AER Preliminary Determination Conference

12th May 2015

Consumer Challenge Panel Perspectives

AER Preliminary Determinations

Energex and Ergon Energy

Hugh Grant

AER Consumer Challenge Panel Member

BACKGROUND

ELEC TRICKERY

INSIDER'S STORY

EXCLUSIVE Did Energex conspire to inflate power bills

KELMENY FRASER

ENERGEX bosses examined how to artificially drive up household power prices after warnings of a "death spiral" in revenue, a whistleblower has claimed.

Cally Wilson, an Energex treasury analyst who quit on Monday to go public with her allegations, said she was asked to manipulate data as the State Government-owned energy company looked at ways to boost revenue.

The allegations come after years of spiralling power prices, with electricity bills doubling in the past six years.

Ms Wilson said the incident took place as Energex was preparing a proposal to the Australian Energy Regulator, which decides how much the company can charge householders.

"Energex were looking at tactics ... to ensure revenues also remained high," Ms Wilson claimed.

Ms Wilson (pictured) said the request was made amid warnings of a looming revenue crisis, labelled by insiders as the "death spiral".

An Energex spokesman disputed Ms Wilson's version of events, saying work on the data was for a corporate plan and not part of the company's revenue bid.

REPORTS P4-5

Energex execs are staying at this luxury NSW resort, to ponder their power prices. But is it really just a case of ...

RUBBING SALT IN OUR WOUNDS

EXCLUSIVE
STEVEN WARDILL
STATE POLITICAL EDITOR

TAXPAYERS have shouted eight of the top executives from Energex to a beachside retreat to help them solve the puzzle of skyrocketing power prices.

The getaway comes just months before households are hit with yet another double-digit power price rise.

And rather than heed the Newman Government's message about holidaying at home, the bosses of the state-owned power distributor last night bedded down in a NSW resort.

The Courier-Mail can reveal the Energex chiefs yesterday ditched their inner-city offices for a one-night stay at holiday retreat Mantra on Salt Beach (pictured), in Kingscliff.

The company refused to identify the exact budgeted cost or the activities planned for the executives but said the bill was expected to be less than $6000, including "accommodation, meals and workshop facilities".

Team-building activities on offer at the resort include kayaking tours, surfing lessons, snorkelling with the turtles and a special adventure challenge.

Consumers, meanwhile, have a challenge of their own coming. The annual bill for the standard household tariff is expected to rise this year by $220.70 to $2225.62.

In a written statement, an Energex spokesman yesterday said the retreat was an important part of the company's planning processes and was a similar distance from Brisbane as past events.

"As a $12 billion company, Energex constantly reviews its operational and planning processes and outcomes," he said. "This is particularly important at this time of the current financial year, and before the new financial year starts."

The Government's power distributors have regularly staged such events, including a two-day workshop in 2012 when senior staff had to don smocks and paint abstract art.

Energy Minister Mark McArdle yesterday said he was "disappointed" Energex had chosen a location outside Queensland.

"We hope the Energex executives use their time to focus on how best to reduce Queenslanders' electricity prices," he said.

Mr McArdle said the Government had not yet made a final decision on whether to operate Energex and Ergon Energy under a single parent company.

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INSIGHT ELECTRICITY COSTS

PRICES POWER AHEAD

As electricity bills continue to rise in Queensland, there have been explosive claims from a former Energex treasury analyst that the company has been price gouging, writes **Kelmeny Fraser**

IN A first-floor office within Energex's shiny Taj Mahal-esque Newstead headquarters, surrounded by coffee shops and cafes, a calculation was in progress that would months later end in scandal.

That calculation of the WACC – weighted average cost of capital – by 33-year-old Energex treasury analyst Cally Wilson would this week burst into the public arena with explosive claims of corporate

PAIGE CARFRAE

CONSUMERS across the state were scratching their heads after receiving abnormal power bills this quarter.

Single mum Alyce Strathie, 28, was left confused and feeling the pressure of extreme rises in electricity prices after receiving an invoice with a huge price hike.

"I just kind of looked at my bill and did not understand it one little bit," Ms Strathie said.

"I haven't had the heater on over winter – I don't even own a heater!

"I don't know how it happened but it's definitely a shock."

Ms Strathie was astounded at

$470m bill for unused power

KELMENY FRASER
SARAH VOGLER

ENERGEX is set to claw almost $470 million from consumers for electricity they never used.

Energex documents reveal that the company last year planned to "recover" $469.8 million in "under-recovered revenue" over the next two years, with the amount to be tagged on to future prices.

The figure reflects the shortfall in actual revenue

vealed allegations by Energex whistleblower Cally Wilson that Energex had examined ways to artificially increase revenues – and power prices.

Ms Wilson, a treasury analyst with seven years' experience, said she was forced to manipulate data to reach targeted weighted average cost of capital (WACC) – a key factor in setting revenues and therefore household electricity bills.

She said she found the debt rate on Bloomberg mid-last year when Energex was

PROFIT FROM PAIN

Government reaps record gains from power bills

KELMENY FRASER

THE State Government reaped a record profit from south-east Queensland electricity users while examining ways to drive down soaring power bills.

And regional Queenslanders could also be paying too much for power, with a report commissioned by lobby group Canegrowers finding an overvalued power network is needlessly driving up bills.

Energex's dividend to the State Government soared by 38 per cent last financial year – injecting $406 million into government coffers, compared with $294 million in 2012-13.

The record profit was made in the months after a panel of government-appointed experts delivered advice early last year on ways to cut power bills.

Energex earned a net profit of $372 from each of its 1.4 million customers – up from $179 each just three years ago.

That came as the Queensland Council of Social Services reported some of the highest levels of power disconnections in years as households felt the sting of double-digit rises.

Network costs, which account for 50 per cent of bills, have been the primary factor in a more than 80 per cent rise in power prices in seven years, the panel found.

"Ergon has become a money-making machine, and it is an incredible source of profit, as is Energex, for the Queensland Government," Canegrowers member and Bundaberg farmer Dale Holliss said.

Energex figures show it turned a more than $500 million profit last financial year, with its board deciding to deliver 80 per cent of that to its owner, the State Government.

Ergon dividends for 2013-14 amounted to $392 million, but the Government paid $620 million in community service obligations the same year to subsidise rural electricity prices.

The dividends have angered consumer groups, who argue the Government is at cross-purposes in accepting fat profits while examining ways to end the cost-of-living pain.

It is also expected to further fuel debate on plans to privatise state-owned networks.

Logan-based action group VETO, which has been in a six-year battle with Energex over claims that "gold plating" is driving up bills, said the dividend raised questions about future expansion plans.

Under energy rules, the more Energex can convince the regulator it needs to spend, the more it can make from consumers – and the higher the dividend to the Government.

But Energy Minister Mark McArdle said the dividends had been used to subsidise power for regional Queensland, as well as funding electricity rebates and concessions.

THEY'RE PYLON ON THE AGONY

EXCLUSIVE
KELMENY FRASER

STRUGGLING householders

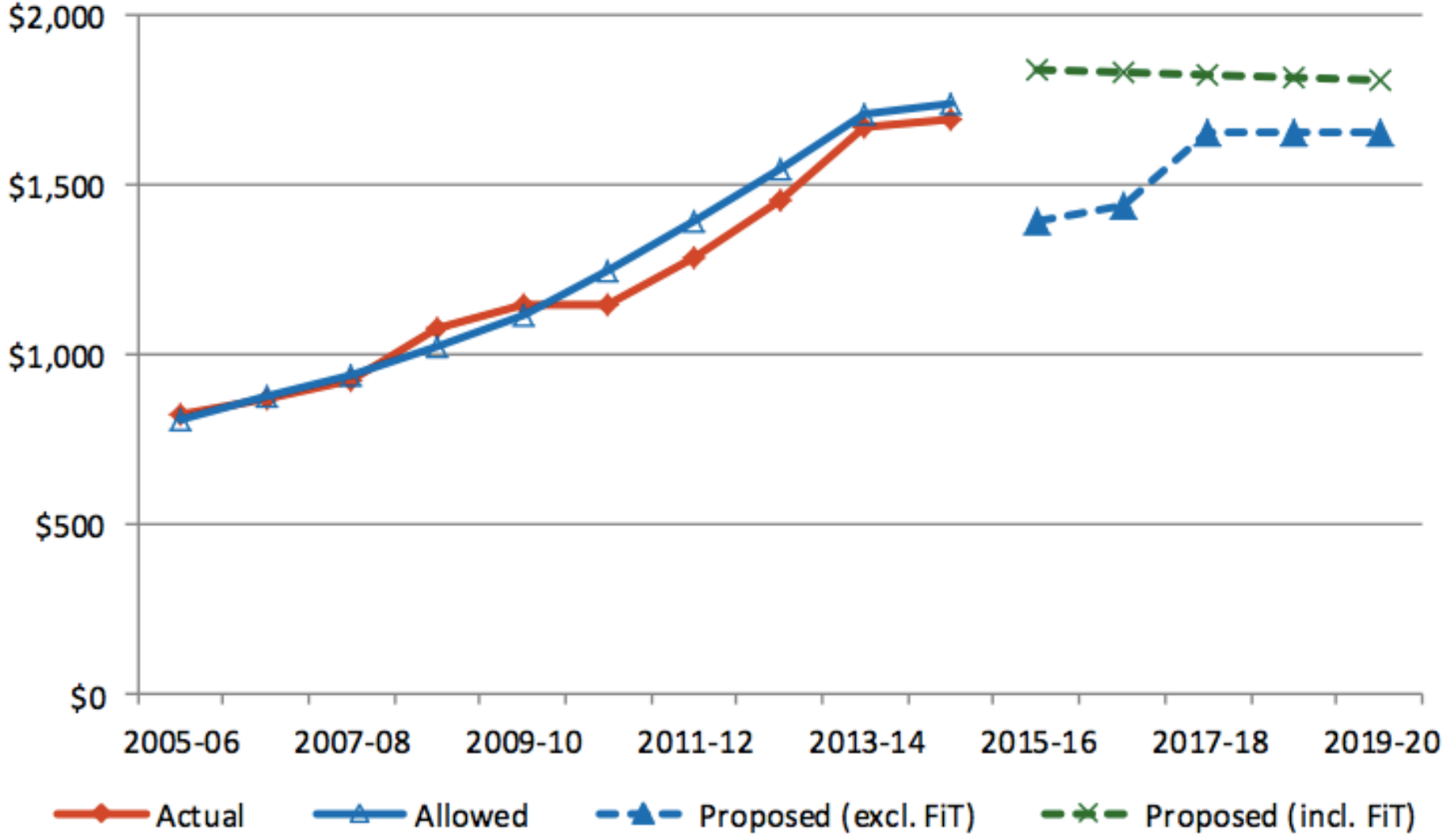
Association chief executive John Bradley said the rules were designed to prevent overspending by giving incentives

Key Criticisms of the AER's Previous Revenue Determinations

- **Excessive Weighted Average Cost of Capital (WACC) allowances** - that enabled the networks to achieve extraordinary profitability levels
- **Excessive augmentation capex allowances** - driven by the networks' over-estimation of load forecasts
- **Excessive replacement capex allowances** – resulting in the premature replacement of assets
- **Excessive opex allowances -** based on the networks' historical costs rather than benchmark efficient costs
- **Excessive incentive scheme payments** - due to the AER setting targets well above the efficient level

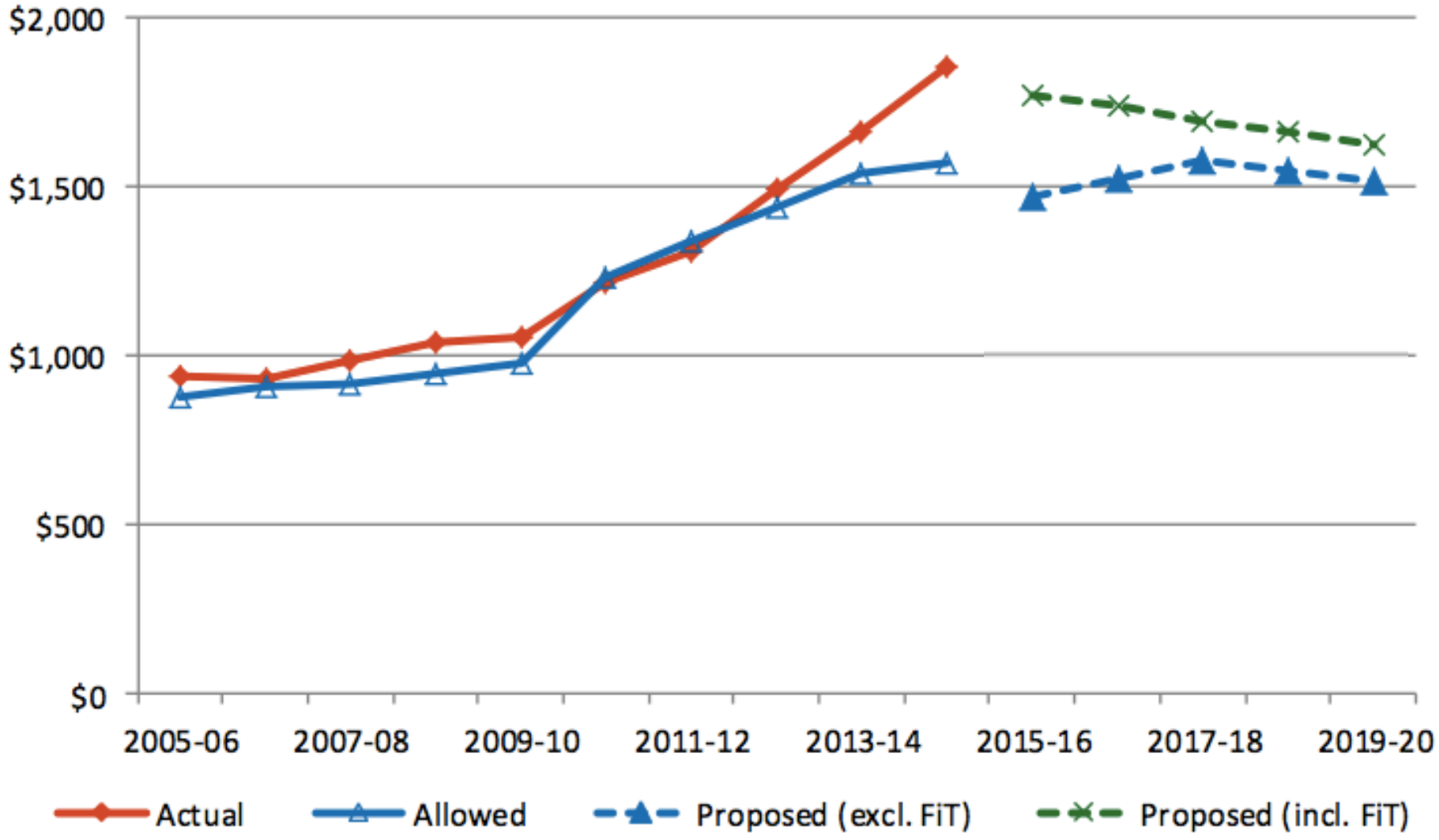
Energex – Historical / Proposed Revenue

Figure 1 **Energex – proposed total revenue ($million, 2014–15)9**

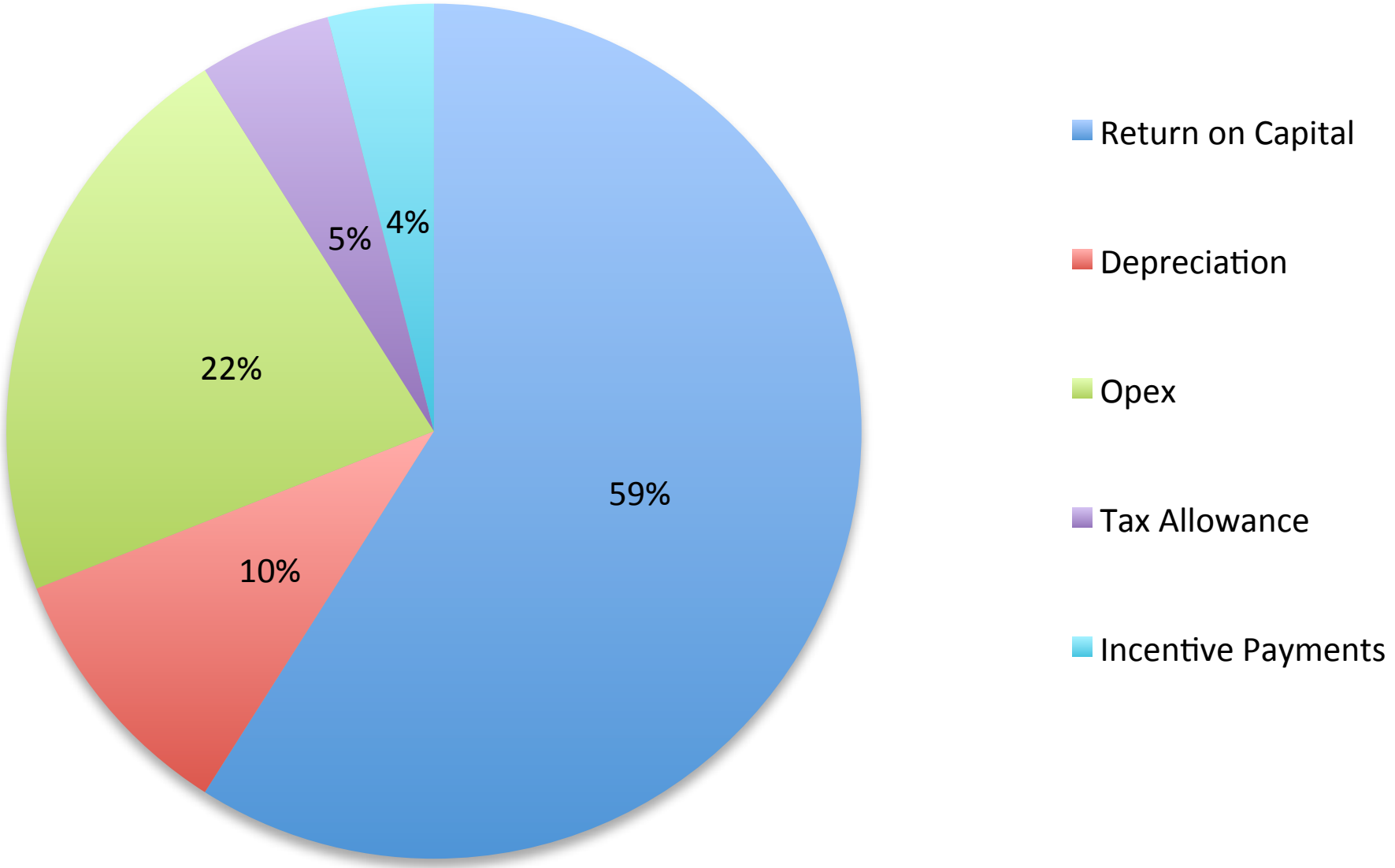


Ergon – Historical / Proposed Revenue

Figure 2 **Ergon Energy – proposed total revenue ($million, 2014–15)[10]**



Ergon Proposed Revenue: Components

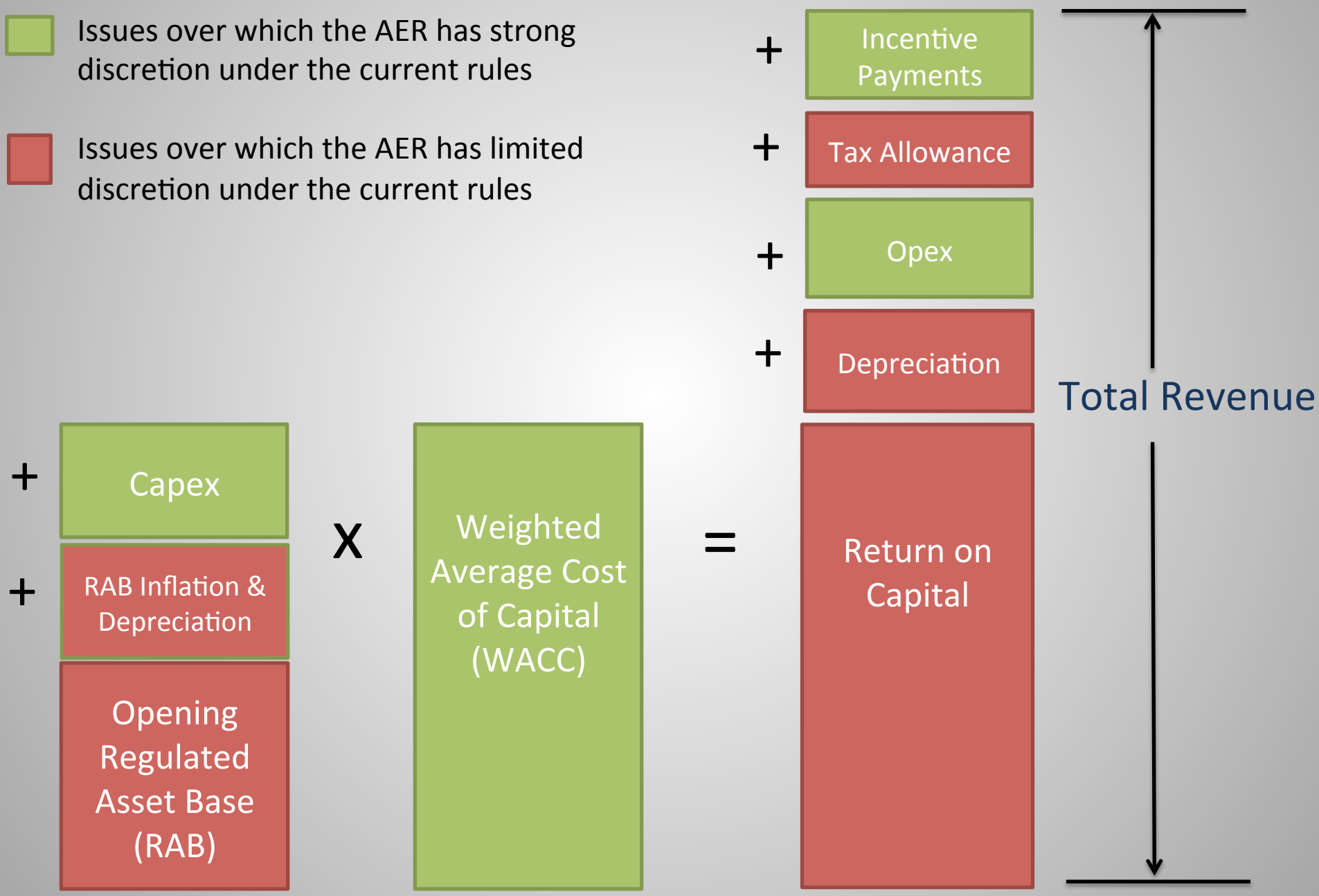


Source: Derived From Ergon Revenue Proposal

Building Block Revenue Components: The AER's Ability to Influence

Issues over which the AER has strong discretion under the current rules

Issues over which the AER has limited discretion under the current rules



THE AER'S PRELIMINARY DETERMINATIONS REVENUE AND PRICE IMPACTS

What We Should Be Seeing - Significant Price Reductions

There are a number of drivers that are producing significant downward pressure on prices:

- Significantly lower cost of capital requirements
- The downturn in electricity demand and consumption
- Less onerous network security and reliability standards
- Excess system capacity
- Reforms driven by the Queensland Government

In light of these drivers, the networks' revenues should revert to the levels that applied prior to the previous two regulatory periods

Preliminary Determinations - Estimated Retail Price Impacts

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20
Energex proposal						
Residential annual bill[a]	1914	1935	1958	1974	1989	2001
Annual change		21 (1.1%)	24 (1.2%)	16 (0.8%)	15 (0.8%)	12 (0.6%)
Small business annual bill[b]	2973	3005	3041	3066	3090	3108
Annual change		32 (1.1%)	37 (1.2%)	25 (0.8%)	23 (0.8%)	18 (0.6%)
AER preliminary decision						
Residential annual bill[a]	1914	1880	1836	1820	1799	1782
Annual change		–34 (–1.8%)	–44 (–2.4%)	–16 (–0.9%)	–21 (–1.1%)	–17 (–0.9%)
Small business annual bill[b]	2973	2920	2851	2826	2794	2768
Annual change		–53 (–1.8%)	–69 (–2.4%)	–25 (–0.9%)	–32 (–1.1%)	–26 (–0.9%)

Note: the actual price impacts will be highly dependent upon the energy delivered by the networks, and the networks' new 'cost reflective' tariff structures currently under development

The AER's Preliminary Determination - Retention of Excessive Prices

- The AER's preliminary determinations would result in the Qld DNSPs' prices being retained at excessive levels

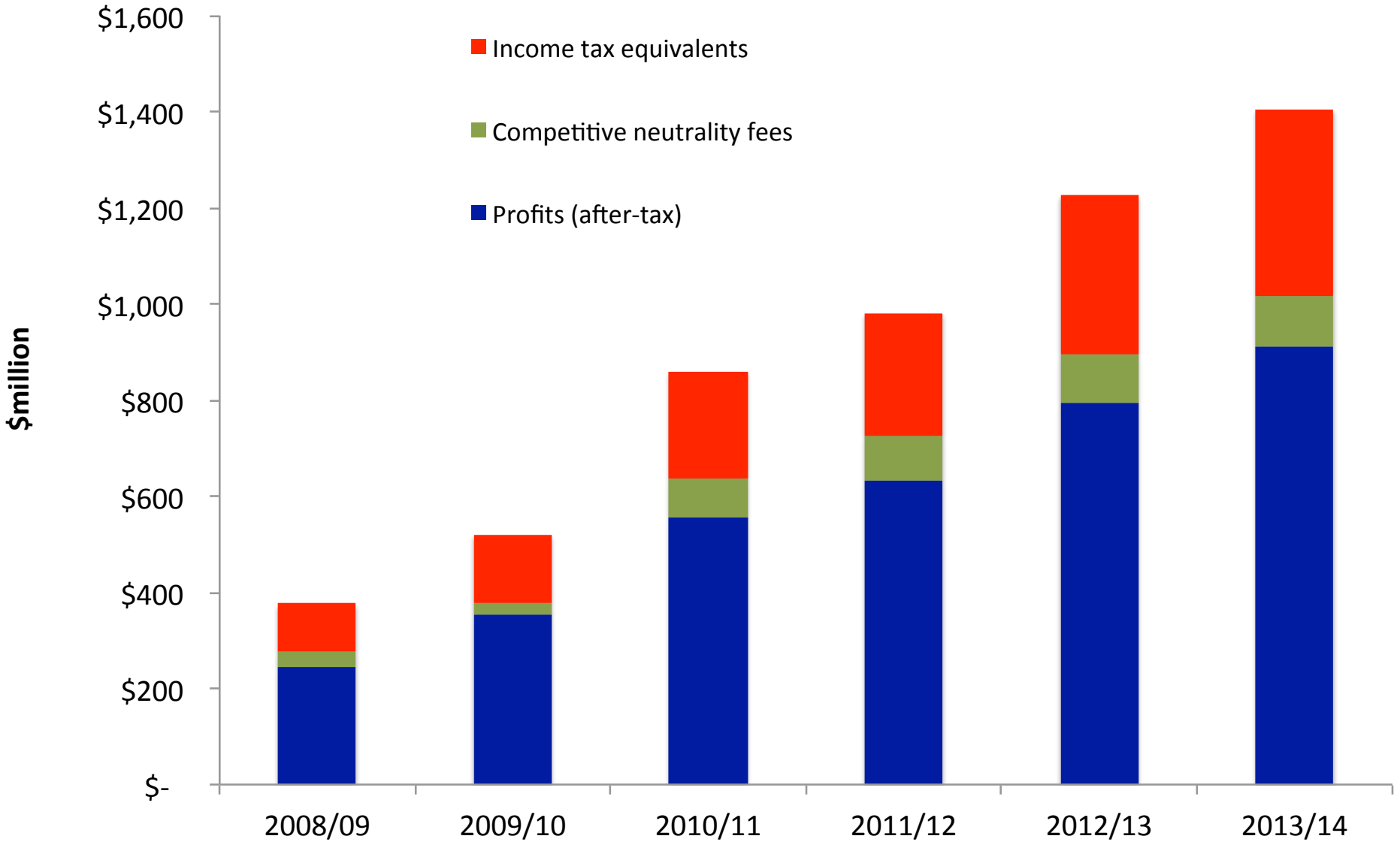
- There are a number of major deficiencies in the AER'S preliminary determinations - in particular:
  - The ongoing provision of excessive WACC allowances
  - The ongoing provision of excessive capex allowances
  - The ongoing provision of excessive opex allowances

RETURN ON CAPITAL

Australia's Electricity Networks are Extraordinarily Profitable

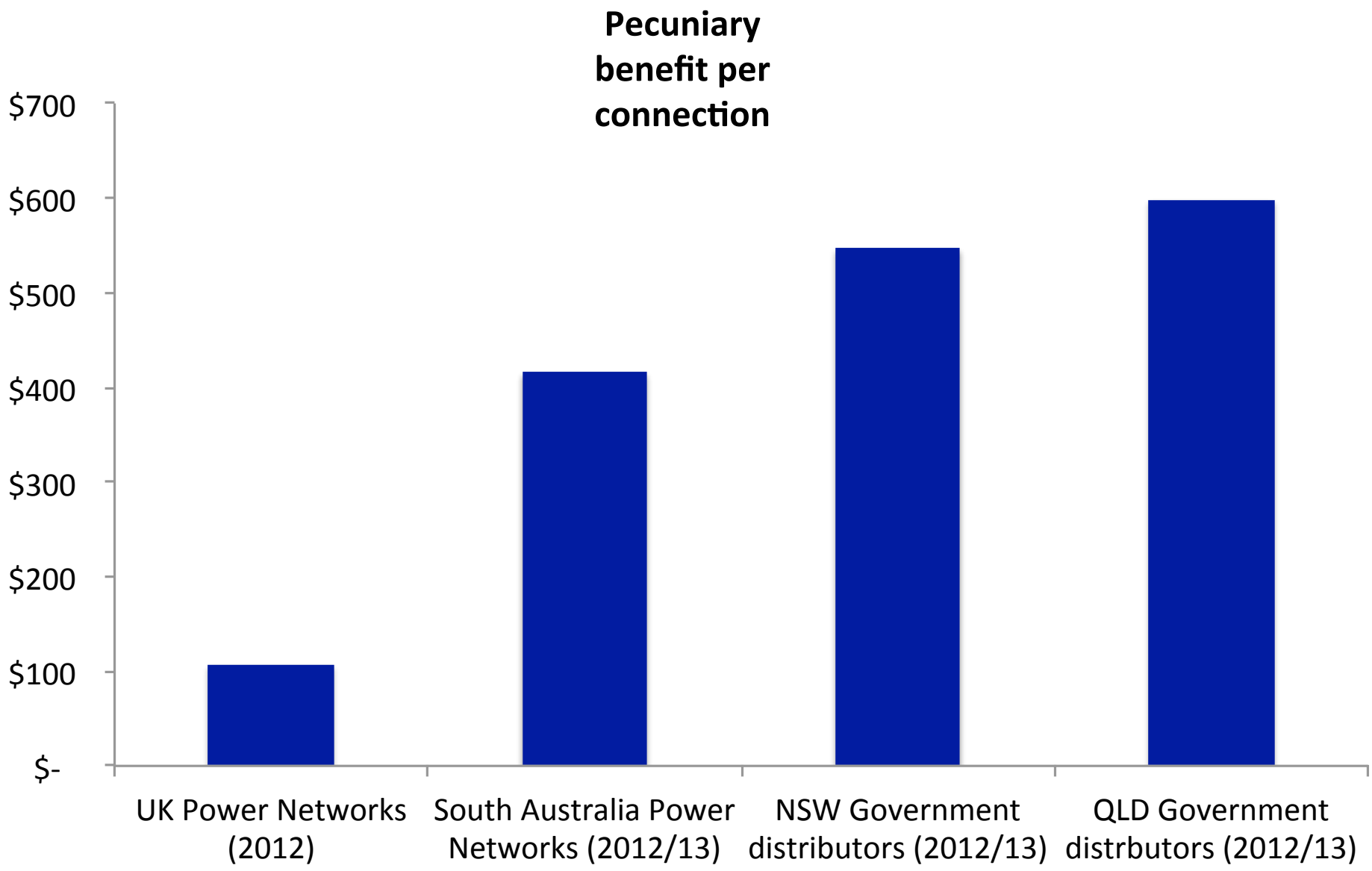
- Australia's electricity networks are much more profitable than the regulatory framework assumes - particularly the government owned networks
- Equity markets and investors are valuing the networks significantly higher than their regulated asset bases (RABs) – with some valuations at over 150% of RAB
- Lenders are lending to the regulated business at significantly lower rates than the 'cost of debt' allowances provided by the AER
- The AER is inappropriately applying its discretion by selecting WACC input parameters at the top end of the possible ranges
- The AER has consistently set higher WACCs than other comparable regulators in Australia and overseas

Ergon Profitability Trends



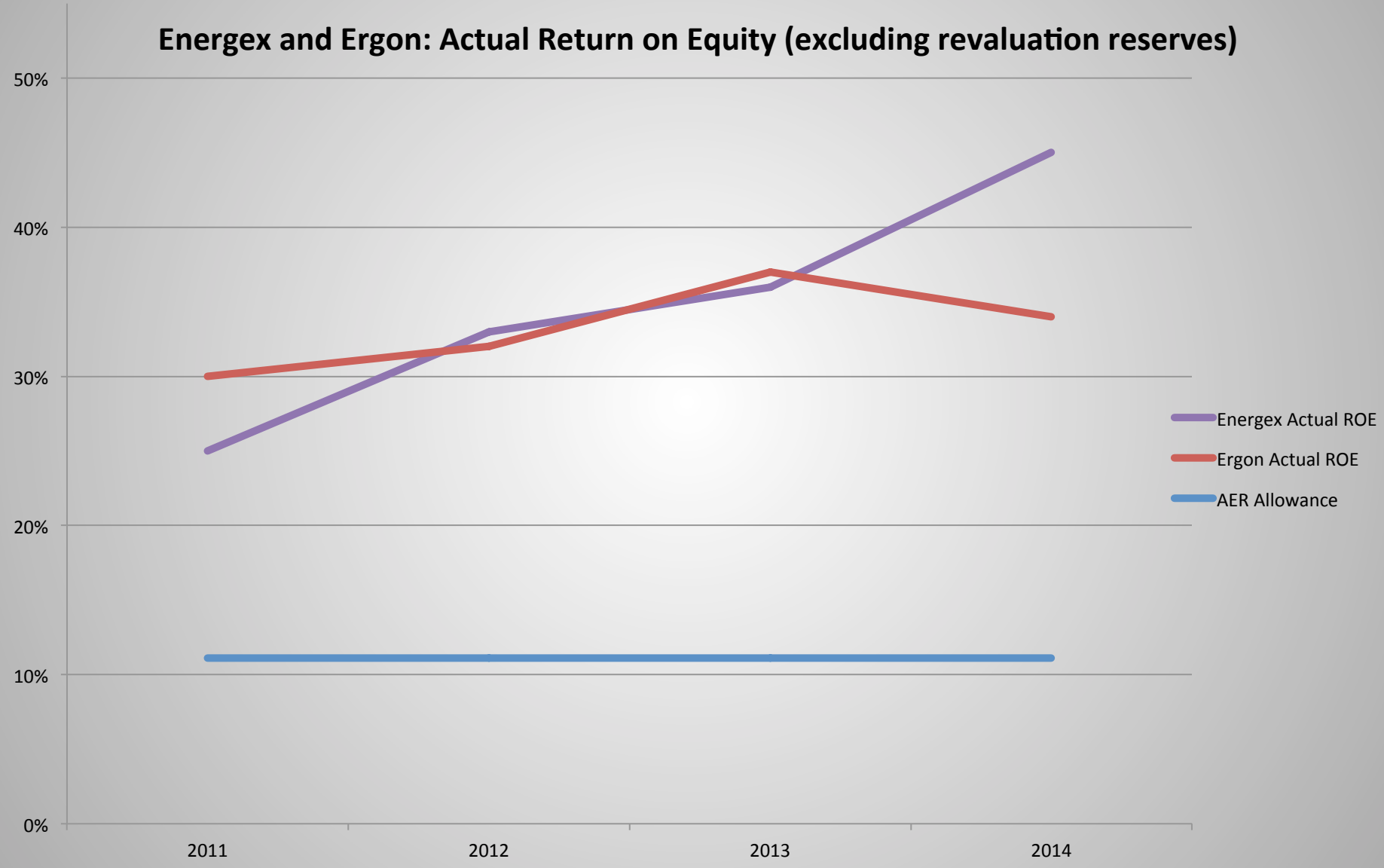
Source: CME (Bruce Mountain) 2015

Qld DNSPs: Comparative Profits per Connection



Source: CME (Bruce Mountain) 2015

Energex and Ergon's Actual Return on Equity



Source: CCP2 Submission on Energex and Ergon's 2015-20 Revenue Proposals

The Queensland Electricity Networks' Extraordinary Profitability

- In recent years Energex and Ergon have achieved return on equity levels of around 3-4 times the level that the AER assumed in its 'return on equity' allowance
- These returns are well in excess of the returns being achieved by Australia's best performing ASX50 entities
- These returns are being achieved, despite:
  - Electricity networks being effectively 'zero risk' businesses; and
  - Queensland's networks being amongst the least efficient in the NEM
- The AER's preliminary determinations will result in Energex and Ergon continuing to deliver extraordinary returns over the next 5 years

The AER's Preliminary WACC Determinations

WACC Component	2010-15 Determination	Qld DNSPs' Revenue Proposals	AER preliminary Decision
Cost of Equity			
Risk Free Rate	5.89%	3.63%	2.55%
Market Risk Premium	6.5%	7.57%	6.5%
Equity Beta	0.8	0.91	0.7
Total Cost of Equity	**11.09%**	**10.5%**	**7.1%**
Cost of Debt	**8.87%**	**5.91 - 6.36%**	**5.01%**
Total WACC	**9.76%**	**7.75 – 8.02 %**	**5.85 %**

Return on Equity - Inappropriate Use of the AER's Discretion

- The AER has inappropriately applied its discretion by setting the cost of equity input parameters at the top of the possible ranges

- Stakeholders provided extensive evidence to justify the AER applying cost of equity parameters at the bottom end of the ranges, i.e.:
  - A market risk premium (MRP) of around 5.0%
  - An equity beta of 0.4

- Stakeholders also provided evidence that demonstrated that the AER's move from a gamma of 0.5 to 0.4 is not justified

The AER's Preliminary Cost of Debt Allowance

- The AER's preliminary return on debt allowance represents a debt risk premium (nominal debt less the nominal risk free rate) of around 2.5%
- This debt risk premium is:
  - Similar to the debt margin than it provided to the networks for the previous regulatory period – i.e. during the Global Financial Crisis
  - Around 2.5 times the debt margin provided by IPART in previous regulatory periods
  - Over 4 times the debt margin currently provided by Ofgem for the UK networks
- This will continue to deliver extraordinary windfall profits to the Queensland DNSPs over the next regulatory period

The Use of BBB+ Ratings

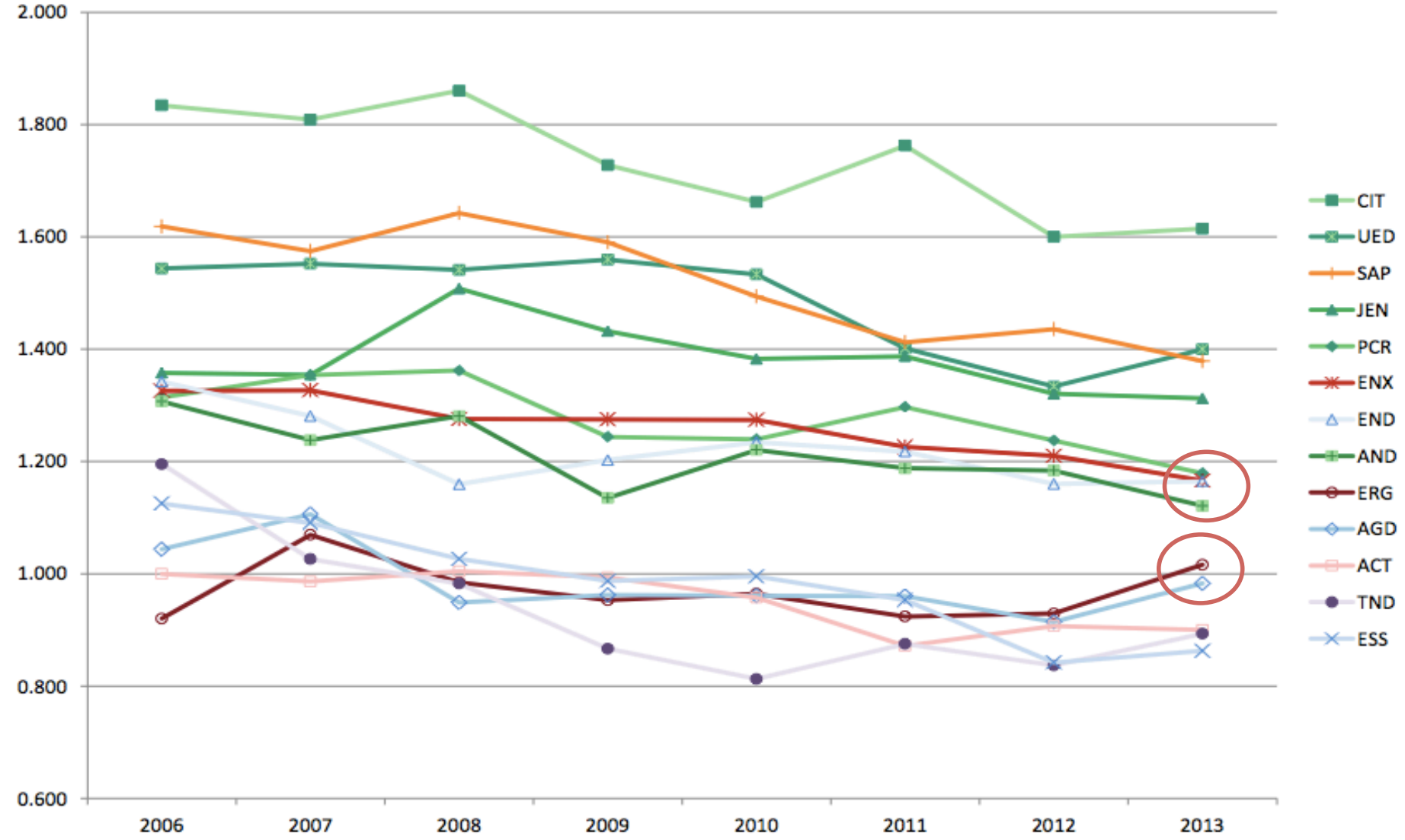
- The AER claims that it has used BBB+ ratings in the development of its return on debt allowance
- However, due to limitations in the availability of Australian BBB+ data, in practice BBB ratings have been used
- Consequently, the AER has provided significantly higher cost of debt allowances than appropriate
- In addition, Energex and Ergon's actual borrowing costs are much lower than the costs implied by their credit ratings

CAPEX

CAPITAL EFFICIENCY

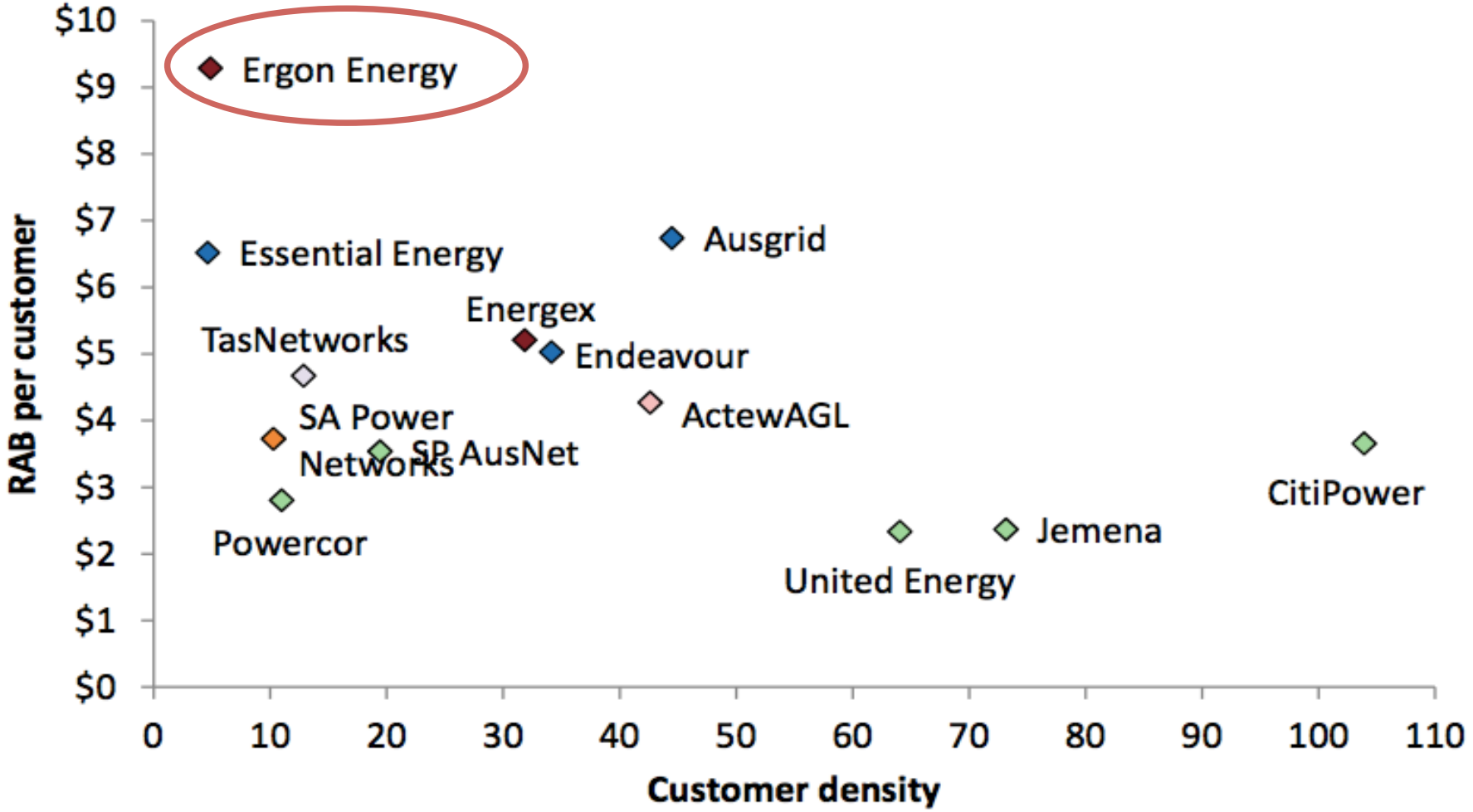
Multilateral Total Factor Productivity

Figure 16 **Multilateral total factor productivity for each distributor**



RAB per Customer

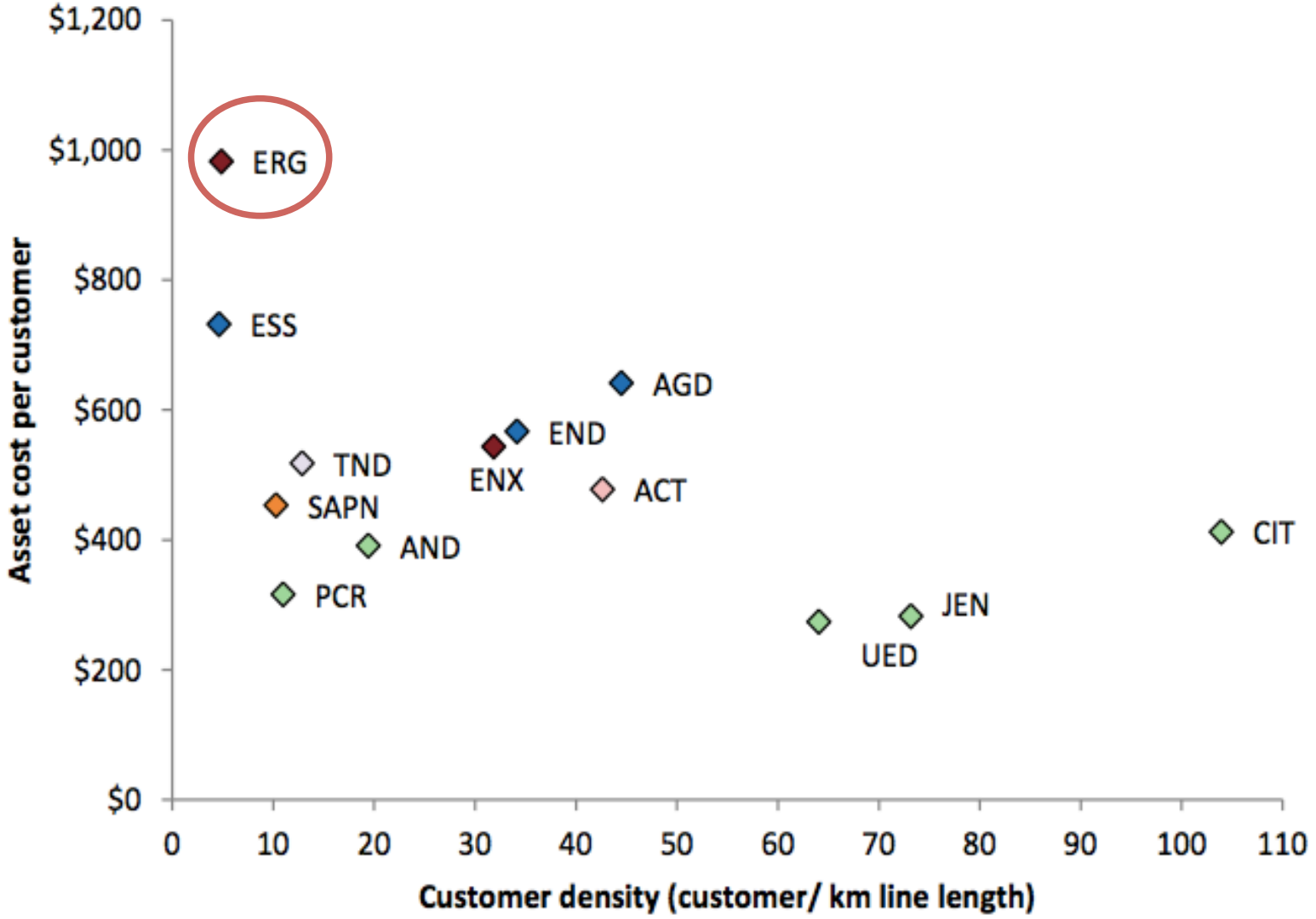
Figure 6-6 **RAB per customer (000s, $2013-14), against customer density**



Source: AER analysis

Asset Cost per Customer

Figure 13 **Asset cost per customer compared to customer density (average 2009–2013)**



Capital Efficiency: Queensland Govt Independent Review Panel Findings

"An industry engineering ***culture biased toward expanding the network infrastructure and enlarging the capital base*** *of the NSPs -* ***driving inefficient expenditure****"*

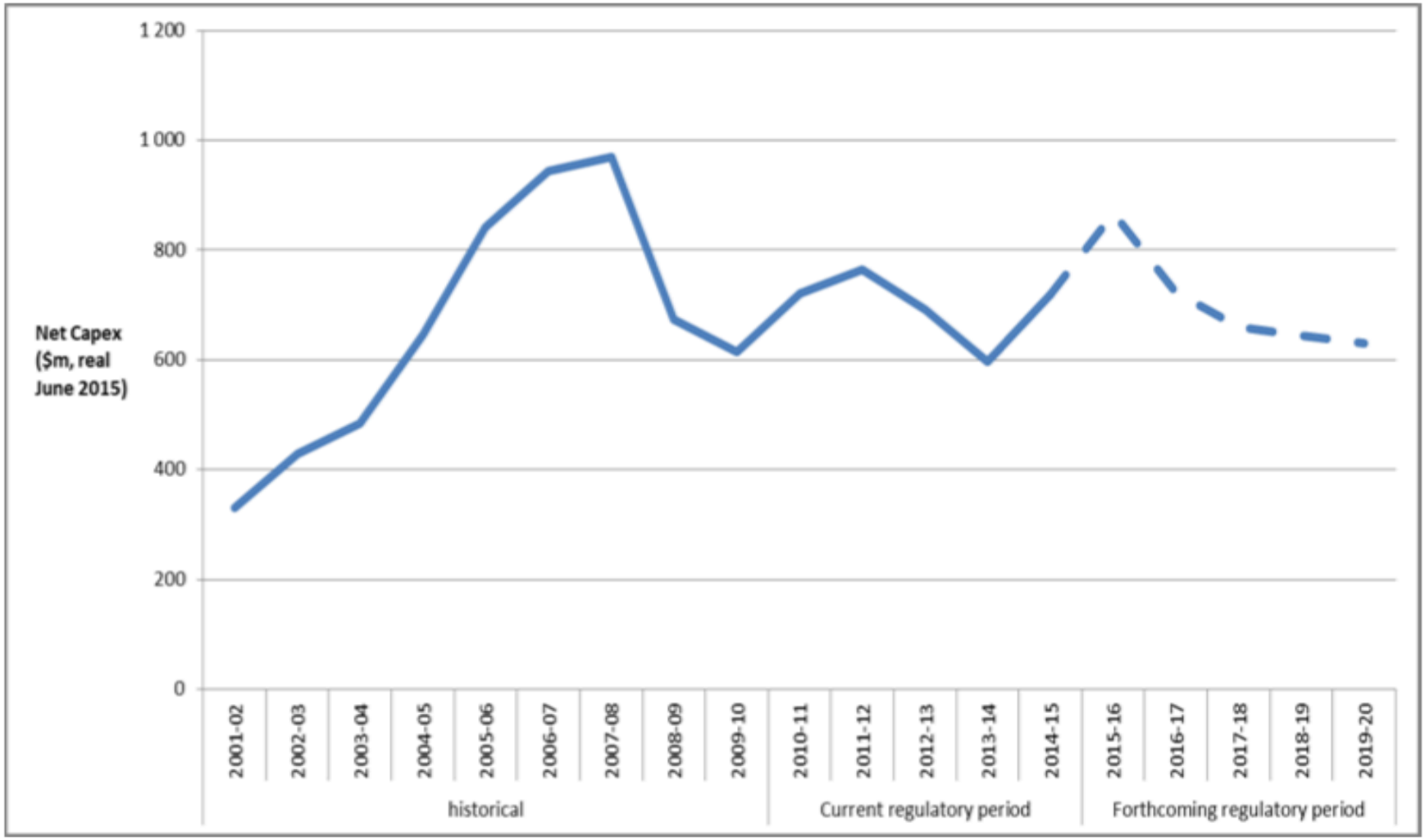
"A ***deficient commercial model*** *in that there was* ***no rigorous capital rationing*** *by the Government, as shareholder and provider of capital, to guide investment decisions"*

"A ***regulatory model that does not allow*** *the Australian Energy Regulator (AER) to drive* ***the networks to deliver efficient capital*** *and operating programs"*

THE QUEENSLAND NETWORKS' CAPEX PROPOSALS

Ergon – Historical / Proposed Capex

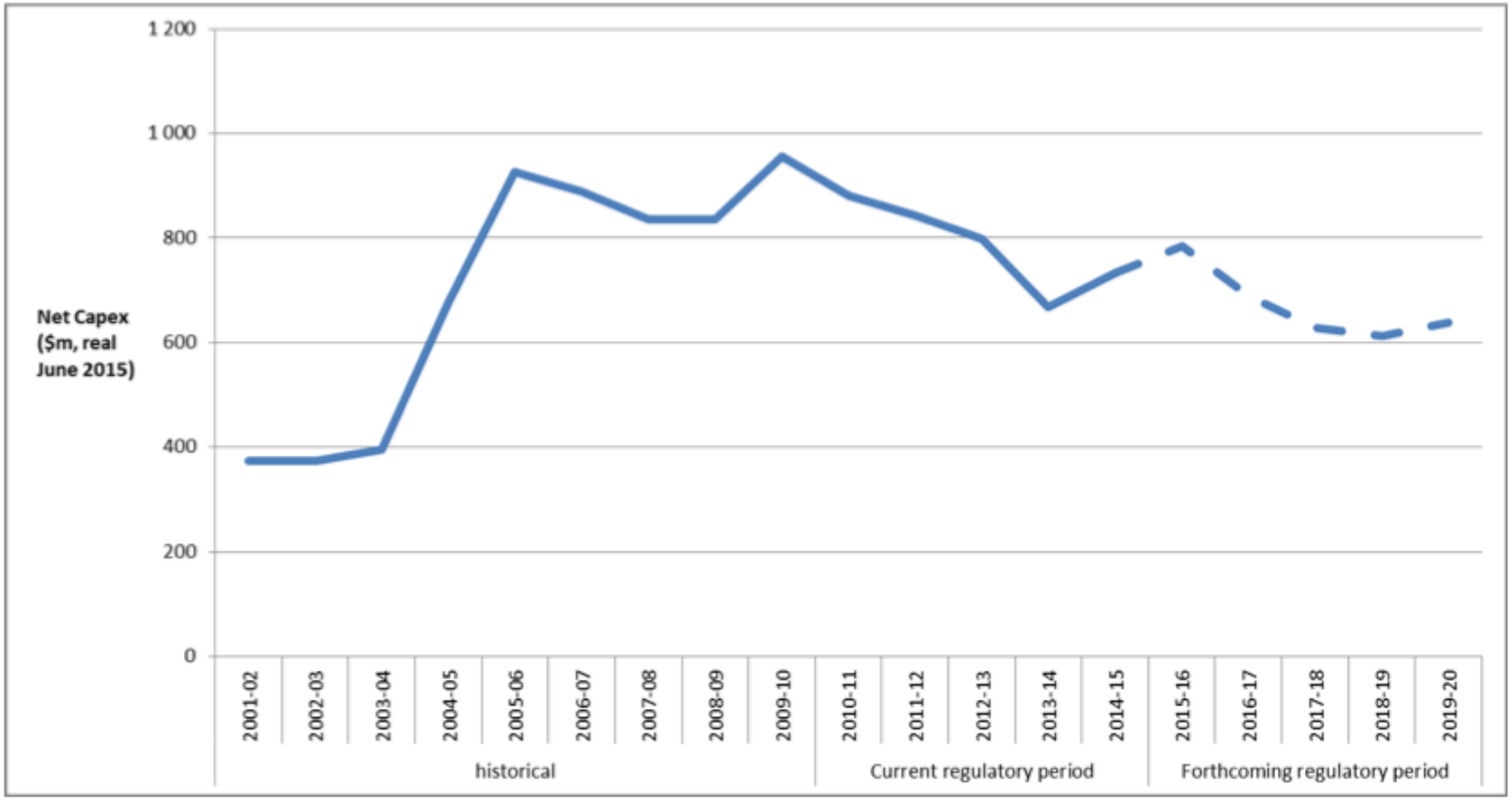
Figure 6.6 Ergon Energy total capex (including overheads)—historical and forecast for 2015–20 regulatory control period



Source: AER analysis

Energex – Historical / Proposed Capex

Figure 6-6 Energex total capex (including overheads)—historical and forecast for 2015–2020 period



Source: AER analysis

The AER's Preliminary Determinations: Total Capex

Table 7 AER preliminary decision on total net capex ($million 2014–15)

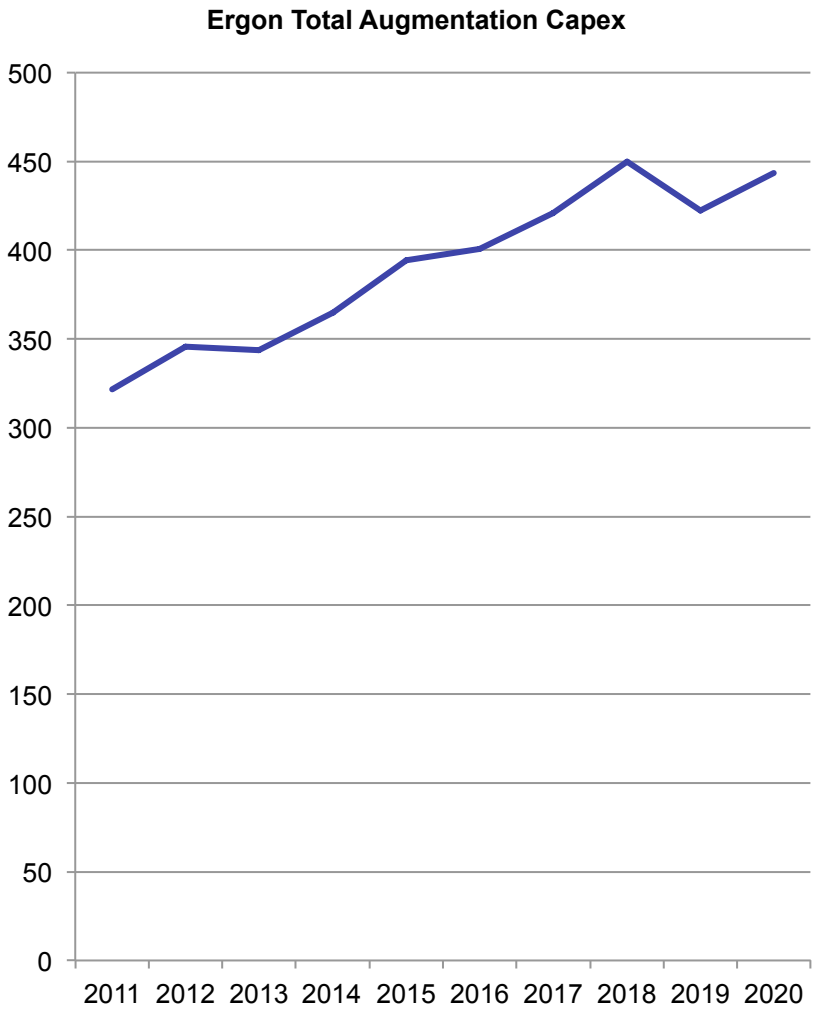
	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Energex's proposal	670.3	688.5	629.0	613.3	638.4	3239.6
AER preliminary decision	498.5	513.6	465.5	446.2	437.8	2361.5
Difference	-171.9	-175.0	-163.5	-167.1	-200.6	-878.1
Percentage difference (%)	-26%	-25%	-26%	-27%	-31%	-27%

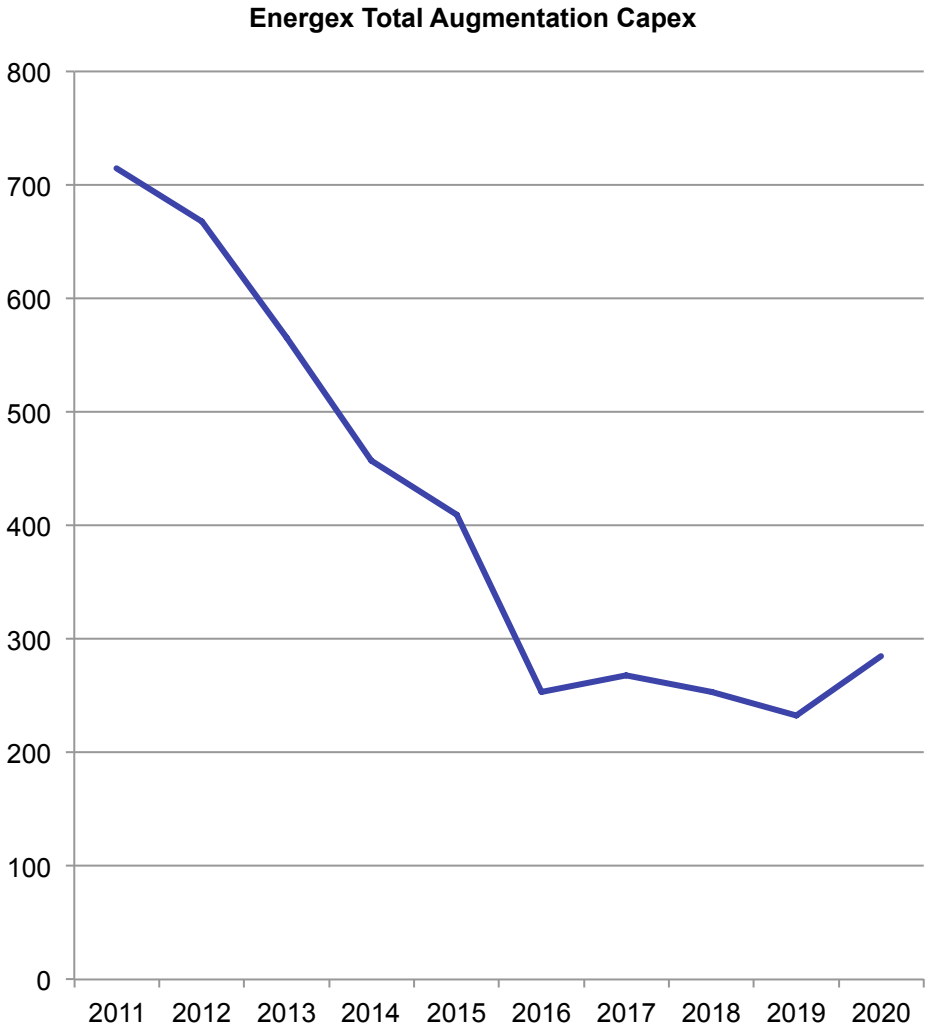
Table 7 AER preliminary decision on total net capex ($million 2014–15)

	2015–16	2016–17	2017–18	2018–19	2019–20	Total
Ergon Energy's proposal	739.8	723.2	659.4	644.5	630.0	3397.0
AER preliminary decision	540.1	495.3	428.1	381.0	337.5	2182.0
Difference	-199.7	-227.9	-231.3	-263.5	-292.6	-1215.0
Percentage difference (%)	-27%	-32%	-35%	-41%	-46%	-36%

AUGMENTATION AND CUSTOMER CONNECTION CAPEX

Historical / Proposed Augmentation Capex

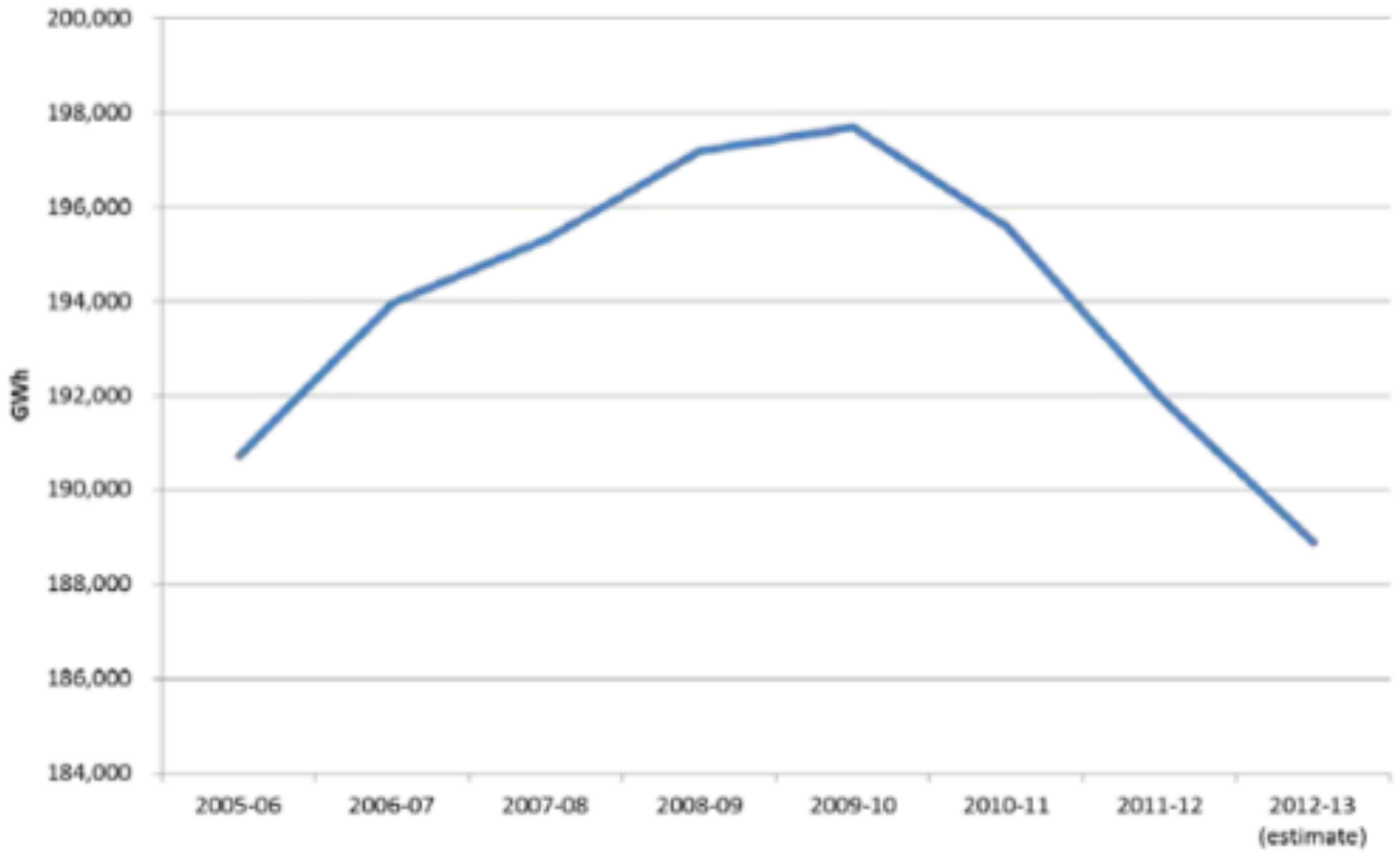




FLAWED DEMAND FORECASTING

Consumption Trend – National Electricity Market

Figure 2.2 Historic average demand in the NEM



Declining Network Demand

- After decades of rising in tandem with economic growth, Australia's electricity consumption and peak demand has declined since 2009

- All credible energy forecasters are predicting that Queensland's recent flat/ declining peak demand and consumption trends will continue, due to:
  - Consumers responding to higher electricity prices by reducing energy use and adopting energy efficiency measures
  - Increasing penetration of distributed generation, including commercial and residential photovoltaic (PV) generation
  - Subdued economic growth and weaker energy demand from the manufacturing and minerals processing sectors
  - Subdued population growth in Queensland, particularly in terms of interstate and international migration
  - The impacts of new building regulations on energy use and efficiency

The Networks' Flawed Demand Forecasts.....

	2015 Forecasts	2015 Actuals	Difference
Energex			
- Peak Demand	5,940 MW	4,200 MW	**41.4 % over-estimation**
- Energy Delivered	24,042 GWhrs	21,055 GWhrs	**14.2% over-estimation**
Ergon			
- Peak Demand	3,330 MW	2,500 MW	**33.2% over-estimation**
- Energy Delivered	16,874 GWhrs	13,496 GWhrs	**25.2 % over-estimation**

Energex and Ergon were rewarded with 'windfall profits' of around $1 billion for these forecasting errors (through returns and depreciation on capex that they did not incur)

The Qld Networks' Systemic Over-Estimation of Demand

"Another factor contributing to the escalation in capital programs has been the ***consistent over- estimation of demand by the NSPs***

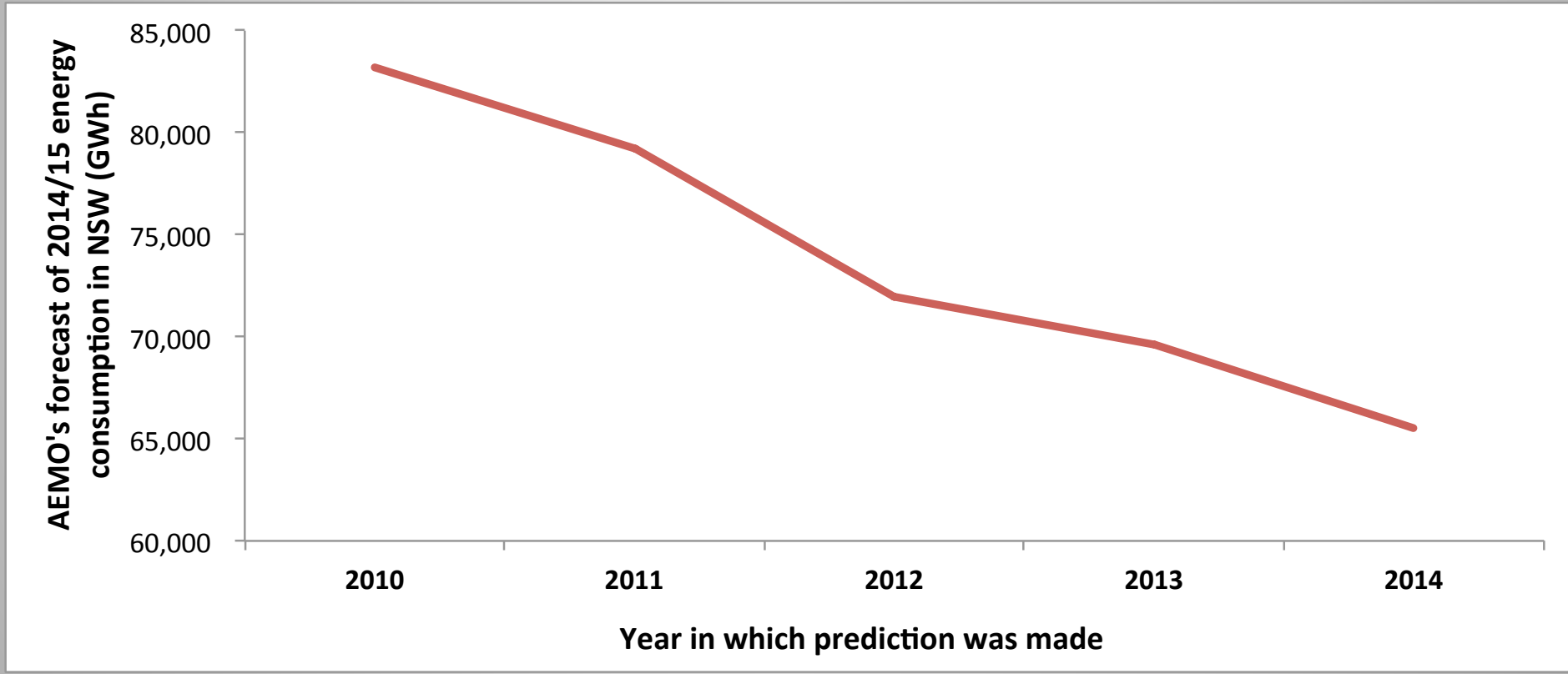
" *The Panel also notes that the current* ***revenue cap control mechanism places volume risk on customers****"*

"Where demand is over-estimated, capital programs will be excess to requirements and ***network tariffs to customers will increase during the regulatory control period to ensure the NSPs are able to recover the allowable revenue"***

Source: Queensland Government Independent Review Panel (IRP) on Network Costs

AEMO's Flawed Demand Forecasts.....

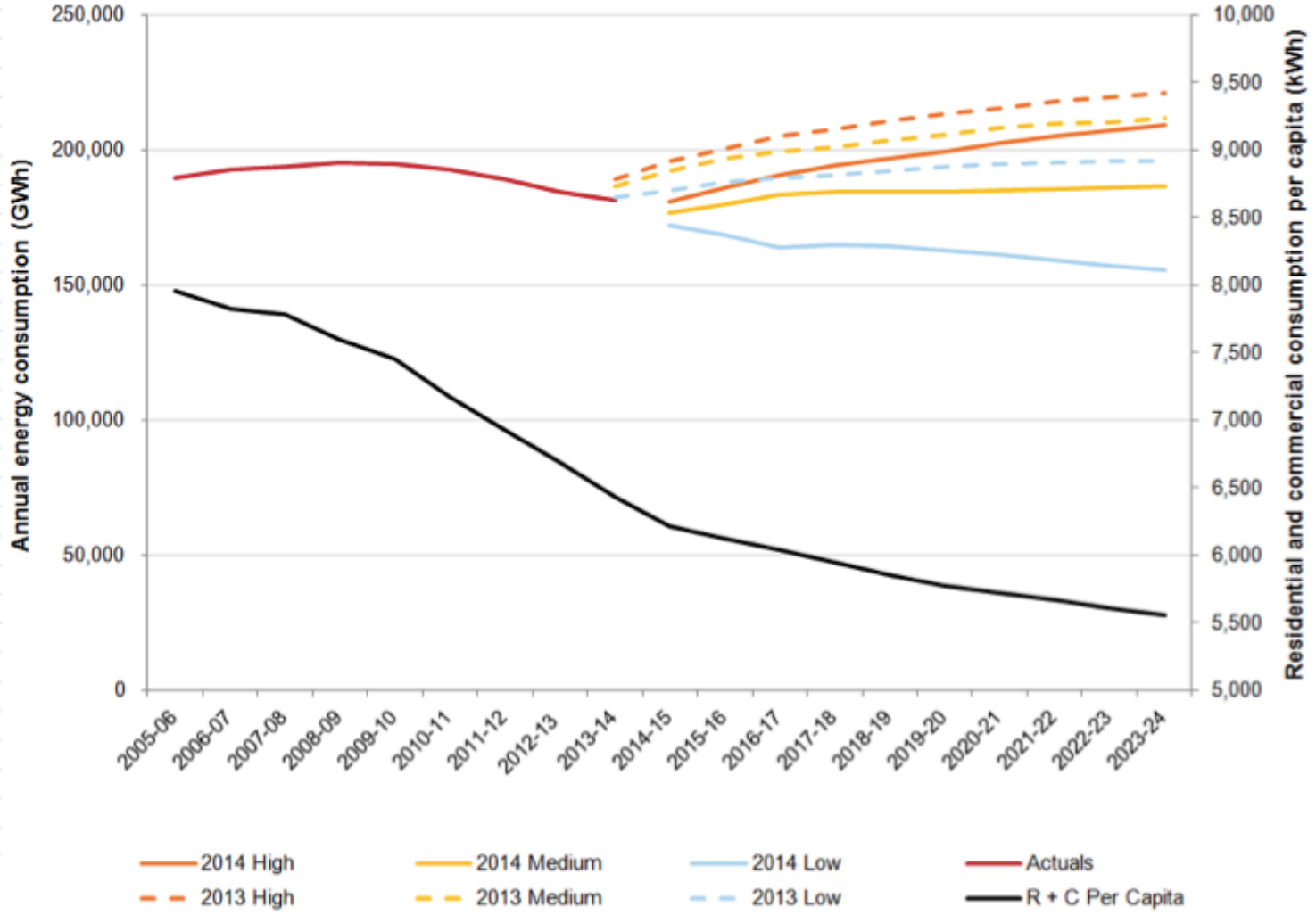
AEMO's changing forecasts of NSW 2014/15 consumption



Source: CME 2015

AEMO's Latest Energy Forecasts

Figure 2.3: Annual energy forecasts for the National Electricity Market (as at December 2014)



Note: R + C is residential and commercial annual energy consumption.

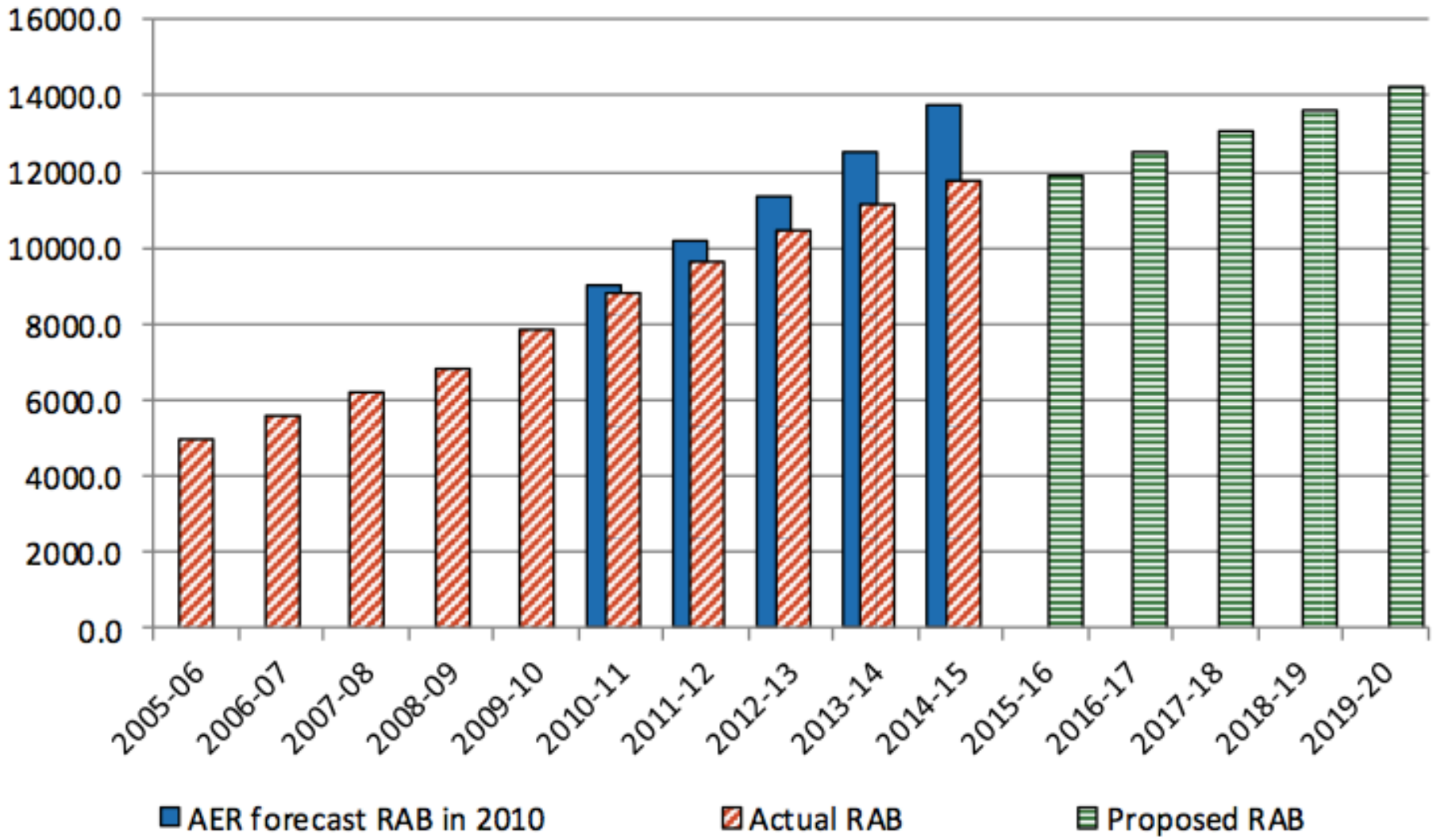
The DNSPs' Augmentation Capex Forecasts - Key Deficiencies

- Insufficient Top-Down Restrain
  - Over-Reliance on "Bottom Up" Forecasting Methodologies
- Excessively Conservative Risk Management/Risk Assessments
  - Systemic bias to overestimating risk and project scopes/costs
- Poor Project Justifications
  - Insufficient justifications of demand drivers for augmentation projects
  - Insufficient justification of reliability drivers and consumers' willingness to pay for reliability capex
  - Unreliable load forecasts
  - Lack of Cost-Benefit analyses
- Insufficient consideration of the networks' excess system capacity and declining system utilisation
- Non-credible assumptions for material and labour escalation rates

THE NETWORKS' EXCESS CAPACITY AND DECLINING UTILISATION

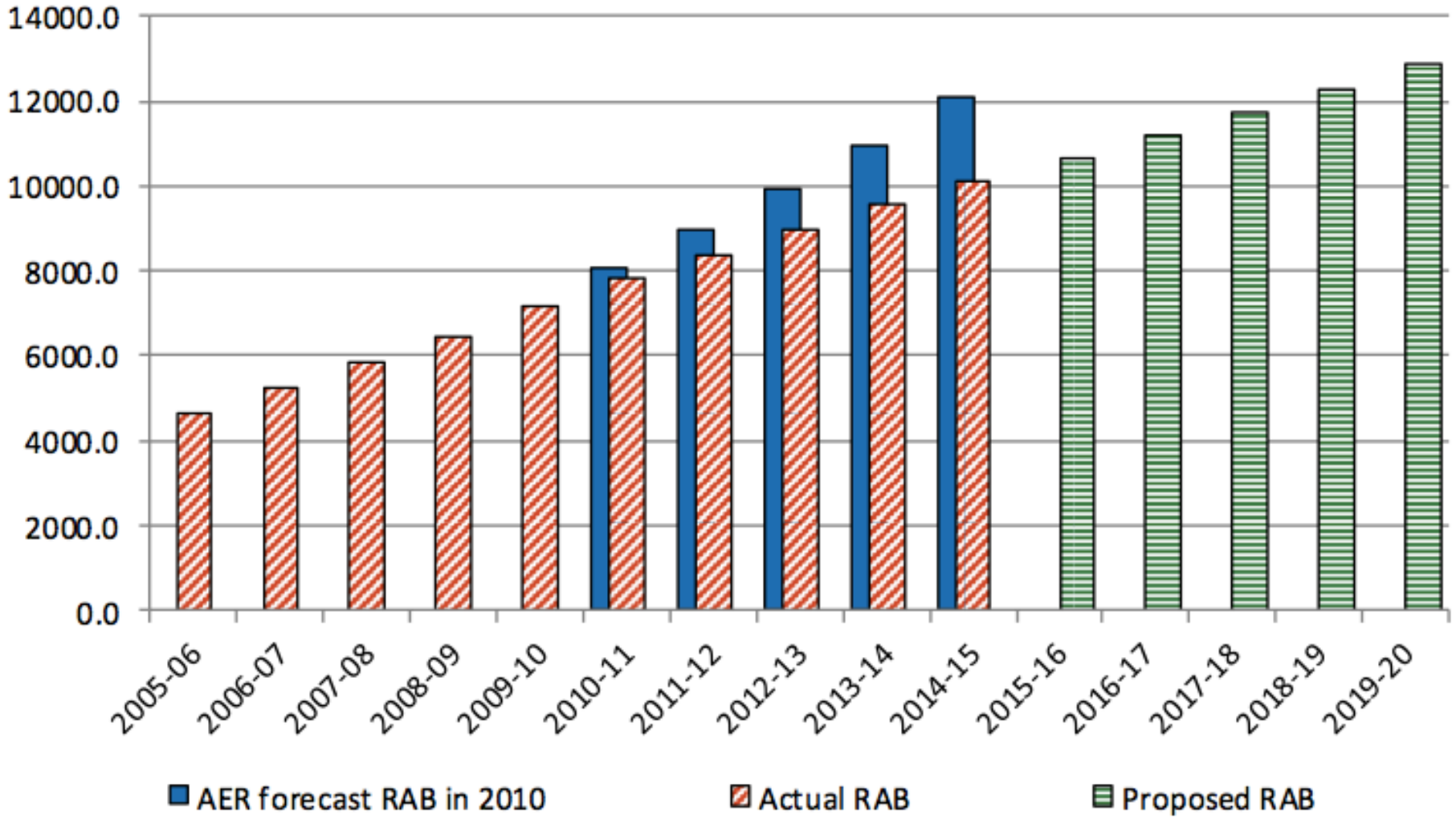
Energex - Historical and Proposed RAB Growth

Figure 9 **Energex – regulatory asset base (RAB) values**



Ergon - Historical and Proposed RAB Growth

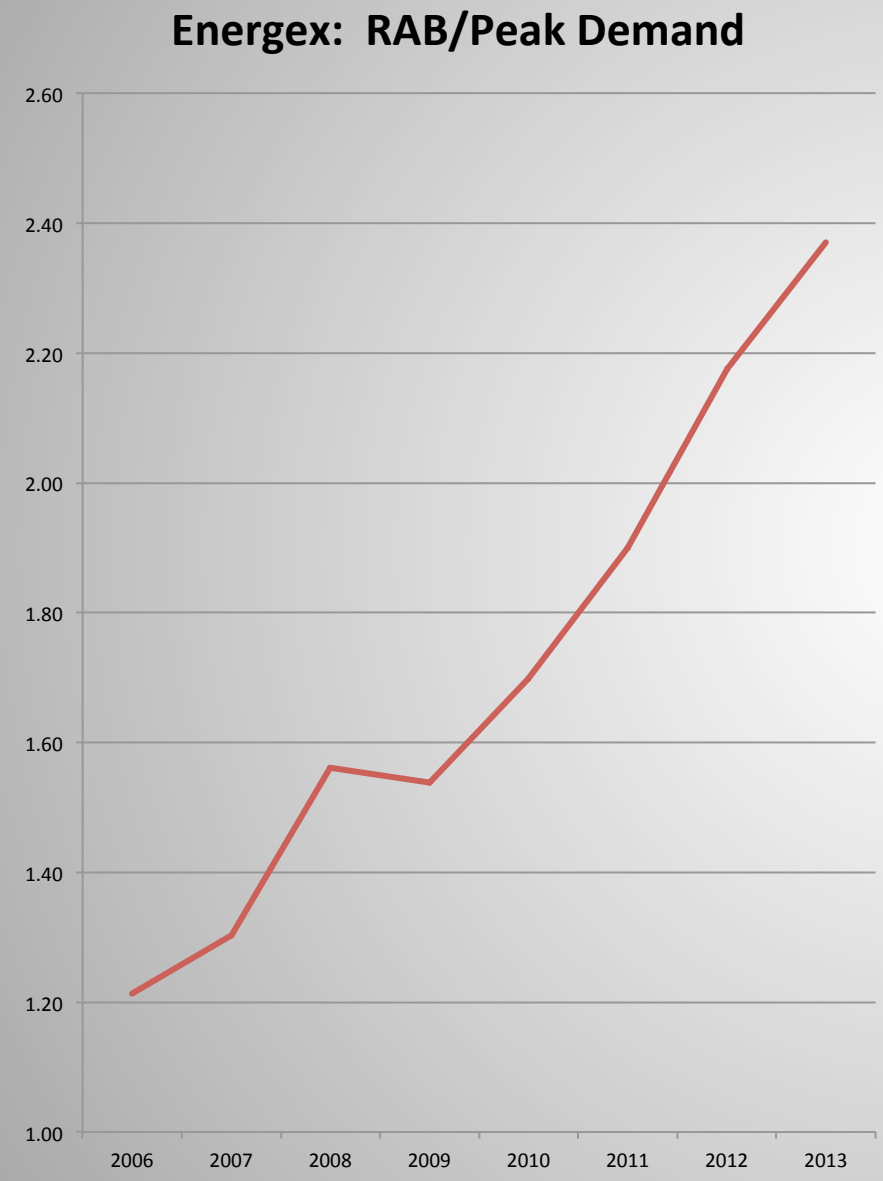
Figure 10 **Ergon Energy – regulatory asset base (RAB) values**



Excess Network Capacity

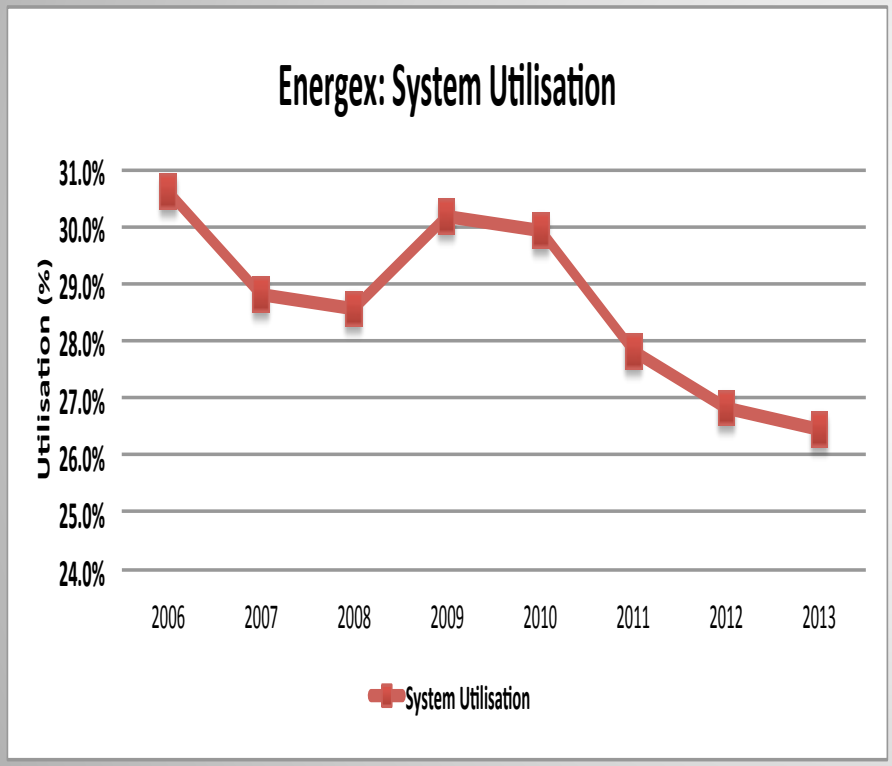
- The networks' major capex programs over the previous decade have produced significant levels of excess capacity on the network
- This excess capacity will ensure that they exceed the requirements of their reliability standards for many years to come
- The AER has not demonstrated that it appropriately considered the networks' excess capacity in its preliminary capex determinations
- These unsustainable trends will continue – the networks' RABs will grow by around 18% over the next period, during which demand is expected to remain flat or decline

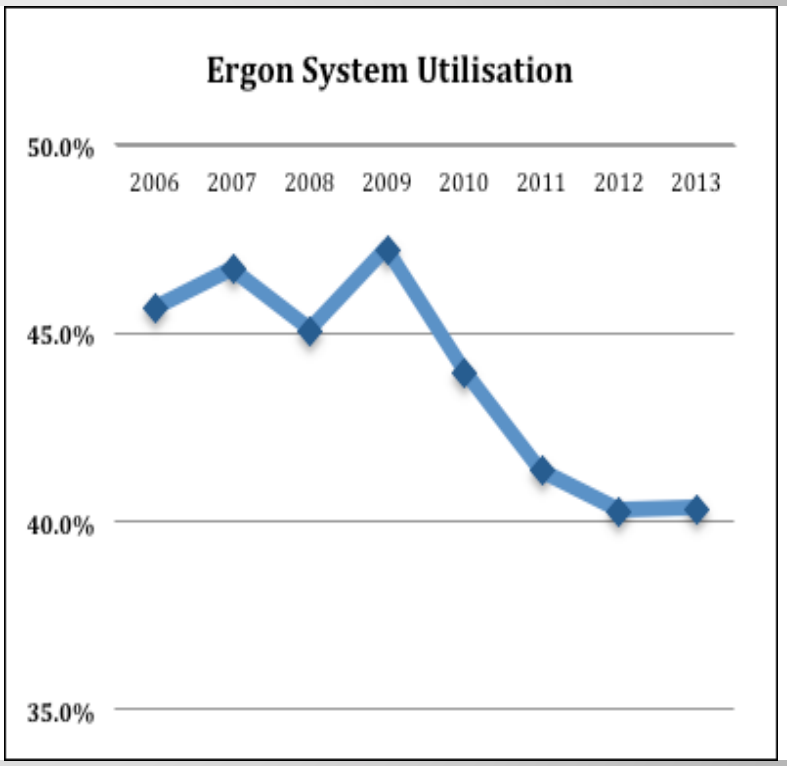
Excess Network Capacity



Source: Derived from Energex and Ergon RINS Data

Declining System Utilisation

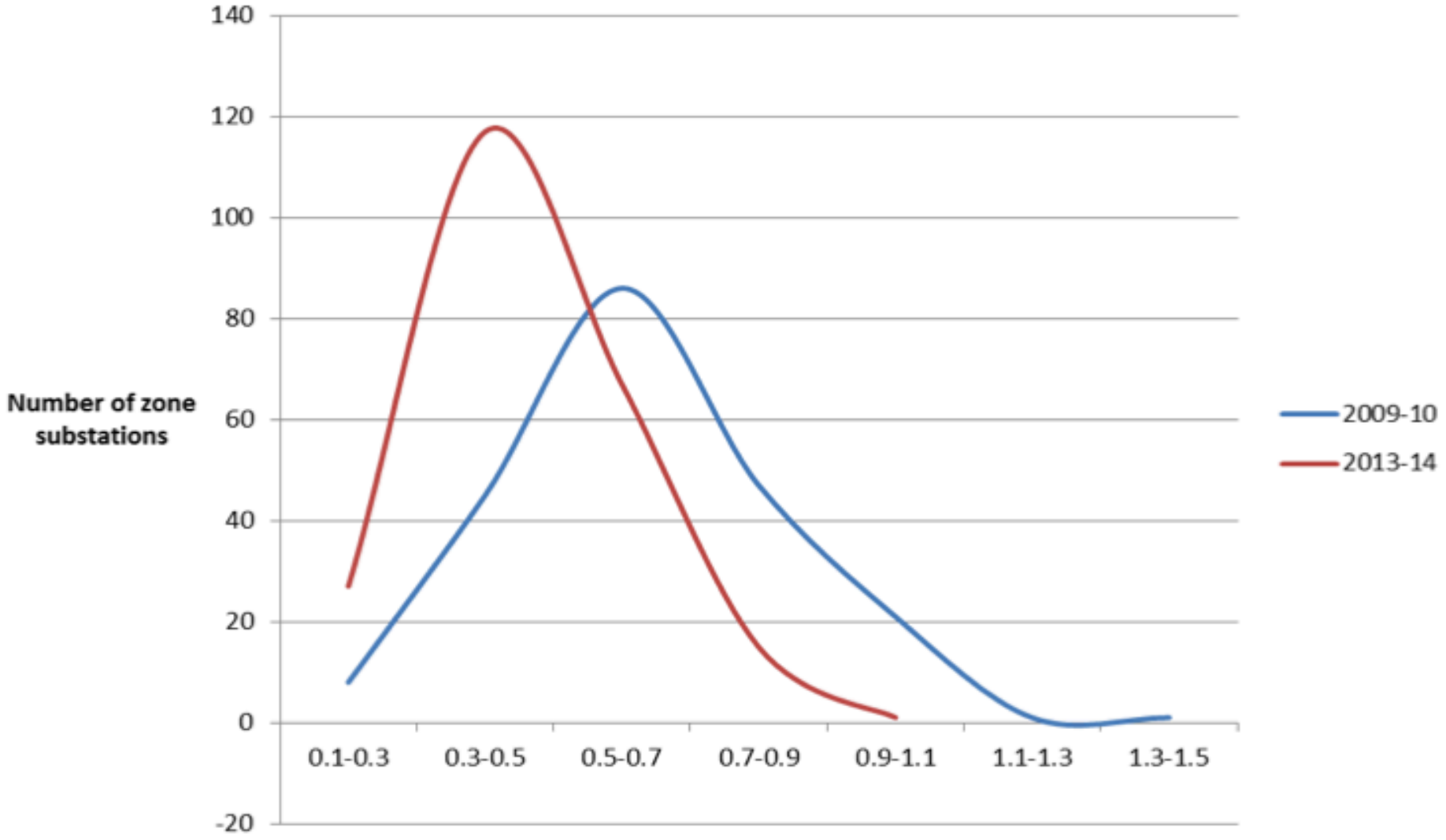




Source: Bev Hughson Analysis of Energex and Ergon RINS Data

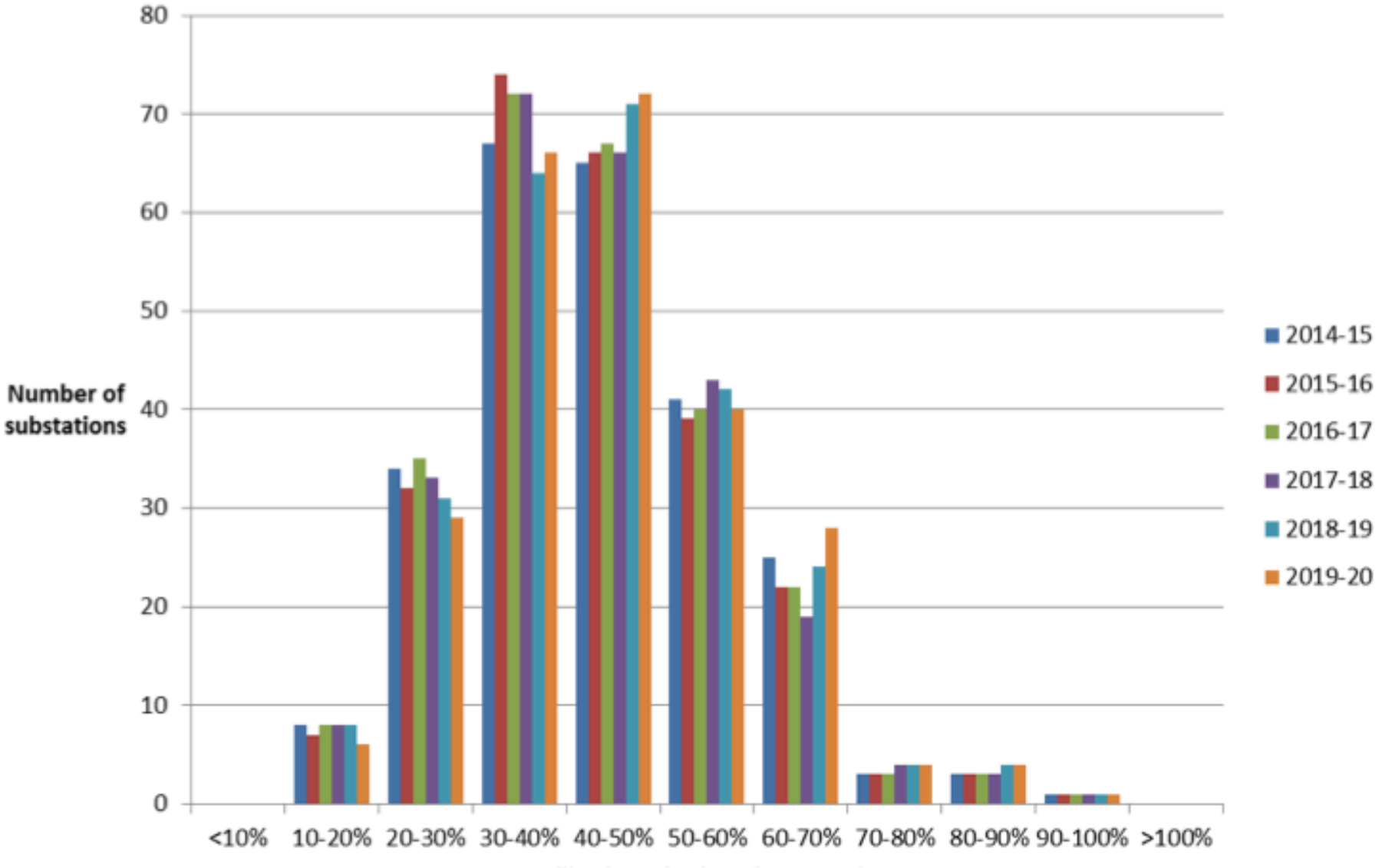
Energex: Recent Substation Utilisation Trend

Figure B-2 Zone substation utilisation 2009–10 and 2013–14



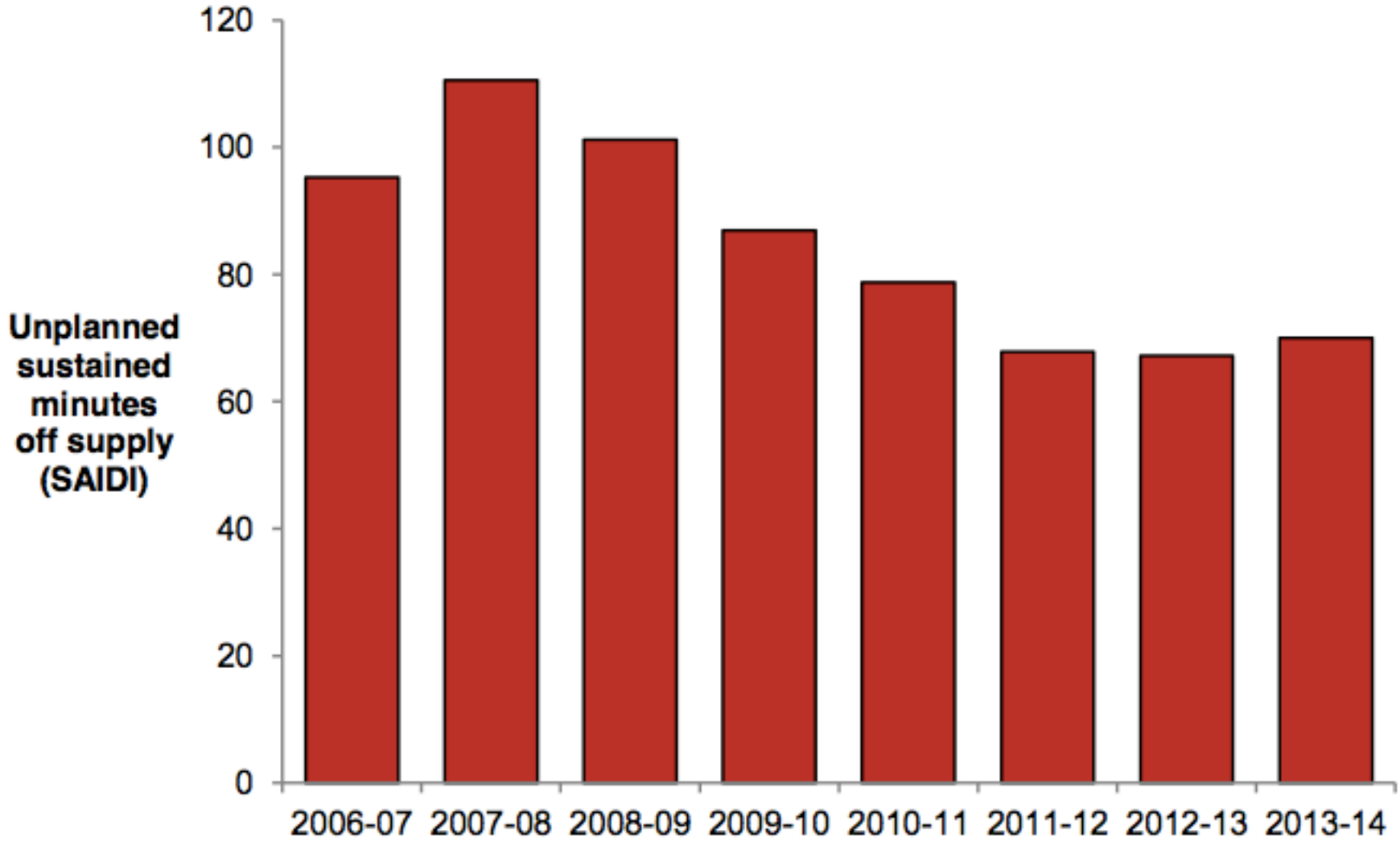
Energex: Forecast Substation Utilisation

Figure B-3 Zone substation forecast utilisation 2014–15 to 2019–20



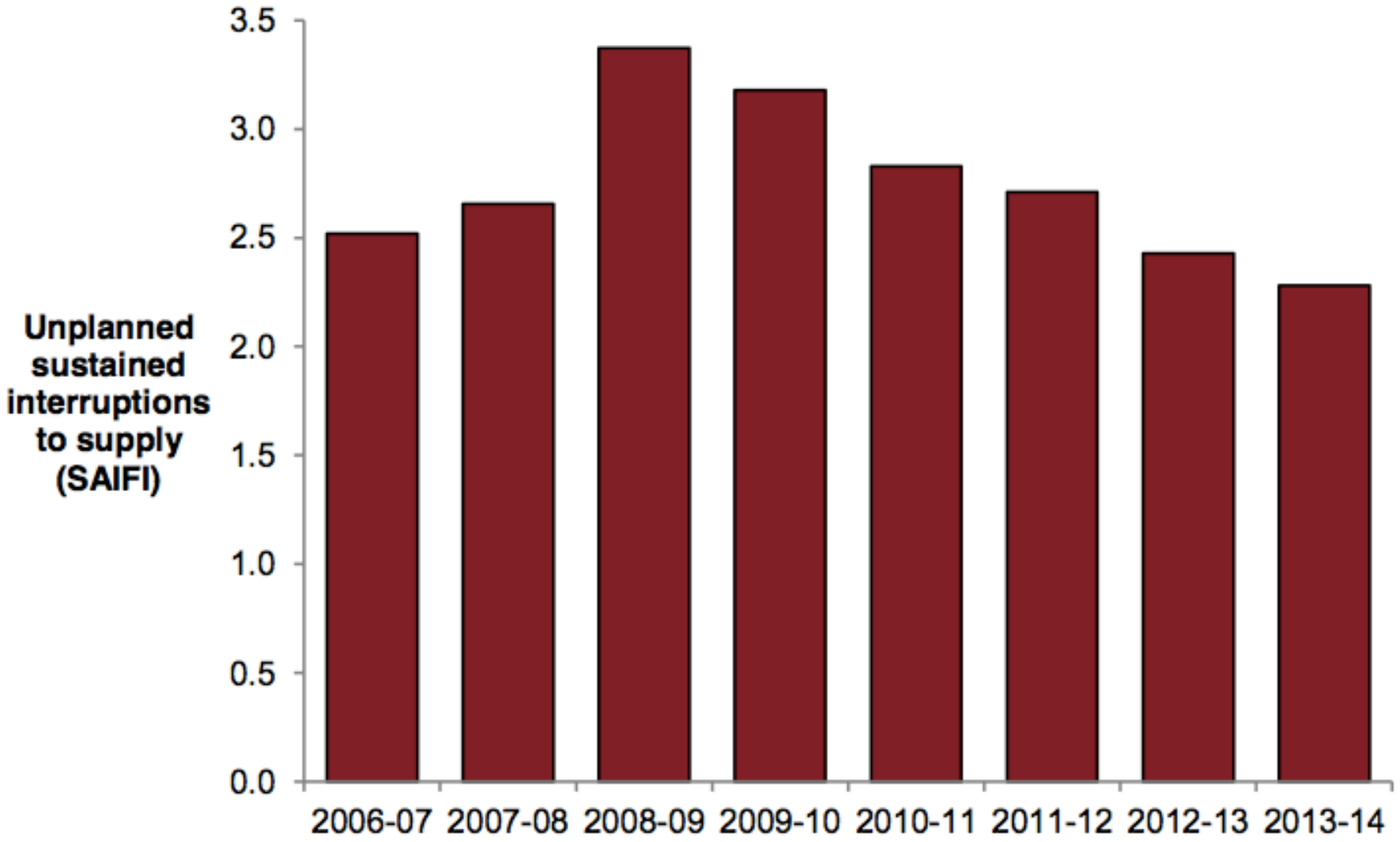
Energex: Reliability Performance Trend

Figure B-6 Energex's reliability performance (SAIDI) 2006–2014



Ergon: Reliability Performance Trend

Figure B.4 Ergon Energy's reliability performance (SAIFI) 2006–2014



Augmentation and Customer Connection Capex

ENERGEX	Proposed	AER Preliminary Determination	Difference
Augmentation	$513 M	$406 M	20% decrease
Customer Connections (net of capital contributions)	$161 M	$100 M	37% decrease
Total	**$674 Million**	**$506 Million**	**25% decrease**

ERGON	Proposed	AER Preliminary Determination	Difference
Augmentation	$660 M	$558 M	15% decrease
Customer Connections (net of capital contributions)	$280 M	$280 M	-
Total	**$940 Million**	**$838 Million**	**10% decrease**

Key Concerns with the AER's Preliminary Augex Determinations

- Insufficient consideration of:
  - The networks' excess capacity and declining utilisation
  - The reduced reliability standards and the value consumers place on reliability
  - The networks' reducing asset age trends
  - The networks' capex efficiency, and the prudency /efficiency of the networks' proposed capex spend
- Inadequate scrutiny of project justifications
  - Load drivers for augmentation projects
  - Reliability drivers for reliability/quality of supply projects
- Over-reliance on trend analysis
- Based on unreliable load forecasts

REPLACEMENT CAPEX

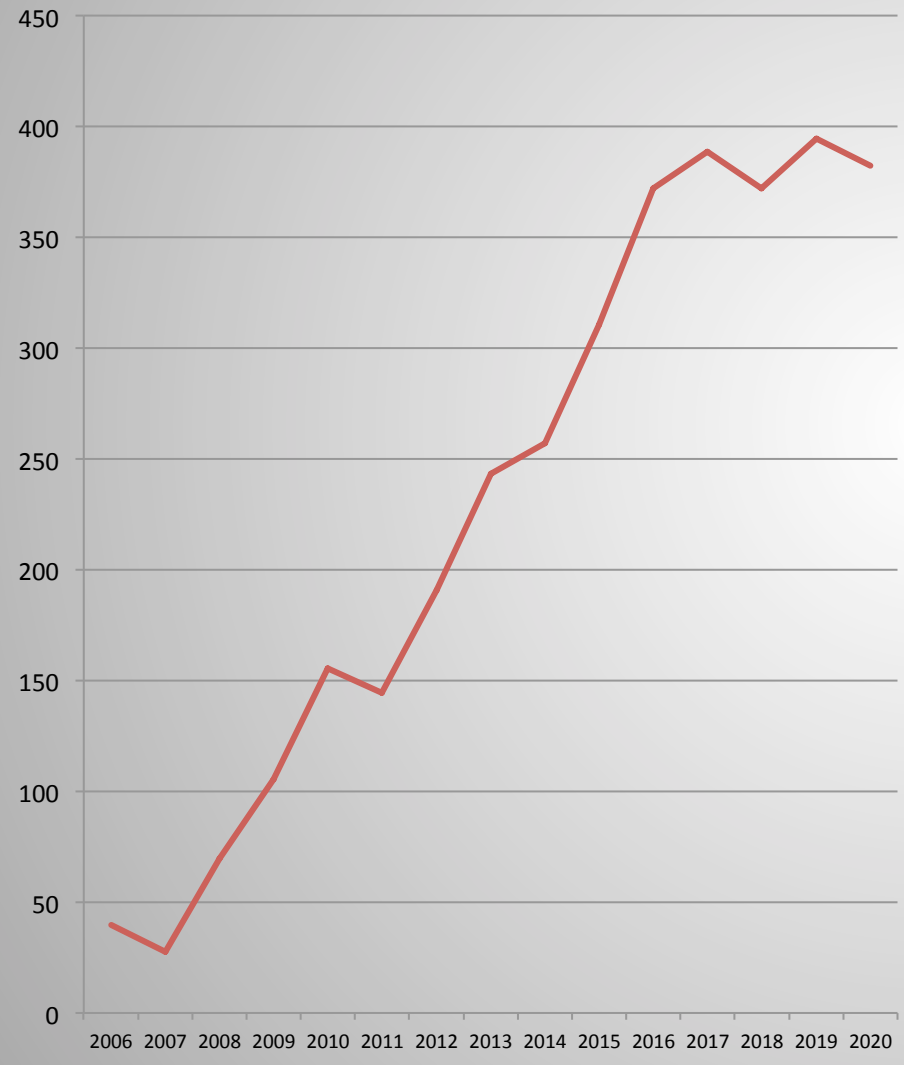
Replacement Capex

"We consider the distributors' repex proposals to be a key issue for our assessment of their regulatory proposals overall…… ***Our general expectation is that repex levels should remain relatively constant over time****"*

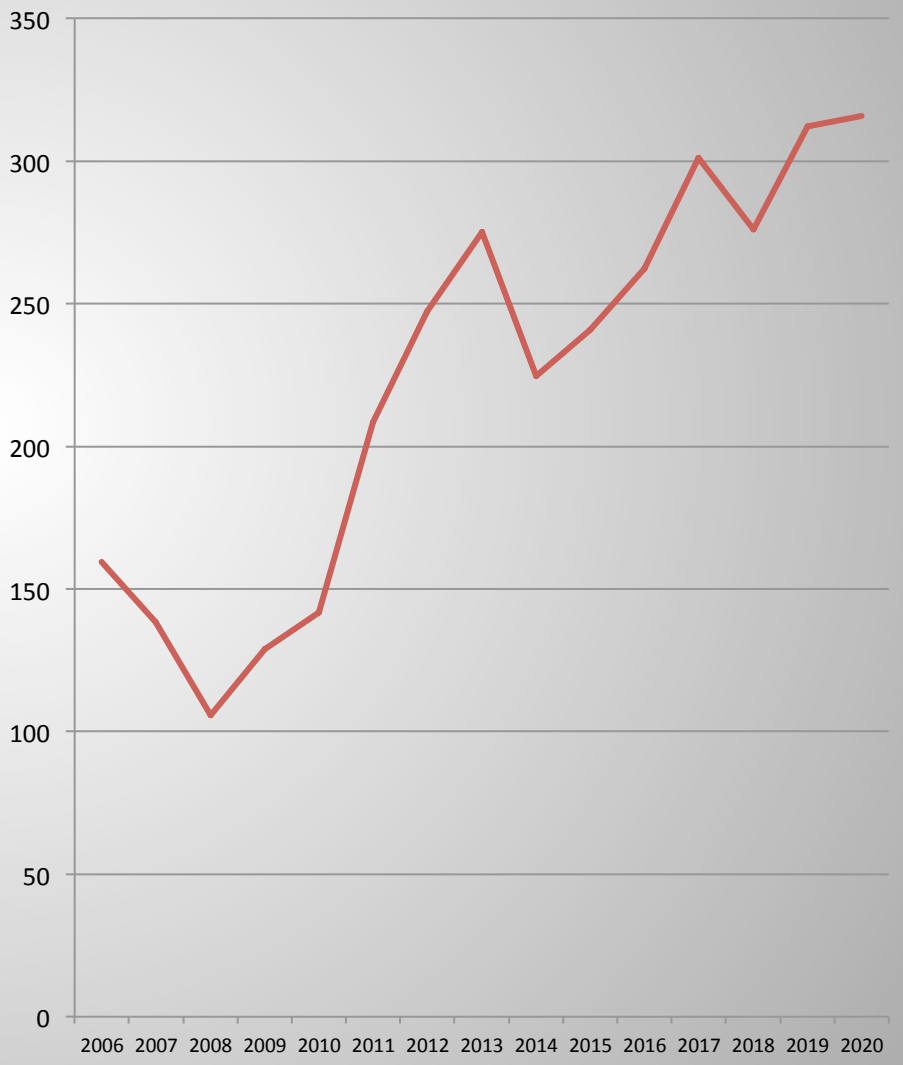
AER Issues paper, Page 15

Qld Networks: Historical/Proposed Replacement Capex

Energex Replacement Capex



Ergon Replacement Capex



Source: Derived from Energex and Ergon RINS Data and 2015-20 Revenue Proposals

Replacement Capex Justifications?

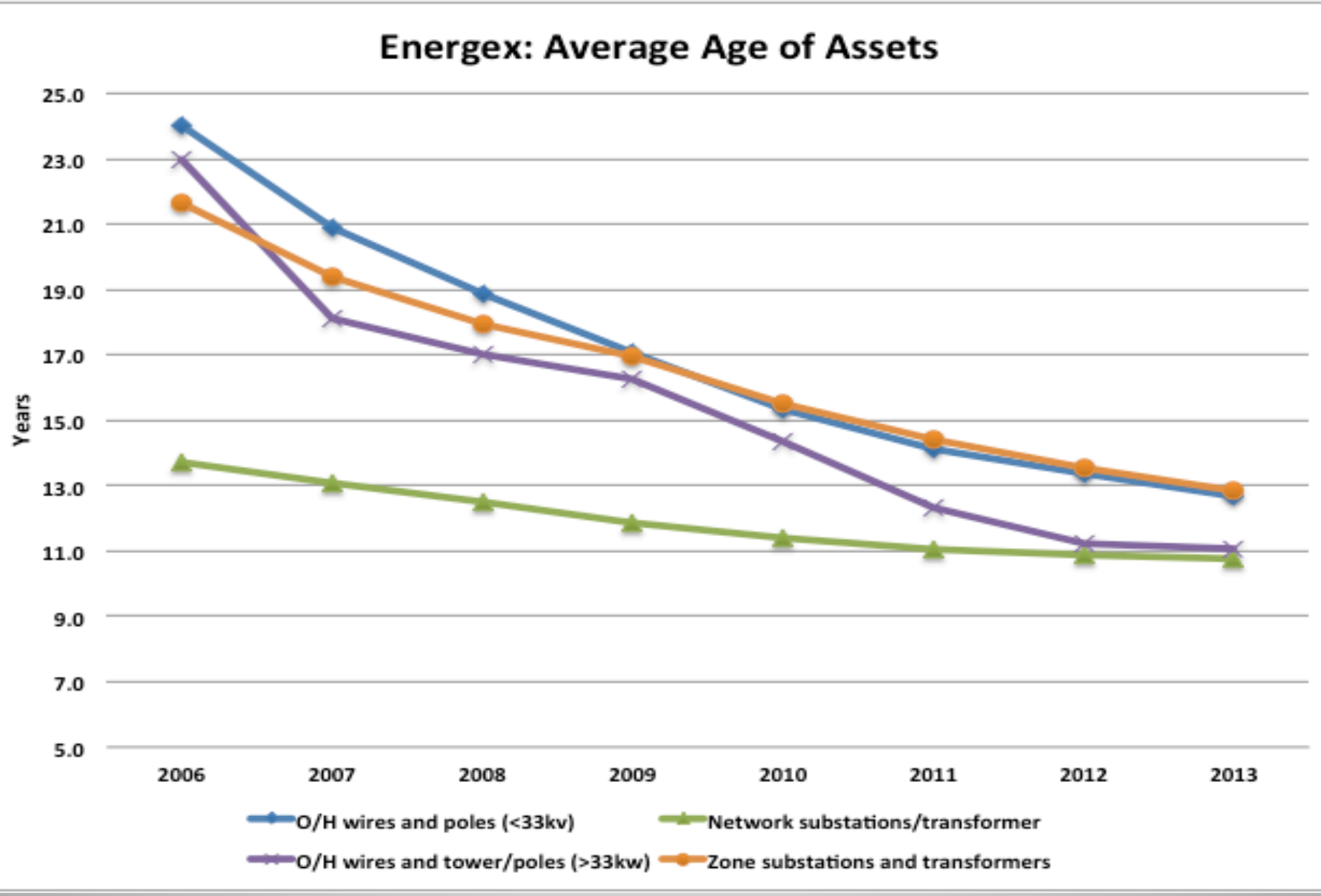
*"Energex is faced with the challenge of monitoring and replenishing its **ageing asset base**"*

Energex Revenue Proposal, P 82

*"Despite undertaking substantial replacement programs in the 2010–15 period, the distributors have submitted that the **average age of network assets continues to increase**. They argue that their **proposed repex is required to maintain the average age of the network within an acceptable range**, consistent with their reliability and safety obligations"*

AER Issues paper, P 15

Energex: Decreasing Asset Ages



Source: Bev Hughson Analysis of Energex and Ergon RINS Data

Key Issues with the Networks' Repex Forecasts

- Excessively conservative risk management/risk assessments
  - Systemic bias to overestimating risks and project scopes
- Insufficient top-down restraint
- Inadequate/poor project justifications
  - The DNSPs have not demonstrated the outcomes (e.g. system performance outcomes) that their major repex programs will deliver
  - Lack of cost-benefit analyses
  - Bias towards bulk replacements of targeted asset categories
  - Insufficient consideration of alternative options to asset replacement (revised maintenance strategies, asset refurbishments, life extensions, etc.)
- Replacements not justified on asset condition
  - Very scant details of actual asset condition information
  - Predominantly based on unjustified assertions regarding average asset ages
- Insufficient consideration of the networks' major repex programs over the past decade

Major Flaws in the Networks' Estimated Asset Lives

"Ergon Energy's estimated replacement lives are shorter than those it achieves in practice"

"Ergon Energy's estimated replacement lives do not reflect its actual replacement practices"

"Energex's estimated replacement lives are shorter than those it achieves in practice"

"Energex's base case lives do not reflect Energex's actual replacement practices"

Source: AER Preliminary Determinations (Attachments 6, Pages 6-79 and 6-80)

AER Preliminary Determinations - Replacement Capex

	Proposed Repex	AER preliminary Determination	Reductions
Energex	$1.25 Billion	$622 Million	50 %
Ergon	$894 Million	$675 Million	24 %
Total	**$2.14 Billion**	**$1.3 Billion**	**39 %**

Source: AER Preliminary Determinations

Key Concerns with the AER's Preliminary Repex Determinations

- Insufficient consideration of actual asset conditions
  - The AER's repex model is too reliant on asset age as a proxy for replacement drivers
- Over-reliance on trend analysis and acceptance of the networks' past asset replacement practices
- Insufficient consideration of the networks recent repex spend
  - The networks' repex programs over the past decade have effectively "pre-installed" a large proportion of their repex needs for the next period

CAPITALISED OVERHEADS

Qld Networks' Overheads: Queensland IRP Report Findings

"The IDC was particularly concerned about the IRP's ***reports of a noticeable cultural disregard for cost within the distribution network businesses"***

"The overhead expenses (indirect costs) of Ergon Energy and Energex have ***grown rapidly in recent years and places the Queensland DNSPs among the least efficient in the NEM"***

"Additional impetus is needed to produce the level of savings required to restore affordability for customers"

AER Preliminary Determinations - Capitalised Overheads

	DNSPs' Proposed Capex	AER Preliminary Determinations	Reductions
Energex	$900 Million	$824 Million	**8.5 %**
Ergon	$1,017 Million	$962 Million	**5 %**
Total	**$1,917 Million**	**$1,786 Million**	**7%**

Concerns with the AER's Preliminary Capitalised Overheads Determination

- The AER has only applied very minor reductions to the networks' proposed capitalised overheads

- The AER's preliminary allowances are predominantly based on maintaining the DNSPs' historical ratios of capitalised overheads to total overheads

- The AER appears to have accepted the networks claims that the majority of their overheads are "fixed":
  - Energex claims that around 80% of its overheads are "fixed'
  - Ergon claims that around 87% of its overheads are "fixed"

The AER is required to determine its allowances based on efficient costs - not historical costs

Concerns with the DNSPs' ICT Expenditure

- ICT expenditure accounts for around 35% of the DNSPs' capitalised overheads
- Energex and Ergon fully own their ICT supplier - SPARQ
- SPARQ's costs have not been market tested, despite:
  - Extensive evidence that there is scope for significant efficiencies
  - The AER identifying that applying 'benchmark efficient costs' would result in an approximate 65% reduction to the networks' proposed costs
- The networks' have not progressed many of the efficiency improvement recommendations proposed by the *Independent Review Panel (IRP) on Network Costs*
- The networks will materially over-recover their ICT financing costs
- The networks are not transparently reporting their ICT costs

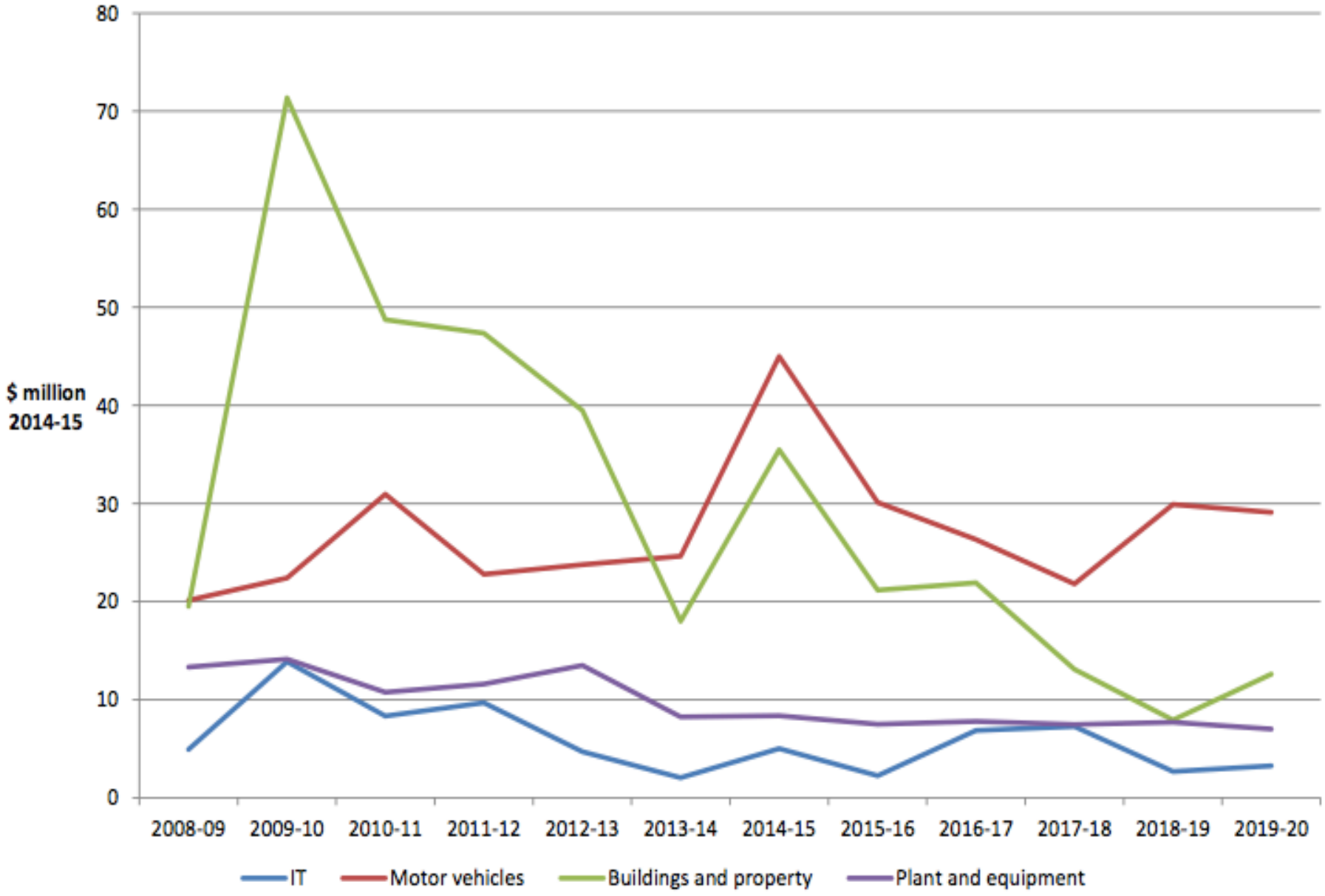
Despite the above concerns, the AER has not applied any reductions to the networks' proposed ICT costs

NON-NETWORK CAPEX

AER Preliminary Determinations: Non-Network Capex

	Proposed Capex	AER preliminary Determinations	Reductions
Energex	$244 Million	$244 Million	-
Ergon	$506 Million	$420 Million	17 %
Total	**$750 Million**	**$664 Million**	**11%**

Figure B-14 Energex's non-network capex by category ($million, 2014–15)



Key Concerns with the AER's Preliminary Non-Network Capex Allowances

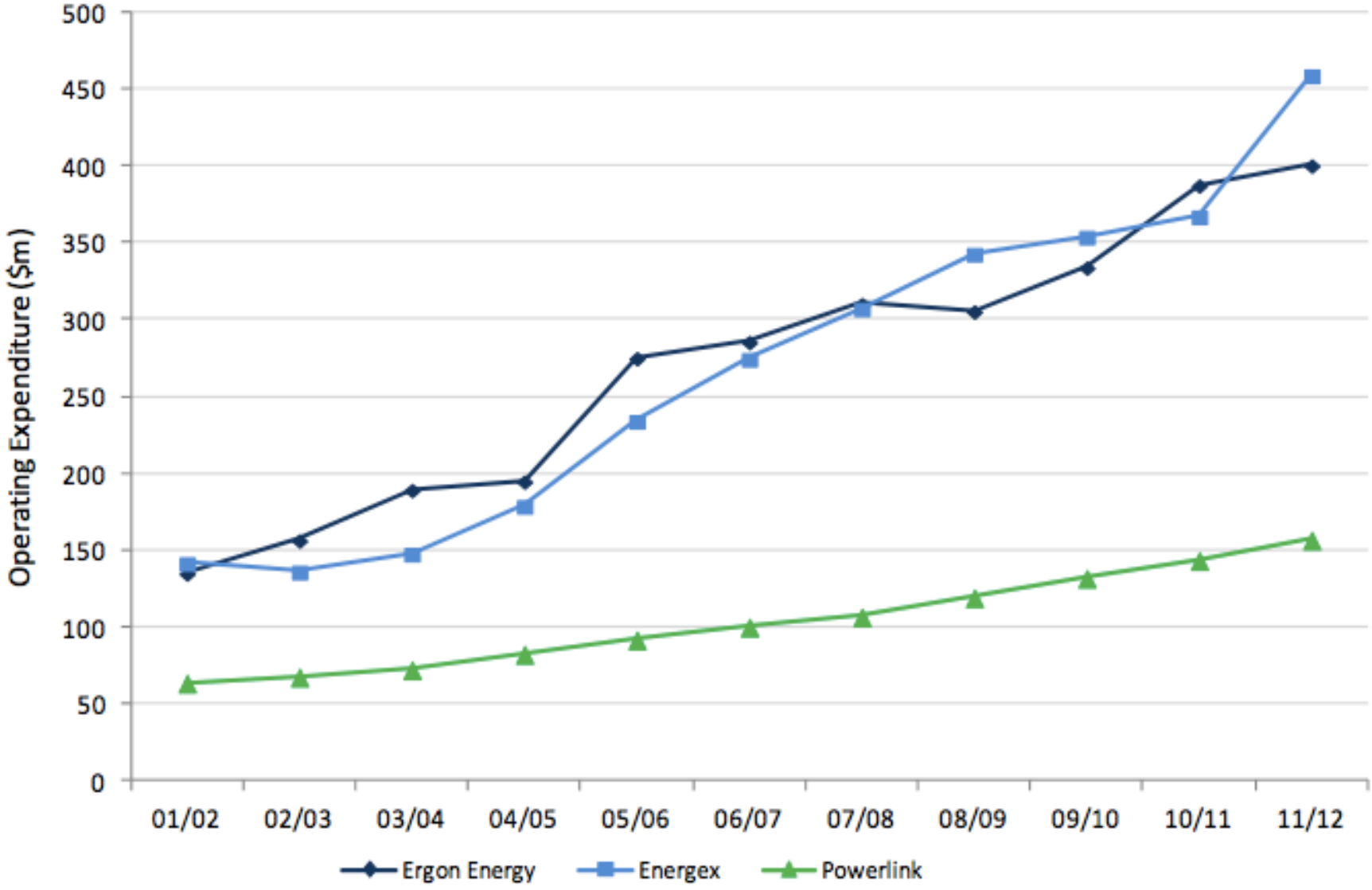
- Insufficient consideration of:
  - The major efficiency improvements opportunities outlined in the IRP report
  - The networks' projected reductions in workforce numbers
  - The networks capex efficiency, and the prudency /efficiency of the networks proposed capex spend
- Inadequate scrutiny of project justifications
- Over-reliance on short-term trend analysis (previous 5 years)

The AER is required to determine its allowances based on efficient costs – not historical costs

OPEX

Qld Networks: Opex Growth Trend

Figure 20. Regulated Operating Expenditure, 2001/02 -2011/12



Source: Queensland Government Independent Review Panel (IRP) on Network Costs

Opex Benchmarking

- The Rules formally require the AER to:
  - Undertake benchmarking to assess the relative efficiencies of networks
  - Apply the outcomes to determine efficient costs for the networks
- This is the AER's first attempt at applying benchmarking to the determination of opex allowances for the distribution networks

Opex Efficiency

Figure 19 **Partial factor productivity of opex**

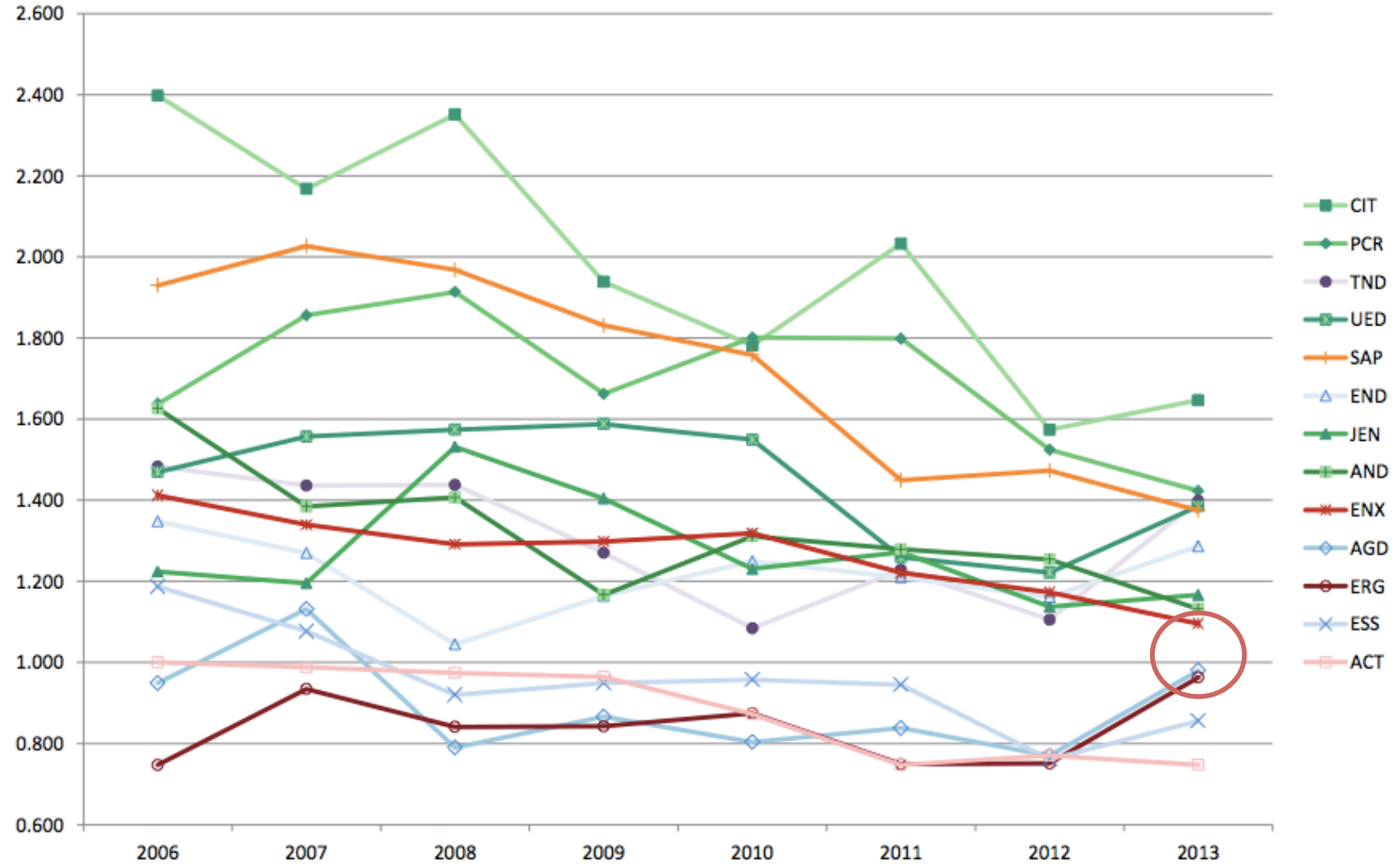
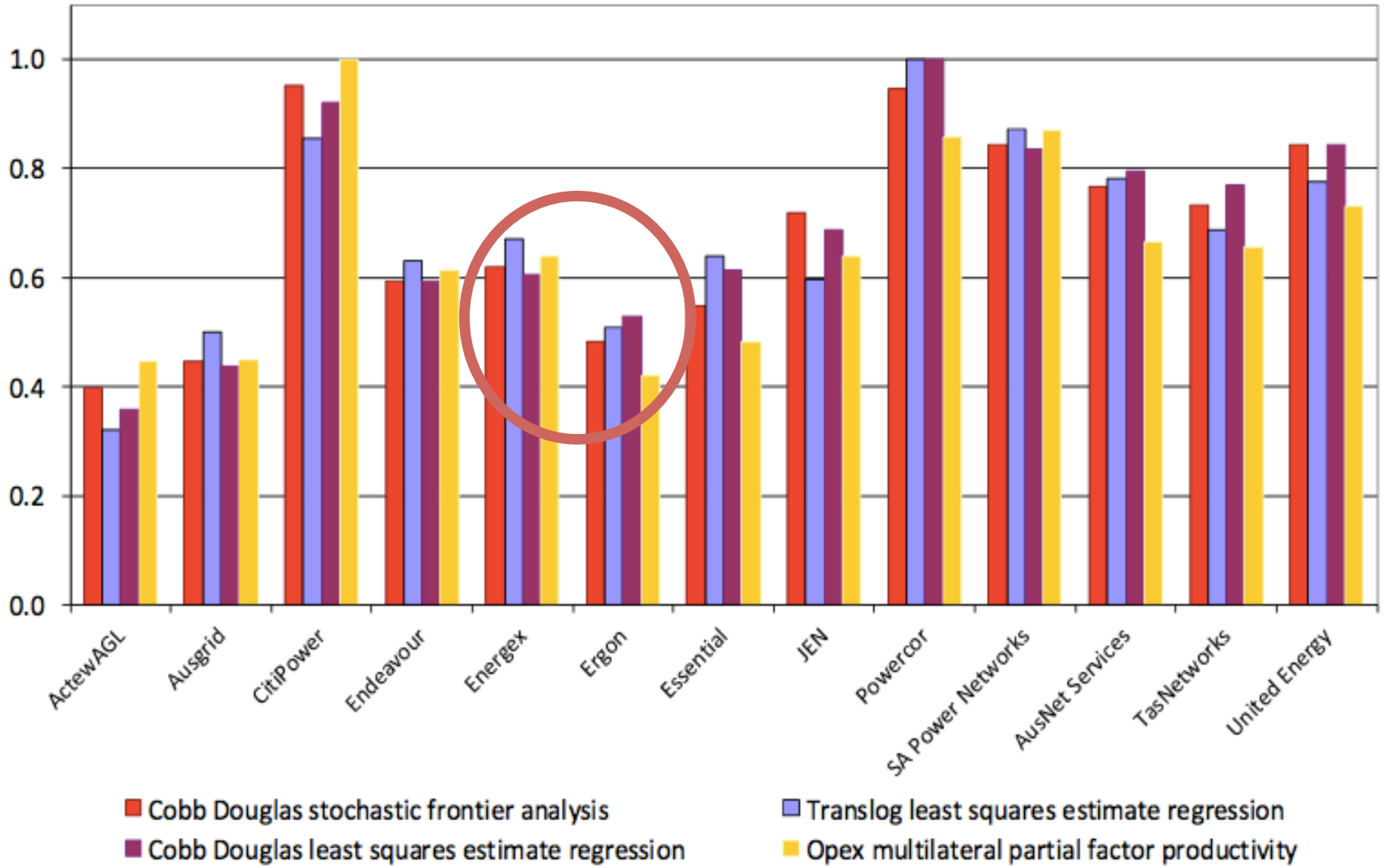


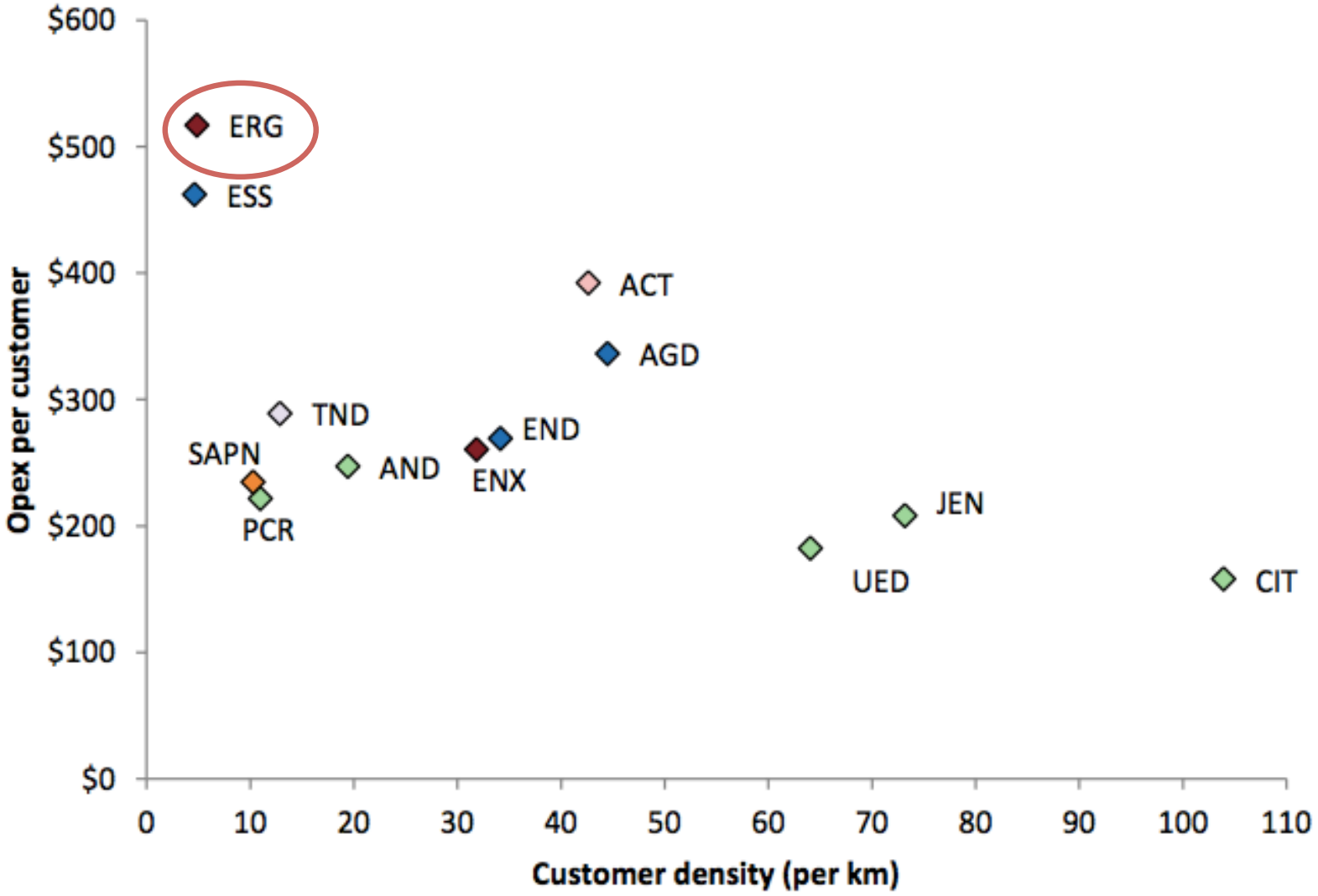
Figure 8-6 Econometric modelling and opex MPFP results



Source: Economic Insights.

Opex per Customer

Figure 12 **Operating expenditure per customer compared to customer density (average 2009–2013)**



Benchmarking Results - Opex Efficiency Gaps

Table 4.2 **DNSP opex efficiency scores and implied opex reductions to reach full efficiency, 2006–2013**

DNSP	*Average opex efficiency score*	*Implied opex reduction to reach full efficiency*
CIT	1.000	0%
SAP	0.869	13%
PCR	0.857	14%
UED	0.730	27%
AND	0.665	34%
TND	0.657	34%
JEN	0.639	36%
ENX	0.639	36%
END	0.613	39%
ESS	0.482	52%
AGD	0.449	55%
ACT	0.445	56%
ERG	0.422	58%

Deloitte's Findings on Ergon's Opex Costs

- Ergon has very high labour costs and employee numbers compared to interstate networks

- Ergon's EBA provisions severely restrict its workforce flexibility and productivity, e.g.:
  - No forced redundancies
  - Contractors are unable to perform certain tasks (unique to Queensland)
  - Prohibiting certain activities from being conducted by a single person (unique to Queensland)
  - Restrictions on outsourcing
  - Minimum apprentice numbers

- Ergon has not implemented various IRP recommendations, e.g.:
  - Market testing the ICT services provided by SPARQ
  - Implementing a local service agenda LSA model for its regional depots

Labour and Workforce Practices - Qld Govt IRP Report

"The IDC was particularly concerned about the IRP's ***reports of a noticeable cultural disregard for cost within the distribution network businesses"***

"The capital programs and operating costs of the GOCs have ***increased sharply and unsustainably****"*

"Overhead expense (indirect costs) have grown rapidly in recent years and places the Queensland DNSPs among the least efficient in the NEM"

"Across the three companies, ***647 employees earned in excess of 1.5 times their base pay….27 employees earned twice their base pay in 2011/12"***

*"Contract resources are used inefficiently……****internal resources are being under-utilised****"*

"The start times of work crews are often not matched to the requirements of particular projects. ***A rigid adherence to these start times means that there is a mismatch, leading to reduced productivity*** *and possibly longer outage durations"*

*"****The differences in fatigue management policies*** *complicate crew scheduling and joint workforce management* ***leading to response delays, inefficiencies and potential safety issues****"*

The AER's Process for Determining Efficient Base Opex

1. Determination of the networks' raw opex efficiency scores using benchmarking
2. **Determination of the *'Benchmark Comparison Point'***
3. **Adjust the raw efficiency scores for *'Operating Environment Factors'***
4. Calculate the percentage reduction in opex
5. Calculate the mid-point efficient opex
6. Trend the midpoint efficient opex forward to the base year
7. Adjust the estimate by CPI to the first year of the new regulatory period

The AER's Determination of the 'Benchmark Comparison Point'

- Rather than apply the benchmark comparison point at the level of the most efficient DNSP (Citipower), the AER has set it at 0.77 - the lowest of the efficiency scores in the top quartile (AusNet Services)

- The AER claims that ....."***a more cautious target is appropriate,*** *particularly given this is the first time economic benchmarking is being used as the primary basis for an Australian regulatory decision"*

- The AER has not justified its decision not to adopt the frontier DNSP as the benchmark comparison point

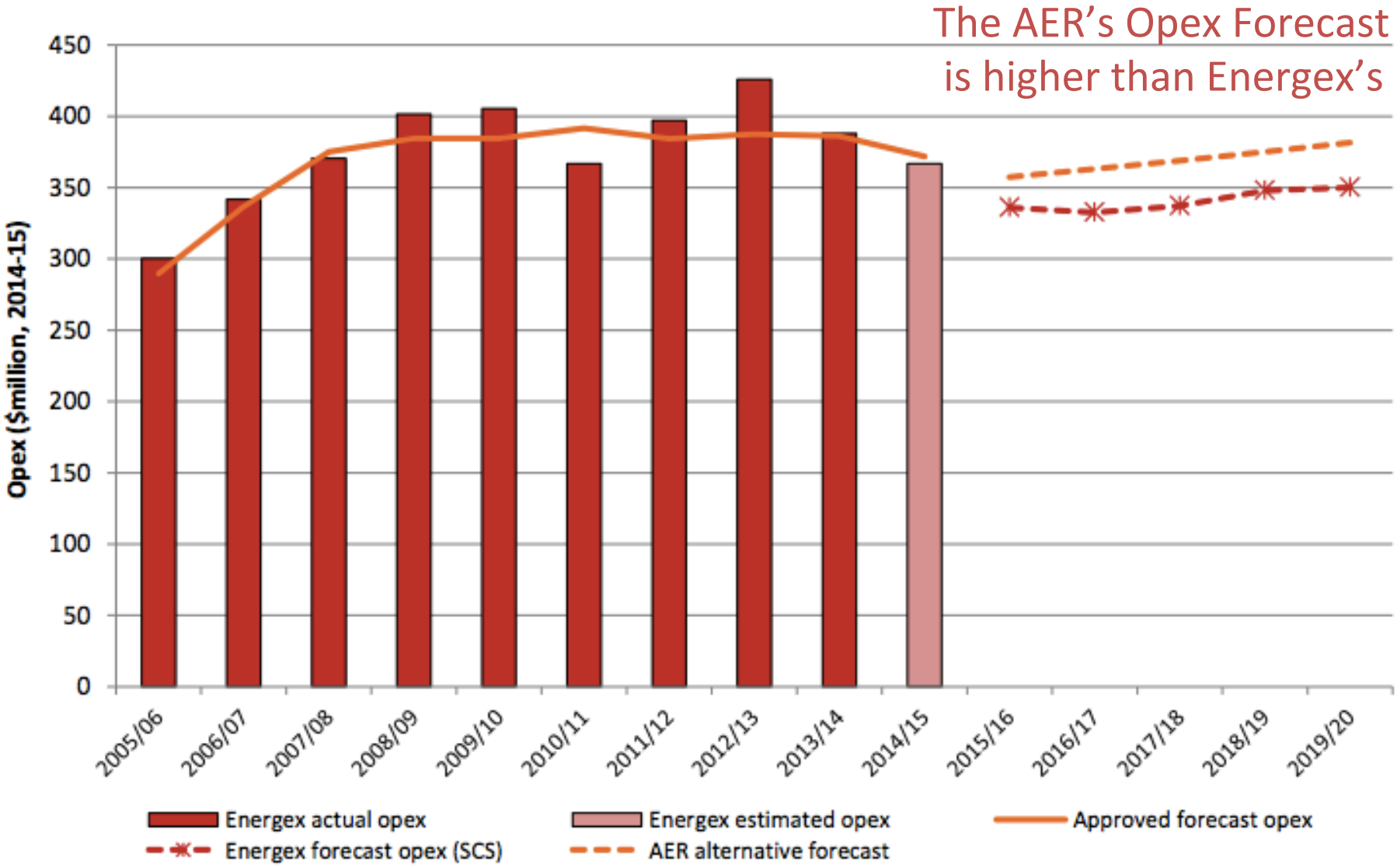
- This adjustment is inconsistent with the AER's obligations under the NEL/ NER

The AER's Operating Environment Factor Adjustments

Factor	Energex	Ergon
Bushfires	- 0.5%	- 2.6%
Cyclones	0.0%	4.6%
Extreme weather	2.7%	3.0%
Licence conditions	0.0%	0.7%
Network Access	0.0%	1.1%
OH&S regulations	0.5%	0.5%
Taxes and levies	2.7%	1.7%
Termite exposure	0.2%	0.5%
Subtransmission	3.2%	4.6%
Vegetation management	3.4%	4.1%
Immaterial factors	**5.0%**	**6.1%**
Total	**17.1%**	**24.4%**

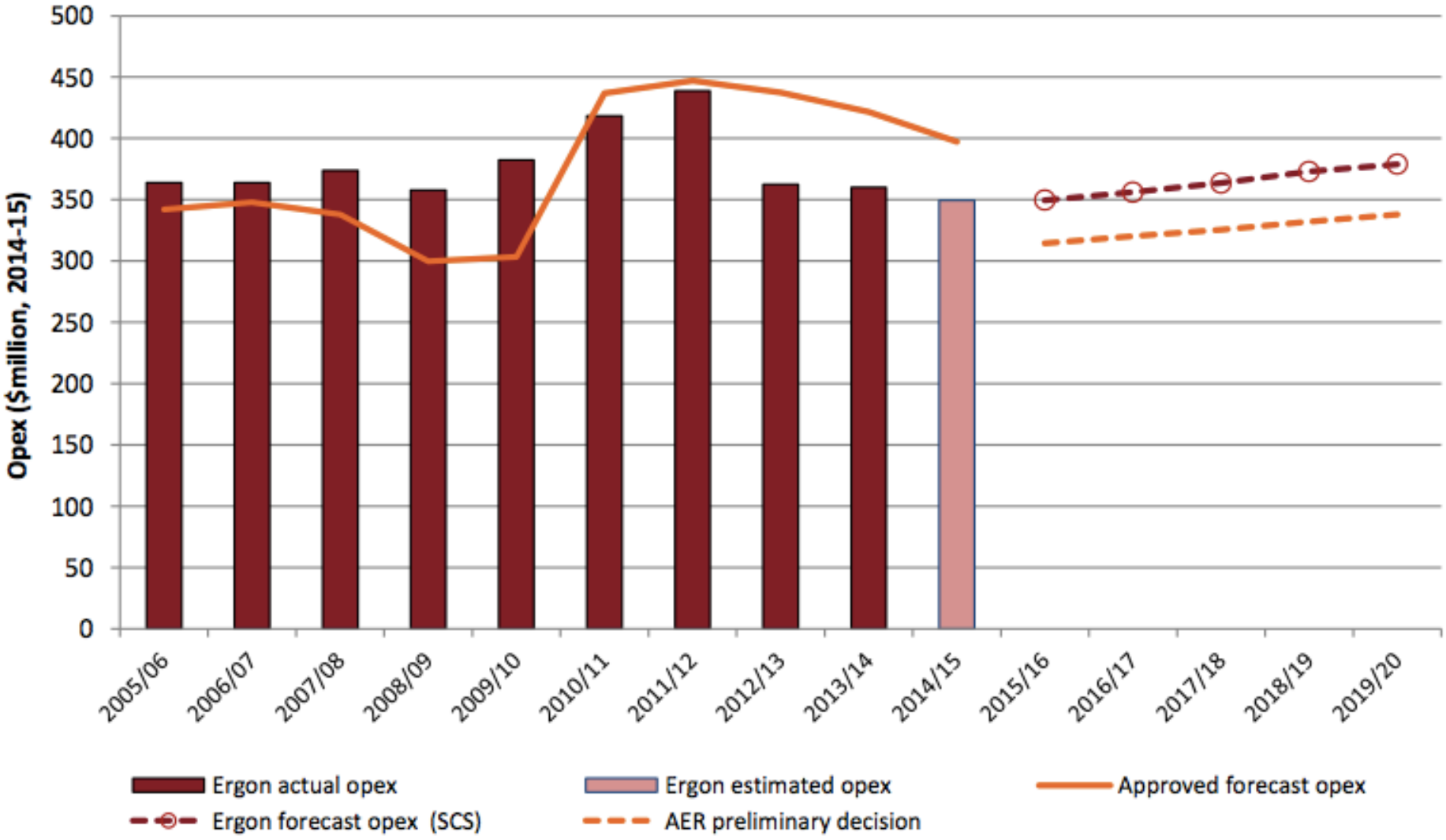
AER Preliminary Opex Determination for Energex

Figure 7 AER preliminary decision compared to Energex's past and proposed opex ($million, 2014–15)



AER Preliminary Opex Determination for Ergon

Figure 7 AER preliminary decision compared to Ergon Energy's past and proposed opex ($million, 2014–15)



Ergon's Expectations regarding the AER's Opex Determination

Implications of AER approach for Ergon Energy

Aspects of the AER's draft NSW DNSPs decision that impact us:

- AER has indicated they will apply the same benchmarking techniques to Queensland
- AER has indicated in draft NSW Decisions that they consider our opex 'materially inefficient'
- Ergon Energy could expect expenditure reductions ranging from 20-40% off our 2015-20 submission.

Source: Ergon Energy Presentation to Customer Council, April 2015

The AER's Preliminary Opex Determinations

	Proposal	AER preliminary Determinations AER2014/15 - 2018/19	Reduction
Ergon	$1,821 Million	$1,630 Million	10 %
Energex	$1,738 Million	$1,738 Million	-
Total	**$3.6 Billion**	**$3.4 Billion**	**5%**

Key Concerns with the AER's Preliminary Opex Determinations

- The AER has not justified its **ultra-conservative** adjustments to the determination of efficient opex, e.g.:
  - Its decision not to adopt the frontier DNSP as the 'benchmark comparison point'
  - Its 'operating environment factor' adjustments
- These adjustments are inconsistent with the AER's obligations under the NEL/NER
- The AER's **ultra-conservative** opex allowances would deliver 'windfall gains' of around $1.3 billion to the Qld DNSPs:
  - $600 million to Energex
  - $700 million to Ergon

Summary

- The AER's Preliminary Determinations for Energex and Ergon Energy are very disappointing
- There is extensive evidence to support significant reductions to the AER's preliminary WACC, capex and opex allowances
- Those reductions would still deliver very generous returns to Energex and Ergon and better reflect consumers' long term interest

Thank You

Hugh Grant

AER Consumer Challenge Panel Member