# FINAL DECISION

## Ergon Energy
## Distribution Determination
## 2020 to 2025

## Attachment 1
## Annual revenue requirement

June 2020

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# Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Ergon Energy for the 2020–25 regulatory control period. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 17 – Connection policy

Attachment 18 – Tariff structure statement

Attachment A – Negotiating framework

# Contents

# 1 Annual revenue requirement

This attachment sets out our final decision on Ergon Energy's annual revenue requirement (ARR) for the provision of standard control services (SCS) over the 2020–25 regulatory control period. Specifically, it sets out our final decision on:

- the ARRs (unsmoothed), which are the sum of annual building block costs
- the total revenue requirement, which is the sum of the ARRs
- the annual expected revenues (smoothed)
- the X factors.

We determine Ergon Energy's ARR using a building block approach. We determine the X factors by smoothing the ARR over the regulatory control period. The X factor is used in the CPI–X methodology to determine the annual expected revenue (smoothed).

## 1.1 Final decision

We determine a total ARR of $5927.6 million ($ nominal, unsmoothed) for Ergon Energy for the 2020–25 regulatory control period, reflecting our final decision on the various building block costs. This is a reduction of $62.1 million ($ nominal) or 1.0 per cent to Ergon Energy's revised proposed total ARR of $5989.7 million.

We determine the annual expected revenue (smoothed) and X factor for each regulatory year of the 2020–25 regulatory control period by smoothing the ARR. Our final decision is to approve total expected revenues of $5925.9 million ($ nominal) for Ergon Energy for the 2020–25 regulatory control period.

Table 1.1 shows our final decision on the ARR, annual expected revenue, and X factor for each year of the 2020–25 regulatory control period.

### Table 1.1 AER's final decision on Ergon Energy's ARR, annual expected revenue, and X factors ($ million, nominal)

| | 2020–21 | 2021–22 | 2022–23 | 2023–24 | 2024–25 | Total |
|---|---|---|---|---|---|---|
| Return on capital | 545.4 | 543.7 | 541.1 | 537.7 | 532.6 | 2700.5 |
| Regulatory depreciation[a] | 188.3 | 207.1 | 222.2 | 233.0 | 252.4 | 1103.1 |
| Operating expenditure[b] | 385.4 | 388.7 | 392.6 | 396.1 | 399.7 | 1962.5 |
| Revenue adjustments[c] | 48.0 | 32.0 | 52.8 | 15.9 | 12.0 | 160.6 |
| Net tax allowance | 0.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.8 |
| Annual revenue requirement (unsmoothed) | 1167.9 | 1171.5 | 1208.8 | 1182.7 | 1196.7 | 5927.6 |
| **Annual expected revenue (smoothed)** | **1178.6** | **1181.9** | **1185.2** | **1188.5** | **1191.8** | **5925.9** |

| | 2020–21 | 2021–22 | 2022–23 | 2023–24 | 2024–25 | Total |
|---|---|---|---|---|---|---|
| X factor[d] | n/a[e] | 1.95% | 1.95% | 1.95% | 1.95% | n/a |

Source: AER analysis.

(a) Regulatory depreciation is straight-line depreciation net of the inflation indexation on the opening regulatory asset base (RAB).

(b) Includes debt raising costs.

(c) Includes revenue adjustments from the efficiency benefit sharing scheme (EBSS), the capital expenditure sharing scheme (CESS) and the demand management innovation allowance mechanism (DMIAM).

(d) The X factors will be revised to reflect the annual return on debt update. Under the CPI–X framework, the X factor measures the real rate of change in annual expected revenue from one year to the next. A negative X factor represents a real increase in revenue. Conversely, a positive X factor represents a real decrease in revenue.

(e) Ergon Energy is not required to apply an X factor for 2020–21 because we set the 2020–21 expected revenue in this decision. The expected revenue for 2020–21 is around 10.9 per cent lower than the approved total annual revenue for 2019–20 in real terms, or 8.9 per cent lower in nominal terms.

## 1.2 Ergon Energy's revised proposal

Ergon Energy’s revised proposal included total expected revenues (smoothed) of $5997.4 million ($ nominal) for the 2020–25 regulatory control period.

Table 1.2 sets out Ergon Energy's revised proposed ARR, the annual expected revenue, and the X factor for each year of the 2020–25 regulatory control period.

### Table 1.2 Ergon Energy's revised proposed ARR, annual expected revenue, and X factors ($ million, nominal)

| | 2020–21 | 2021–22 | 2022–23 | 2023–24 | 2024–25 | Total |
|---|---|---|---|---|---|---|
| Return on capital | 538.1 | 540.7 | 542.9 | 544.5 | 543.7 | 2709.9 |
| Regulatory depreciation[a] | 176.7 | 195.7 | 212.0 | 223.7 | 243.4 | 1051.5 |
| Operating expenditure[b] | 385.8 | 389.4 | 393.7 | 397.6 | 401.5 | 1968.0 |
| Revenue adjustments[c] | 68.0 | 62.4 | 76.2 | 28.4 | 25.2 | 260.2 |
| Net tax allowance | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Annual revenue requirement (unsmoothed) | 1168.5 | 1188.2 | 1224.8 | 1194.3 | 1213.9 | 5989.7 |
| **Annual expected revenue (smoothed)** | **1144.0** | **1171.1** | **1198.8** | **1227.2** | **1256.3** | **5997.4** |
| X factor | n/a[d] | 0.0% | 0.0% | 0.0% | 0.0% | n/a |

Source: Ergon Energy, *Revised regulatory proposal 2020–25*, 10 December 2019, p. 14; Ergon Energy*, ERG - 4.002 PTRM - SCS*, 10 December 2019.

(a) Regulatory depreciation is straight-line depreciation net of the inflation indexation on the opening RAB.

(b) Includes debt raising costs.

(c) Includes revenue adjustments from EBSS, CESS and DMIAM.

(d) Ergon Energy is not required to apply an X factor for 2020–21 because we set the 2020–21 expected revenue in this decision.

## 1.3 Assessment approach

We did not change our assessment approach for the ARR from our draft decision. Attachment 1 (section 1.3) of our draft decision details that approach.[1]

## 1.4 Reasons for final decision

For this final decision, we determine a total ARR of $5927.6 million ($ nominal, unsmoothed) for Ergon Energy for the 2020–25 regulatory control period. This is a reduction of $62.1 million ($ nominal) or 1.0 per cent to Ergon Energy's revised proposed total ARR of $5989.7 million ($ nominal) for this period (2015–20). This reflects the impact of our final decision on the various building block costs.

Figure 1.1 shows the building block components from our determination that make up the ARR for Ergon Energy, and the corresponding components from its revised proposal and our draft decision.

The changes we made to Ergon Energy's revised proposed building blocks include (in nominal terms):

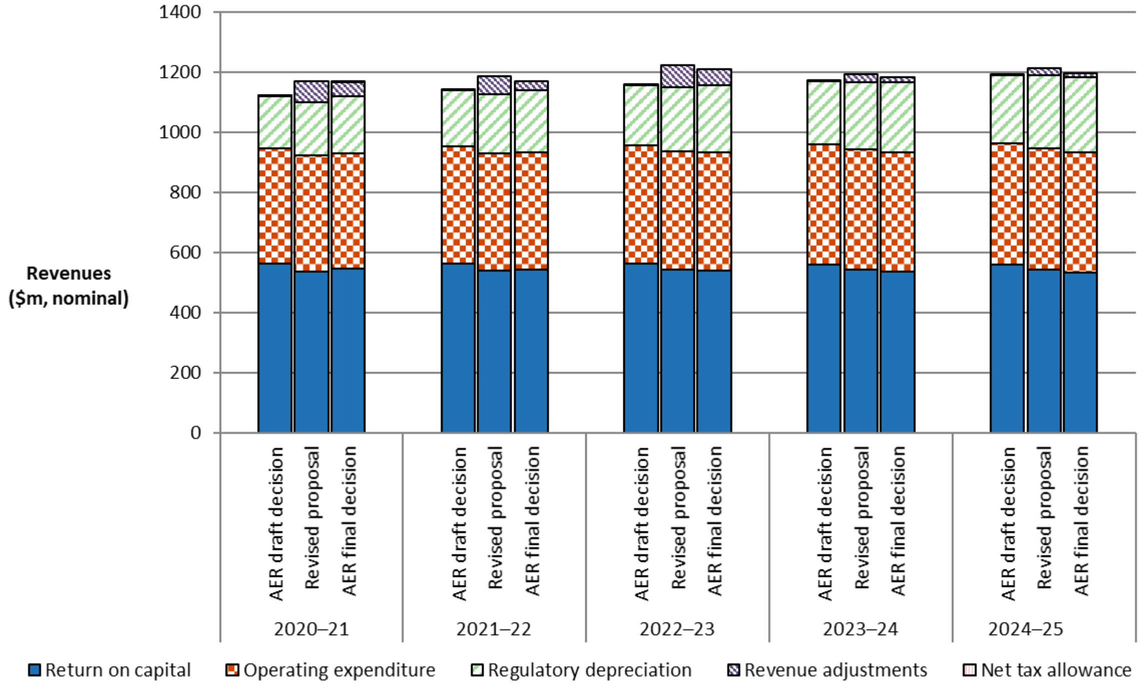
- a reduction in the return on capital allowance of $9.4 million or 0.3 per cent (attachments 2, 3 and 5)
- an increase in the regulatory depreciation allowance of $51.6 million or 4.9 per cent (attachment 4)
- a reduction in the operating expenditure (opex) allowance of $5.6 million or 0.3 per cent (attachment 6)[2]
- a reduction in the revenue adjustments of $99.6 million or 38.3 per cent (attachments 8, 9 and 11).[3]

1 AER, *Ergon Energy 2020–25 Determination – Draft Decision – Attachment 1 – Annual Revenue Requirement,* October 2019, pp. 7–9.

2 Although we have accepted the opex proposal, there were some updates for expected inflation which results in this small difference in nominal dollar terms.

3 This is mainly driven by a reduction in EBSS of $95.5 million.

## Figure 1.1 AER's draft and final decisions and Ergon Energy's revised proposed annual building block revenue requirement ($ million, nominal)




Source: Ergon Energy, *ERG - 4.002 PTRM - SCS*, 10 December 2019; AER analysis.

Note: Revenue adjustments include EBSS, CESS and DMIAM amounts. Opex includes debt raising costs. While our draft decision reflected Ergon Energy's proposal to not include EBSS and CESS rewards, our final decision reflects Ergon Energy's revised proposal to include EBSS and CESS rewards as revenue adjustments.

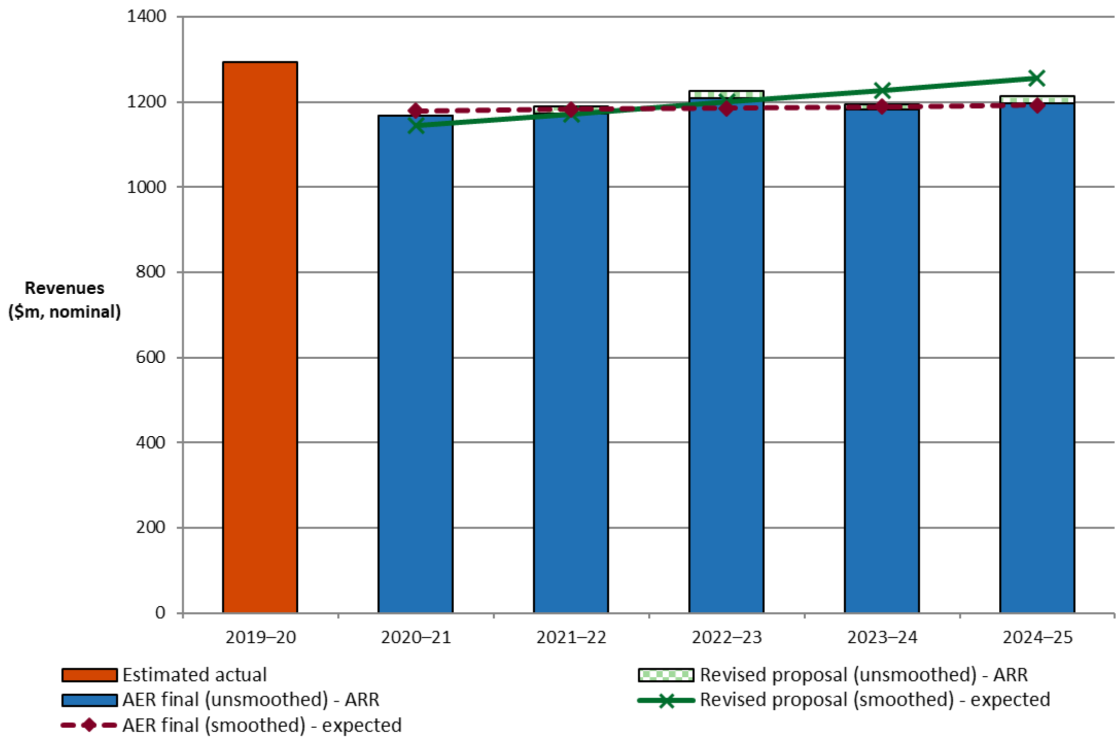
### 1.4.1 X factor and annual expected revenue

For this final decision, we determine an X factor for Ergon Energy of 1.95 per cent per annum for the four years of the regulatory control period from 2021–22 to 2024–25.[4] The net present value (NPV) of the ARR is $5192.8 million ($ nominal) as at 1 July 2020. Based on this NPV and applying the CPI–X framework we determine that the expected revenue (smoothed) for Ergon Energy is $1178.6 million in 2020–21 increasing to $1191.8 million in 2024–25 ($ nominal). The resulting total expected revenue for Ergon Energy is $5925.9 million for the 2020–25 regulatory control period.

Figure 1.2 shows our final decision on Ergon Energy's annual expected revenue (smoothed revenue) and the ARR (unsmoothed revenue) for the 2020–25 regulatory control period.

[4] Ergon Energy is not required to apply an X factor for 2020–21 because we set the 2020–21 expected revenue in this decision.

### Figure 1.2 AER's final decision on Ergon Energy's revenue for the 2020–25 regulatory control period ($ million, nominal)




Source: AER analysis; Ergon Energy, *ERG - 4.002 PTRM - SCS*, 10 December 2019.

We have taken into account the building block costs determined in this final decision when smoothing the expected revenues for Ergon Energy over the 2020–25 regulatory control period. In doing so, we have set the expected revenue for the first regulatory year at $1178.6 million ($ nominal) which is $10.7 million higher than the ARR for that year. We then apply an expected inflation rate of 2.27 per cent per annum and an X factor of 1.95 per cent per annum to determine the expected revenue in subsequent years.[5] We consider that our profile of X factors results in an expected revenue in the last year of the regulatory control period that is as close as reasonably possible to the ARR for that year.[6]

Our final decision results in an average decrease of 1.6 per cent per annum ($ nominal) in the expected revenue over the 2020–25 regulatory control period.[7] This consists of an initial decrease of 8.9 per cent from 2019–20 to 2020–21, followed by

5 NER, cl. 6.5.9(a).

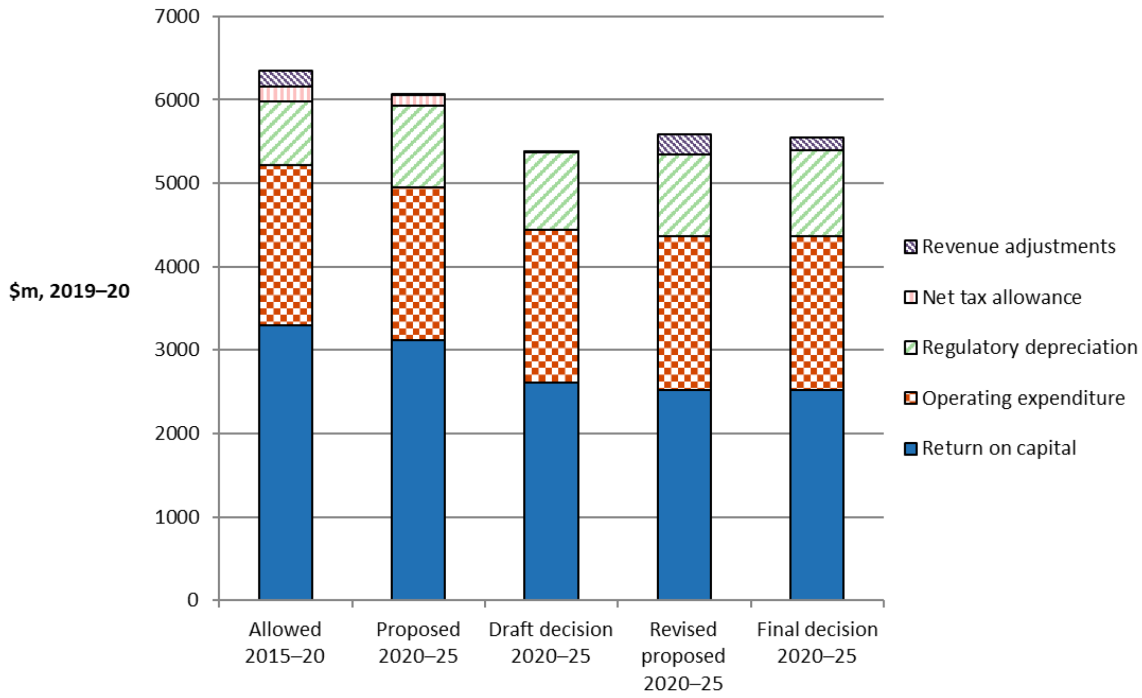
6 NER, cl. 6.5.9(b)(2). We consider a divergence of up to 3 per cent between the expected revenue and ARR for the last year of the regulatory control period is appropriate, if this can achieve smoother price changes for users over the regulatory control period. In the present circumstances, based on the X factors we have determined for Ergon Energy, this divergence is around 0.4 per cent.

7 In real 2019–20 dollar terms, our approved expected revenue for Ergon Energy results in an average decrease of 3.8 per cent per annum over the 2020–25 regulatory control period.

average annual increases of 0.3 per cent during the remainder of the 2020–25 regulatory control period.[8] Our final decision also results in a decrease of 12.7 per cent in real terms ($2019–20) to Ergon Energy's average ARR relative to that in the 2015–20 regulatory control period. This is primarily because we have determined a lower weighted average cost of capital (and therefore lower return on capital) and a lower corporate income tax allowance in this final decision for the 2020–25 regulatory control period than that approved in the 2015–20 determination.

Figure 1.3 compares our final decision building blocks for Ergon Energy's 2020–25 regulatory control period with Ergon Energy's revised proposed revenue requirement for the same period, and the approved revenue for the 2015–20 regulatory control period.

### Figure 1.3 Total revenue by building block components ($ million, 2019–20)




Source: AER Analysis; Ergon Energy, *ERG 4.002 PTRM - SCS*, 10 December 2019.

## 1.4.2 Shared assets

Our final decision is not to apply a shared asset revenue adjustment to Ergon Energy's total expected revenue for the 2020–25 regulatory control period.

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8 In real 2019–20 dollar terms, this consists an initial decrease of 10.9 per cent from 2019–20 to 2020–21, followed by average annual decrease of 2.0 per cent during the remainder of the 2020–25 regulatory control period.

In our draft decision, we did not apply a shared asset revenue adjustment to Ergon Energy's revenues because we estimated that the unregulated revenues were less than one per cent of its expected revenues in each year of the 2020–25 regulatory control period. Therefore, the materiality threshold was not met in any year of the 2020–25 regulatory control period.[9] Using the same assessment approach as the draft decision, we consider that this materiality threshold is also not met in any year of the 2020–25 regulatory control period for this final decision, and we do not apply a shared asset revenue adjustment.

Ergon Energy's revised proposal noted that following the announcement by the Queensland Government that Powerlink and Energy Queensland would jointly operate a new optic fibre network business, QCN Fibre (previously FibreCo), it does not currently expect an increase in the scope or volume of unregulated services using its shared assets as a result of the formation of QCN Fibre.[10] Customer contracts (for services currently provided by Powerlink and to a lesser extent by Ergon Energy and Energex) are initially being novated to QCN Fibre. Ergon Energy submitted that any increased activity on its network over and above existing arrangements being novated were expected to be insignificant in the short to medium term and subject to high levels of uncertainty over the longer term. We will monitor the use of shared assets by QCN Fibre in future regulatory control periods.

### 1.4.3 Indicative average distribution price impact

Our final decision on Ergon Energy's expected revenues ultimately affects the prices consumers pay for electricity. There are several steps required in translating our revenue decision into indicative distribution price impact.

We regulate Ergon Energy's SCS under a revenue cap form of control. This means our final decision on Ergon Energy's expected revenues does not directly translate to price impacts. This is because Ergon Energy's revenue is fixed under the revenue cap form of control, so changes in the consumption of electricity will affect the prices ultimately charged to consumers. We are not required to establish the distribution prices for Ergon Energy as part of this determination. However, we will assess Ergon Energy's annual pricing proposals before the commencement of each regulatory year within the 2020–25 regulatory control period. In each assessment we will administer the pricing requirements set in this distribution determination.

For this final decision, we have estimated some indicative average distribution price impacts flowing from our final determination on the expected revenues for Ergon Energy over the 2020–25 regulatory control period. In this section, our estimates only relate to SCS (that is, the core electricity distribution charges), not alternative control services (such as metering charges). These indicative price impacts assume that

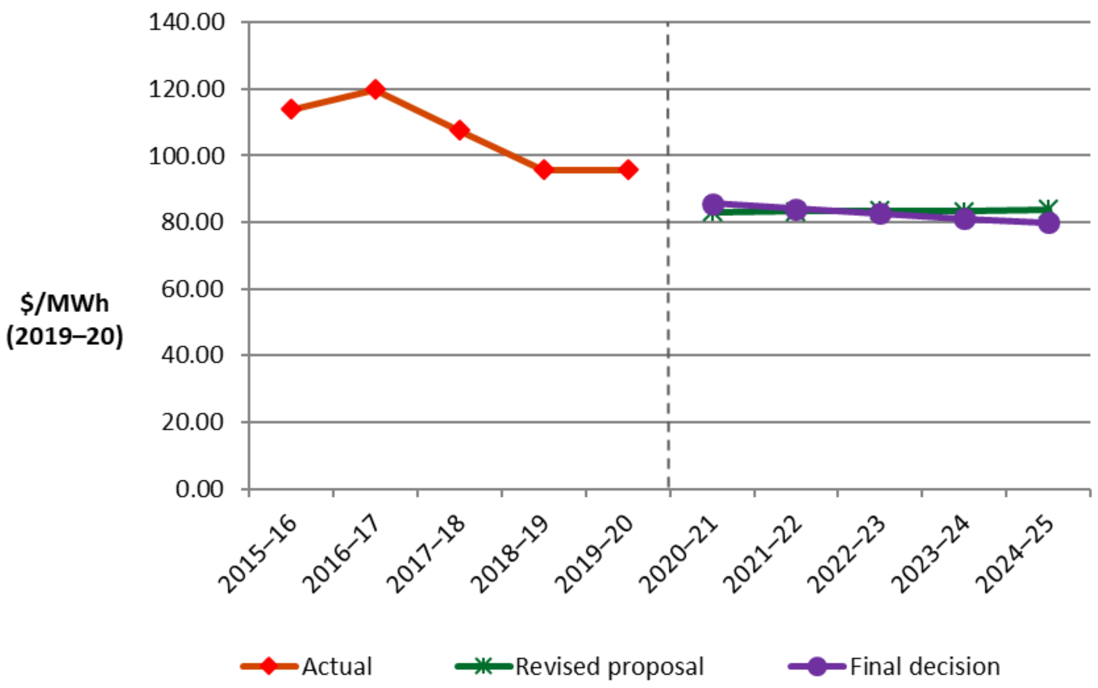
9 AER, *Ergon Energy 2020–25 Determination - Draft Decision - Attachment 1 - Annual revenue requirement*, October 2019, pp. 11–12.

10 Ergon Energy, *Revised regulatory proposal 2020–25*, 10 December 2019, p. 18.

actual energy consumption across the 2020–25 regulatory control period matches Ergon Energy's revised forecast energy consumption, which we have adopted for this final decision.

Figure 1.4 shows Ergon Energy's indicative average price path over the period 2015–16 to 2024–25 in real 2019–20 dollar terms based on the expected revenues established in our final decision compared to Ergon Energy's revised proposed revenue requirement.

### Figure 1.4 Indicative price path for Ergon Energy ($/MWh, 2019–20)




Source: AER analysis.

We estimate that our final decision on Ergon Energy's annual expected revenue will result in a decrease to average distribution charges by about 3.5 per cent per annum over the 2020–25 regulatory control period in real 2019–20 dollar terms.[11] This compares to the real average decrease of approximately 2.6 per cent per annum in Ergon Energy’s revised proposal for the 2020–25 regulatory control period.[12] These high-level estimates reflect the aggregate change across the entire network and do not reflect the particular tariff components for specific end users.

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11 In nominal terms we estimate average distribution charges to decrease by 1.3 per cent per annum. This amount reflects an expected inflation rate of 2.27 per cent per annum as determined in this final decision.

12 In nominal terms Ergon Energy's revised proposal would decrease distribution charges by 0.3 per cent per annum. This amount reflects an expected inflation rate of 2.37 per cent per annum as proposed by Ergon Energy in its revised proposal.

Table 1.3 compares the revenue and price impacts of Ergon Energy's revised proposal and our final decision.

### Table 1.3 Comparison of revenue and price impacts of Ergon Energy's revised proposal and the AER's final decision ($ nominal)

| | 2019–20 | 2020–21 | 2021–22 | 2022–23 | 2023–24 | 2024–25 |
|---|---|---|---|---|---|---|
| **AER final decision** | | | | | | |
| Revenue ($ million) | 1293.4 | 1178.6 | 1181.9 | 1185.2 | 1188.5 | 1191.8 |
| Price path ($/MWh)[a] | 95.66 | 87.60 | 87.98 | 88.52 | 88.65 | 89.41 |
| Revenue (change) | | –8.9% | 0.3% | 0.3% | 0.3% | 0.3% |
| Price path (change) | | –8.4% | 0.4% | 0.6% | 0.2% | 0.9% |
| **Ergon Energy revised proposal** | | | | | | |
| Revenue ($ million) | 1293.4 | 1144.0 | 1171.1 | 1198.8 | 1227.2 | 1256.3 |
| Price path ($/MWh)[a] | 95.66 | 85.03 | 87.17 | 89.54 | 91.54 | 94.25 |
| Revenue (change) | | –11.6% | 2.4% | 2.4% | 2.4% | 2.4% |
| Price path (change) | | –11.1% | 2.5% | 2.7% | 2.2% | 3.0% |

Source: AER analysis; Ergon Energy, *ERG - 4.002 PTRM - SCS*, 10 December 2019.

(a) The price path is in nominal terms and is constructed by dividing nominal expected revenue for SCS by forecast energy consumption for each year of the regulatory control period.

## 1.4.4 Expected impact of decision on electricity bills

Our bill impact calculations for Ergon Energy adopt the network charges in our final decision for Energex. This is because retail electricity prices in Ergon Energy's distribution area are determined under the Queensland Government's uniform tariff policy. The policy results in regulated retail electricity prices in Ergon Energy's distribution area being matched to those in Energex's area.[13]

Our bill impact calculation does not take into account the Queensland Government's electricity asset ownership dividend which offsets the residential bill amount by $50 for each year in the 2020–23 period.[14] It also does not take into account the household relief package for COVID-19 impacts announced by the Queensland Government, which reduces the residential bill amount by a further $50.[15] It also does not take into account the impact of Solar Bonus Scheme costs currently being funded by the

13 Queensland Competition Authority, *Final Determination–Regulated retail electricity prices for* 2019–20, May 2019, p.iii.

14 Queensland Government, *QLD power assets continue to pay dividends*, 15 March 2020.

15 Queensland Government, *Palaszczuk Government unveils $4 billion package to support health, jobs, households and Queensland businesses*, 24 March 2020; Queensland Government, *Electricity Relief for Households and Businesses Q&A*, 24 March 2020.

Queensland Government.[16] This subsidy is due to end on 1 July 2020. The end of the subsidy will have an upward impact on the network component of electricity bills. This is because the Solar Bonus Scheme costs will be recovered from consumers as jurisdictional scheme amounts through network charges. Energy Queensland has advised that the Solar Bonus Scheme costs to be recovered in 2020–21 is estimated to be around $148 million for Energex and $90 million for Ergon Energy.

The annual electricity bill for consumers in Ergon Energy's network reflects the combined costs of all the electricity supply chain components—wholesale energy generation, transmission, distribution, metering, and retail costs. This final decision primarily relates to the distribution charges for SCS, which represent approximately 35.5 per cent on average for residential consumers' and 28.4 per cent for small business consumers' annual electricity bills in Ergon Energy's network area.[17]

We estimate the expected bill impact by varying the distribution charges in accordance with our final decision, while holding all other components—including the metering component—constant. This approach isolates the effect of our final decision on the core distribution charges only. However, this does not imply that other components will remain unchanged across the regulatory control period.[18]

Based on this approach, we expect that our final decision on the distribution component will decrease the average annual residential electricity bill in 2024–25 by about $63 ($ nominal) or 4.0 per cent from the 2019–20 total bill level. By comparison, had we accepted the revised proposal, the expected change in the distribution component would decrease the average annual residential electricity bill in 2024–25 by about $55 ($ nominal) or 3.5 per cent from the 2019–20 total bill level.

Similarly, for an average small business consumer, we expect that our final decision on the distribution component will decrease the average annual electricity bill in 2024–25 by about $71 ($ nominal) or 3.2 per cent from the 2019–20 total bill level. By comparison, had we accepted the revised proposal, the expected change in the distribution component would decrease the average annual small business electricity bill in 2024–25 by about $63 ($ nominal) or 2.8 per cent from the 2019–20 total bill level.

Our estimated impact is based on an average annual electricity usage of around 4600 kWh per annum for residential households[19] and 6831 kWh for small businesses.[20] Therefore, consumers with different usage will experience different

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16 Queensland Competition Authority, *Draft Determination–Regulated retail electricity prices for 2020–21*, pp. 13–16

17 AEMC, *Residential electricity price trends 2019 data – trends in QLD supply chain components*, December 2019; AER, *Final decision – Determination of default market offer prices* 2020–21, April 2020.

18 It also assumes that actual energy consumption will equal the forecast adopted in our final decision. Since Ergon Energy operates under a revenue cap, changes in energy consumption will also affect annual electricity bills across the 2020–25 regulatory control period.

19 AER, *Final determination, Default Market Offer Prices 2019–20*, April 2019, p. 8.

20 Queensland Competition Authority, *Draft Determination–Regulated retail electricity prices for 2020–21*, p. 5.

changes in their bills. We also note that there are other factors, such as metering, wholesale and retail costs, which affect electricity bills.

Table 1.4 shows our estimated impact of our final decision and Ergon Energy's revised proposal on the average annual electricity bills for residential and small business consumers in its network over the 2020–25 regulatory control period.

### Table 1.4 Estimated impact of Ergon Energy's revised proposal and AER's final decision on annual electricity bills for the 2020–25 regulatory control period ($ nominal)

| | 2019–20 | 2020–21 | 2021–22 | 2022–23 | 2023–24 | 2024–25 |
|---|---|---|---|---|---|---|
| **AER final decision** | | | | | | |
| Residential annual bill | 1570[a] | 1497 | 1499 | 1503 | 1506 | 1507 |
| Annual change[c] | | –73 (–4.6%) | 2 (0.1%) | 4 (0.3%) | 3 (0.2%) | 2 (0.1%) |
| Small business annual bill | 2222[b] | 2140 | 2142 | 2146 | 2149 | 2151 |
| Annual change[c] | | –82 (–3.7%) | 2 (0.1%) | 5 (0.2%) | 3 (0.1%) | 2 (0.1%) |
| **Ergon Energy revised proposal** | | | | | | |
| Residential annual bill | 1570[a] | 1473 | 1482 | 1494 | 1505 | 1515 |
| Annual change[c] | | –97 (–6.2%) | 9 (0.6%) | 12 (0.8%) | 11 (0.7%) | 10 (0.7%) |
| Small business annual bill | 2222[b] | 2112 | 2122 | 2136 | 2148 | 2159 |
| Annual change[c] | | –110 (–5.0%) | 11 (0.5%) | 13 (0.6%) | 12 (0.6%) | 11 (0.5%) |

Source: AER analysis; AER, *Final determination, Default Market Offer Prices 2019–20*, April 2019, p. 8; Queensland Competition Authority, *Draft Determination–Regulated retail electricity prices for 2020–21*, p. 5.

(a) Annual bill for 2019–20 is sourced from our final determination on Default Market Offer Prices for 2019–20, and reflects the average consumption of 4600 kWh for residential consumers in Queensland.

(b) Annual bill for 2019–20 is sourced from Queensland Competition Authority's Draft Determination on regulated retail electricity prices for 2020–21, and reflects the average consumption of 6831 kWh for small business consumers in Queensland.

(c) Annual change amounts and percentages are indicative. They are derived by varying the distribution component of the 2019–20 bill amounts in proportion to yearly expected revenue divided by forecast energy. Actual bill impacts will vary depending on electricity consumption and tariff class.

# Shortened forms

| Shortened form | Extended form |
|---|---|
| AER | Australian Energy Regulator |
| ARR | annual revenue requirement |
| CESS | capital expenditure sharing scheme |
| DMIAM | demand management innovation allowance mechanism |
| EBSS | efficiency benefit sharing scheme |
| NER | National Electricity Rules |
| NPV | net present value |
| opex | operating expenditure |
| PTRM | post-tax revenue model |
| RAB | regulatory asset base |
| SCS | standard control services |