flooded mining operations, also had a specific effect in Queensland (and was not replicated in the rest of Australia).[10] The subsequent high $AUD also dampened trade-exposed economic activity, particularly in the manufacturing sector.
- Queensland households are becoming increasingly price sensitive as a result of substantial ongoing electricity price rises. As consumers have become more concerned about the cost of electricity they have adopted measures to reduce usage. While these measures have resulted in an overall fall in consumption they have not necessarily resulted in reduced retail bills. As a result consumers are increasingly questioning what more they can do to reduce their bills.

[9] Queensland Government. 2011. *Electricity Network Capital Program Review 2011: Detailed report of the independent panel*. p 65. (http://www.business.qld.gov.au/__data/assets/pdf_file/0018/9117/ENCAP_Review_Final_Report_3_new.pdf)

[10] Queensland Commissioner of Audit. 2013. *Final Report – Volume 2.* February. p 5.

- Consumption patterns have changed markedly since 2010 as a result of higher prices for electricity, the adoption of strategies to enhance energy efficiency and broad take-up of demand management initiatives.
- Climate change policies and subsidies for rooftop solar photovoltaic (PV) installations have led to a rapid increase in the number of households and businesses with solar PV. The uptake for solar PV has exceeded initial expectations with more than 19% of Queensland households now with solar energy systems. Despite many of the government incentives to encourage the installation of solar PV being removed, Queenslanders continue to install solar at strong rates.
- The installation of solar PV has a twofold effect on the network:
  (1) it introduces an additional source of power for which, in the main, the networks were not designed
  (2) the pattern of solar generation is such that the peak demand has not significantly dropped, whereas overall consumption has. The net effect is that the DNSPs must still build networks to cater for the peak, yet there are less units of electricity being distributed.

Early in the regulatory control period 2010-15 it became apparent to us that a number of these developments represented, or had led to, permanent changes in our operating environment.

We therefore sought to understand our customers' expectations more fully. This has been built on through the engagement undertaken to inform the preparation of the Regulatory Proposal.

4. Addressing electricity affordability in current regulatory control period

Our understanding of the increasing gap between our customers' expectations of the reliability of electricity service they receive and the price they must pay for it, led to a number of areas being identified where we could improve our operational performance including:

- our demand forecasting methodologies
- areas of unacceptable service reliability in relation to our worst performing feeders on the long rural part of the network.

We also became aware of the need to reduce costs to match the contraction in energy sales volume and demand, suppressed customer network connections and to improve efficiency across the range of Ergon Energy's operations while meeting regulatory, safety and customer service requirements.

Ergon Energy realised that an immediate and proactive response was required to address the electricity affordability issue rather than wait until the end of the regulatory control period 2010-15.

In recognition of the cost pressures created by the higher reliability standards introduced following the EDSD Review, we investigated alternative methods for achieving security of supply on the distribution network that may be more cost effective and efficient in the long-term. Based on this work and our belief that greater flexibility was required to adapt to change and deliver value and choice to our customers, we commenced discussions with the Queensland Government and made submissions to the 2011 ENCAP Review for a change in the policy settings[11]. This review ultimately recommended a relaxation of the security criteria (N-1) and changes to Minimum Service Standards.

In recognition of the change in the level of growth in electricity demand resulting from not only the impacts of the global economy but also Queensland Government and network business initiatives with respect to demand management and renewable energy, the Queensland Government believed it was important the capital programs of the DNSPs reflected these changes to ensure efficient operation. For these reasons it felt it was timely to revisit the findings of the 2004 EDSD Review to ensure the recommendations in terms of security and reliability standards still provided for a secure and reliable network at an efficient cost.

The Terms of Reference ENCAP Review required:[12]

- a review of reports provided by the DNSPs on the delivery (in particular with respect to the capital programs) of the electricity networks
- the provision of advice to government on the appropriateness of any changes proposed by the DNSPs to provide for a more efficient and secure, reliable network.

The ENCAP Review recommended, in general, less strict criteria associated with the security of supply for zone substations and distribution feeder maximum load levels. During the review a range of measures were also identified by Ergon Energy to deliver capital savings over the regulatory control period 2010-15.

Building on its "get fit" efficiency drive from 2007, in the latter half of 2011, Ergon Energy adopted a strategic goal to limit increases to average network charges to less than the CPI over the medium to longer term.

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[11] Ergon Energy Corporation Limited Submission to the Electricity Network Capital Program Review – Somerville Review Panel, 31 October, 2011.

[12] Queensland Government. 2011. *Electricity Network Capital Program Review 2011: Detailed report of the independent panel*. p 6. (http://www.business.qld.gov.au/__data/assets/pdf_file/0018/9117/ENCAP_Review_Final_Report_3_new.pdf)

This saw the commencement of a number of efficiency and effectiveness initiatives in 2011 covering both direct and indirect expenditure to identify the areas offering the greatest cost reduction opportunities. The initiatives covered all elements of the business, for example HR, ICT, Procurement, and Property and Fleet, and sought to identify cost savings that were now available as a result of the changed operating, policy and regulatory environment.

4.1 Our initiatives to reduce costs reinforced by independent analysis and interrogation

The efficiency and effectiveness initiatives mentioned above were complemented by independent analysis and interrogation of our underlying expenditure. Our approach to reducing costs and improving efficiency was also informed by the various energy industry sector efficiency and productivity reviews (both at State and Federal level) that occurred over the course of the 2012-13 year and the results of various global benchmarking surveys regarding the efficiency of energy utilities.[13]

In 2012 the Queensland Government introduced some initial measures aimed at addressing retail electricity price pressures (e.g. froze residential retail electricity prices). However, it was acknowledged at the time that longer term reforms were required to resolve the underlying challenges facing the electricity sector.[14] To inform this sectorial reform, the Queensland Government's IDC commissioned a panel of industry experts, the Independent Review Panel on Network Costs (IRP), to develop options to address the impact of network costs on electricity prices in Queensland.

The objectives of the IDC were to ensure:[15]

- electricity in Queensland was delivered in a cost effective manner for consumers
- Queensland has a viable, sustainable and competitive electricity industry
- electricity was delivered in a financially sustainable manner from the Queensland Government's perspective.

It is important to note that in meeting the above objectives, the IDC/IRP was not required to have regard to the National Electricity Rules (NER) when considering the appropriateness of the costs associated with the supply of electricity. Rather the focus was on identifying ways to reduce the cost of supply while ensuring the long term sustainability of the energy sector. The IDC/IRP's remit also covered the breadth of Ergon Energy's consolidated operations (including the retail business), not just the costs of the network business.

The IDC/IRP was able to complete a 'first principles assessment' of the existing governance frameworks and asset management strategies and systems. These matters were taken 'as granted' at the time of setting the 2010-15 capital and operating expenditure forecasts, as under the NER (at the time) the AER was to have regard to the costs of a prudent operator *in the circumstances of the DNSP under consideration*.

The IDC/IRP identified a number of areas for improvement, some of which built on initiatives that had already been initiated by the Queensland DNSPs. These included:[16]

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[13] Refer to 13th PWC Annual Global Power & Utilities Survey, Energy Transformation: The impact on the power sector business model; IRP Chapter 8, Bain and Company (2013) "Sustained Cost Reductions in Utilities".

[14] Interdepartmental Committee on Electricity Sector Reform: Report to Government. May 2013. p 5.

[15] Interdepartmental Committee on Electricity Sector Reform: Report to Government. May 2013. p 5.

[16] Interdepartmental Committee on Electricity Sector Reform: Report to Government. May 2013. p 50.

- continuing to implement efficiency programs already underway in each network business
- focusing on core information and communication technology service requirements and improved service delivery
- refocusing on core business activities and reducing external contractors and consultants.

Consistent with, and in response to Ergon Energy's submissions, the IRP also recommended a shift away from overly prescriptive redundancy-based standards (e.g. N-1) to outcome based reliability standards,[17] as the key way to sustainably reduce capital expenditure and increase the use of existing assets while still meeting customers' expectation for reliability and cost of supply.

4.2 Other steps we took in 2010-15 to reduce costs

In response to concerns raised by the AER during the 2010 regulatory re-set, we took significant steps toward improving the robustness and accuracy of our demand forecasting methodologies. Our new load forecasting process is based on expert advice from external consultants on how to improve our forecasting methodology. The new forecasting process is econometrically based and explicitly accounts for demand management programs, impact of solar generation and air conditioning growth. It also more accurately captures changing economic conditions than the existing trend based process.

4.3 Outcomes in the regulatory control period 2015-20 for customers

As reported in our Statement of Corporate Intent for 2012-13, in excess of $100 million in benefits have been achieved from various efficiency initiatives, supported by an organisational restructure and reduction in the size of our workforce (employees and contractors) of over 600 positions. Over the course of the 2013-14 and 2014-15 years, we ensured these gains were maintained for the remainder of the period, and continued to focus on reducing our cost to serve our customers.

In terms of capital expenditure, Ergon Energy identified net savings of around $709 million in capital expenditure reductions compared to the original AER allowance for 2010-15 as a result of the ENCAP Review.[18] The majority of these savings (96.6%) could not be captured when we finalised the 2010-15 Distribution Determination as they were attributable to ENCAP's proposed changes to the security standards (subsequently accepted by the Queensland Government), improvements in our investment decision making processes,[19] lower than expected growth in new customer connections and electricity demand meaning some works have been delayed, deferred or are no longer required. Ergon Energy identified the following material ENCAP Review savings:[20]

- around $250 million attributed to the proposed changes to security standards
- $360 million due to a reduction in Customer Initiated Capital Works
- around $300 million in Corporation Initiated Works.

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17 Interdepartmental Committee on Electricity Sector Reform: Report to Government. May 2013. p 53

18 Ergon Energy identified capital savings totalling $910 million over the current regulatory control period although the total saving is offset by $220 million in additional costs, resulting in a net saving of around $709 million. Queensland Government. 2011. Electricity Network Capital Program Review 2011: Detailed report of the independent panel. p 73. (http://www.business.qld.gov.au/__data/assets/pdf_file/0018/9117/ENCAP_Review_Final_Report_3_new.pdf)

19 For example the establishment of the Network Investment Review Committee.

20 Queensland Government. 2011. Electricity Network Capital Program Review 2011: Detailed report of the independent panel. p 73. (http://www.business.qld.gov.au/__data/assets/pdf_file/0018/9117/ENCAP_Review_Final_Report_3_new.pdf)

In response to the ENCAP Review, Ergon Energy received a direction notice in February 2012 from the Queensland Government not to seek revenue associated with the expected reduction in capital expenditure arising from the implementation of the recommendations of the ENCAP Review, by excluding it from the annual network pricing proposal. Over the period up to the end of 2014-15, this revenue would have been approximately $99 million.

Coupled with the capital expenditure savings identified by Ergon Energy and ENCAP, Ergon Energy is on track to achieve a reduction of 22% in total expenditure (totex) in real$2014-15, against the approved regulatory allowances. Our analysis suggests that this reduction, combined with more favourable market conditions for debt financing in the 2015-20 period, will deliver substantial benefits for customers from 1 July 2015. Customers were facing a double-digit increase in the network component of their bill for 2015-16 if the expenditure reductions had not been made and financing costs had remained the same.[21]

Over the regulatory control period 2010-15, in addition to the ENCAP direction notice from the Queensland Government, Ergon Energy absorbed the financial impact of the following events:[22]

- $40.9 million in revenue associated with the Australian Competition Tribunal's decision on gamma (under direction of the Queensland Government)
- the full financial cost impact of Cyclone Yasi and Cyclone Oswald, with our costs for these two events totalling approximately $120 million.

Collectively these measures mean our starting point for prices in 2015-20 are lower than they would have otherwise been.

21 Note this is a reduction to the network component of the customer's bill and does not take into account other costs (transmission, retail, generation) or QCA determined notified prices.

22 Ergon Energy Annual Stakeholder Report 2010-2011. p 75.

5. Addressing affordability in regulatory control period 2015-20

5.1 Operating expenditure

Ergon Energy has a continued focus to reduce costs to match contraction in energy sales volume and demand, suppressed customer network connections and to improve efficiency across the range of our operations while meeting regulatory, safety and customer service requirements.

The initial wave of cost reduction initiatives implemented from September 2011 through to 30 June 2013 included a focus on the overhead areas of the business and making incremental efficiency improvements to the company's business model and operating practices. We continue to leverage these initiatives in 2013-14 and 2014-15.[23]

Ergon Energy's focus on cost reduction initiatives has strengthened our ability to deliver on our strategic commitments to our customers to deliver Standard Control Services for the best possible price. This focus on operational efficiency was also consistent with the aims of our Shareholder, who has been seeking to lower capital and operating expense levels, and the reductions achieved were aligned to the outcomes of the recent industry reviews in Queensland designed to support better electricity price outcomes for consumers.

During 2013-14 and into 2014-15 Ergon Energy has been focused on delivering network services on budget (i.e. in accordance with 2012-13 adjusted levels) while establishing frameworks that will drive future cost savings. The outcomes to date from this continual focus on efficiency and effectiveness have included:

- signing off a new business direction and model
- implementing a new executive and senior management structure
- reducing total expenditure spend by over 20% against the regulatory allowance
- contracting business headcount significantly
- success in securing new security and reliability standards that will ease investment.

We have reviewed our five-year investment plans to ensure we are building, maintaining and operating the network, and delivering on our service commitments for the best possible price. In doing so, we have been able to reduce our expenditure overall a further $300 million, a reduction of over $1 billion on 2010-15.

This approach is consistent with experience in local and overseas markets and positions Ergon Energy in line with trend levels for indirect costs outlined in the recommendations contained in the IRP report.[24] It is also in line with the range of predicted outcomes using a reasonable application of the AER's Expenditure Forecast Assessment Guideline.

Importantly, the approach taken in adjusting our base year for forecast regulated expenditure is designed to reinforce Ergon Energy's cost conscious culture, strategically position Ergon Energy to meet its share of the IRP savings levels for indirect costs at an Ergon Energy group level and maintain as much downwards pressure on prices as possible. Conscious of feedback received from its customers and shareholders, Ergon Energy continues to maintain a sense of urgency to reduce our costs as quickly as practicable to meet its customer commitments.

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[23] Refer to 12/13 and 13/14 Statement of Corporate Intent

[24] Further details of Ergon Energy's share of indirect cost reductions to date in maintaining and driving its culture of operational and financial efficiency across everything it does can be found in the IRP Report (Figure 42, page 78) and in the 2012/13 and 2013/14 SCI .

We have also been undertaking further analysis on the evolving operating environment, anticipated regulatory and policy changes, future economic conditions and trends in energy consumption, innovation and consumer expectations to identify where further efficiencies can be achieved. This work has also included the development of supporting processes and procedures to implement the Queensland Government's new network security and reliability standards. These standards are being progressively implemented across the network and will have a material impact on how we plan, invest in and maintain the network over the regulatory control period 2015-20 and beyond.

Our commitment to lower operating expenditure forecasts is equivalent to a 10% fall in overheads from what was reported in 2013-14. It should be noted that Ergon Energy's top down assessment to reduce overheads in future years by a further 10% from the 2013-14 starting point is consistent with our previous demonstrated ability to deliver overhead cost reductions that match the pace of our overall reductions in its broader capital and operational work programs. Other specific initiatives underway also will help support Ergon Energy's ability to achieve this targeted reduction.

The changes will provide Ergon Energy with a further opportunity to review the way we will meet consumers' expectations around reliability, performance and the range of services provided. Additional reductions are expected to be leveraged through the implementation of new management structures, driving a culture of operational and financial efficiency.

As a number of these regulatory, structural and technological changes are still in development or transition we have not fully costed the possible collective impact of these over the regulatory control period 2015-20. However, we are confident of lower cost outcomes and have targeted a lower allowance as a result, equivalent to a reduction of approximately 10% of overhead cost functional areas[25] over the regulatory control period 2015-20. This is consistent with our previous demonstrated ability to deliver overhead cost reductions that match the pace of our overall reductions in the broader capital and operational work programs. At the end of June 2014, Ergon Energy had 4,246 full time equivalent (FTE) staff (excluding casual staff) compared to 4,435 FTEs as at the end of June 2013, representing a reduction of 189 FTEs.

5.3.3 Particular Initiatives

There is also scope to achieve further efficiency gains, that benefit Ergon Energy and our customers, via productivity and other benefits expected from:

- further organisational redesign
- potential improvements in back office technology redesign, various data and information management roadmap initiatives
- incremental benefits flowing from various call centre and other information technology initiatives to replace existing systems
- increased synergies generated by Ergon Energy and Energex joint workings activities
- various improvements in the effectiveness of its outsourcing arrangements (including the New Service Delivery model established by its joint venture ICT company, SPARQ Solutions).

A number of these initiatives are outlined below.

Distribution Management System

The Distribution Management System (DMS) is core operational technology that builds upon current supervisory control and data acquisition (SCADA) technologies. Ergon Energy continues to

[25] Excludes Fleet, ICT and IT Asset charges

implement our DMS project to automate many of the manual processes in operating a distribution network and supporting new smart technologies in the network.

Field Force Automation

Ergon Energy currently manages and allocates work to field staff primarily through labour intensive paper based processes and multiple legacy systems, processes and tools. Customer service and fault response work is dispatched through a largely decentralised model from more than 24 locations with limited process standardisation utilising many technology and communication solutions.

The Field Force Automation project (FFA) aims to automate field operations by providing computers and smart devices to field staff. This will ensure field staff have the information required to do the work (including location, job type, specifications), and it will enable field staff to update the status of dispatched work as it progresses. FFA is expected to improve operational performance and service levels by standardising dispatch and automating field operations. FFA will also support compliance with the National Energy Customer Framework (which commenced in Queensland on 1 July 2015) and allow Ergon Energy to meet the requirements and demands of Full Retail Competition as competition expands in regional Queensland.

Phase 1 of FFA is now complete. This includes dispatch standardisation and rollout of the computer devices for Customer Service work and Fault Response (major and minor) work.

ROAMES

Ergon Energy currently has a project (ROAMES Sustainable Integration Design) underway and is working with the new owners of ROAMES (the automated modelling and economic simulation capability), to develop a future state and options analysis for the sustainable integration of ROAMES into business operations. This design project is expected to result in an implementation project which will integrate the ROAMES products and data into Ergon Energy processes and systems in order to improve decision-making and operational effectiveness.

Over 2014-15 a number of initial products have been progressed that will support Ergon Energy through greater visibility of accurate network data including vegetation intrusions into network corridors, conductor clearance and attachment heights, pole locations and disaster response.

These products, together with the further development of ROAMES over the coming years, are expected to enhance Ergon Energy's ability to:

- better target vegetation management activities and reduce network risk by improved management of vegetation intrusions into network corridors through vegetation growth forecasting and change reporting
- improve the quality of network data (such as pole locations) by updating corporate systems with accurate geospatial location information, clearly identifying correct pole locations, and the ability to more effectively address (remove) inaccurate, duplicate or 'bad' data
- enhance asset inspection processes through the provision of accurate asset locations, reducing the time wasted searching for assets
- improve the effectiveness of desktop audits, investigations and design work through access to comprehensive asset information such as conductor clearance and attachment heights and line length data provided both visually (as a Google Earth layer) and in a raw data format for analysis

- provide greater visibility of network defects such as low conductors, broken cross-arms and leaning poles that will assist with quicker reporting and response, resulting in lower network risk and improved public safety
- respond to disasters faster and more effectively by having comprehensive details of all damaged and missing network infrastructure shortly after a disaster has occurred.

5.1 Bringing forward future benefits to customers

Notwithstanding that Ergon Energy's existing actual operational support and overhead costs for 2013-14 and 2014-15 are likely to be at a higher level than the above top down reduction implies, Ergon Energy considers that it is appropriate make an adjustment to the 2013-14 base year now. The reasons for this are set out below:

- Ergon Energy is committed to improving the affordability of electricity for our customers, while not compromising safety and reliability. Based on our customer engagement activities we understand the majority of residential customers would prefer to see prices remain unchanged and for small businesses an immediate reduction in electricity prices. With this in mind, Ergon Energy is prepared to pass on the anticipated savings from the above regulatory, structural and technological changes to our consumers, in full and at the start of the regulatory control period (i.e. 2015-16).
- We acknowledge and recognise the timing differences associated with some key ICT driven efficiency investments for 2010-15 period, relative to forecasts made in the lead up to the 2010-15 Regulatory Proposal.
- We have separately checked the outcomes of this forecast against our own internal top down assessment of areas of differences between our performance and other Australian DNSPs based on benchmarking data from Huegin[26] and feedback contained in the IRP review. While exact comparisons against such reports should be treated with caution, those studies indicate that the proposed reduction to the base year is within the reasonable range.

[26] Refer to Huegin – Ergon Benchmarking 0A.02.01

- Recent benchmarking analysis by our experts confirm our approach is reasonable and that our estimates of operating expenditure are within a reasonable range.
- This approach does not unnecessarily delay the bringing forward of benefits for consumers in terms of making sustainable price reductions and strikes an appropriate balance between the incentives Ergon Energy will gain under the Efficiency Benefit Sharing Scheme. Feedback from consumers and other key stakeholders (including the Consumer Challenge Panel) also indicates there is support for energy companies to deliver the best possible price to consumers as soon as possible, and not unduly defer or delay the sharing of benefits.[27]

While these reductions are not certain, and even if realised, will only start to be delivered over the term of the regulatory control period 2015-20, Ergon Energy is prepared to absorb the associated delivery and implementation risks so that we are able to provide the best possible price to our customers from 1 July 2015. Therefore, Ergon Energy is bringing forward the benefits of our forecast improvements in efficiency for customers.

Attaining this level of operational efficiency represents a challenge for the organisation, but one which we believe can be achieved while meeting all of our regulatory and safety obligations. Further, while price is a key issue for consumers, we are cognisant of our consumers' expectations around network safety, reliability and being able to respond to whatever Mother Nature delivers.

Ergon Energy will also apply a 0.75% annual productivity improvement to its forecasts for 2015-20.

5.2 Capital expenditure

Based on the latest available assessment of the impacts of the changes in our security and network planning criteria contained in our new Distribution Authority (effective from 1 July 2014) and our forward planning for non-network expenditure, we expect that our overall capital expenditure for the regulatory control period 2010-15 will be less than the AER approved total capital expenditure allowance.

Given the above efficiency measures (i.e. ENCAP, IRP), improved planning processes, a slowdown in peak demand growth and the changes to our reliability standards, Ergon Energy is seeking a materially lower capital expenditure allowance for the regulatory control period 2015-20.

Enhanced risk management requirements for planning, portfolio analysis and reduced costs through a stronger focus at both the design and delivery stages have also positively contributed to our reduced forecast volume of works for 2015-20, and the reductions achieved to date in the regulatory control period 2010-15.

Our expenditure in 2014-15 ensures we deliver on our customer commitments for the regulatory control period 2010-15 and to deliver the best possible price outcome for the start of the regulatory control period 2015-20.

[27] Refer CCP Feedback 19 March 2014, CCP Presentations to AER forums, Feedback from Ergon customer surveys and Customer Council meetings.

5.3 Network price outcomes

The cumulative impact of the above measures on Ergon Energy's forecast network revenue for the regulatory control period 2015-20 is provided in the document, *An Overview Our Regulatory Proposal*. Lower forecast network revenue is consistent with our commitment to customers to deliver the 'best possible price' and to keep overall increases in network charges at 2014-15 levels for the remaining four years of the period (i.e. 2016-17 to 2019-20).

In 2015, Ergon Energy notes that a report called "Networking Pricing Trends – A Queensland Perspective" (the "Pricing Trends Report") was released. This report concluded that privately-owned businesses generally operated more efficiently, resulting in lower price increases compared to their government-owned counterparts. In considering the findings of this report, Ergon Energy identified various flaws in the reasoning and analysis provided and a review of the report by PwC was arranged to assess the validity of the concerns we had identified. The PwC report identified that while the factors outlined in the Pricing Trends Report may impact prices, they do not provide a holistic view of the reasons for the differential in network prices between Victoria and Queensland over the last two decades. A copy of the PwC report is attached.[28]

Additional information

For further information go to:

www.ergon.com.au/futureinvestment

[28] *0A.02.21 – PwC – Network Pricing Trends*

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