QUEENSLAND ELECTRICITY USERS NETWORK

"Advocating for affordable and reliable electricity in Queensland"

Submission
To
Australian Energy Regulator

On
The Process for Reviewing the Rate of Return Guideline

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OVERVIEW

The Rate of Return Guideline is a major driver of rising power bills throughout the National Electricity Market. Consequently, it is imperative that the Australian Energy Regulator (AER) provides consumer advocates throughout Australia with the same opportunity as network businesses to input into the Rate of Return Guideline.

Equitable representation from all classes of consumers

Throughout the National Electricity Market there is a dearth of representation from advocates representing small business, middle Australia and regional consumers.

The Australian Energy Regulator needs to actively engage with this under-represented class of consumers. In particular regional consumers, as the network component of a power bill is higher in regional Australia compared to capital cities. Therefore, business and residential consumers in regional Australia are more affected than urban consumers by rises in the regulated revenue of distribution and transmission networks.

For example, in Queensland the Ergon Energy distribution network covers 97 percent of the geographic area of Queensland, has a line length of 140,415 km and a customer density of 5.3 customers per kilometre. In comparison, the Energex distribution network covers only 3 percent of Queensland has a line length of 43,798 km and a customer density of 32.5 customers per kilometre.

Consumer advocates based in regional Australia also face the additional hurdle of being chronically under resourced both in financial and human terms.

To ensure equitable participation from regional consumers it is essential that the Australian Energy Regulator organises and provides at no cost to regional consumers, video and telephone conferencing links to workshops and information sessions on the Rate of Return Guideline.

The review needs to investigate the ratio of the Weighted Average Cost of Capital (WACC)

The current Rate of Return Guideline was released by the Australian Energy Regulator in December 2013. Global interest rates and the ownership of Australian electricity assets have changed significantly since 2013.

Historically, electricity assets in Australia were largely owned by state governments. In a global financial market offering limited opportunities for lucrative guaranteed returns, Australia's electricity assets have attracted strong investment from private & public companies and foreign governments.

This is evidenced by investors willing to be pay 1.6 times the value of an electricity asset's Regulated Asset Base, above the 1.4 - 1.5 times analysts and investors say a company can afford to pay for electricity network assets and still make money.

High gearing ratios have also become a feature of electricity assets owned by state governments such as Ergon Energy, the 100 percent Queensland Government owned regional distribution network.

Ergon Energy's gearing ratio (debt to fixed assets) has risen significantly to 67.5 percent since the dividend payment of $1.925 Billion in 2014-15 (see Table 1). This does not reflect the 60/40 ratio used by the Australian Energy Regulator to calculate the Weighted Average Cost of Capital (see Table 2).

Table 1: Ergon Energy Financial Performance Targets

Table 2: Financial Performance Targets

Quarter 2015/16 Sep	Dec	Mar	Jun		2014/15 Budget	2014/15 Est Actual	2015/16 Forecast
242.3	294.6	337.4	217.3	EBIT (consolidated)	1,187.4	1,300.7	1,091.6
128.8	155.2	180.5	95.9	Net Profit After Tax (NPAT) – Consolidated ($M)	590.7	693.0	560.4
-	-	-	-	Return on Assets[1] – Consolidated	9.7%	11.3%	9.2%
-	-	-	-	Return on Assets – Regulated	10.7%	11.5%	8.0%
-	-	-	-	Return on Assets – Non-Regulated	16.0%	13.9%	17.2%
-	-	-	-	Return on Assets – Group excluding EEQ	9.1%	9.4%	8.0%
53.0%	71.8%	70.0%	67.5%	Debt to Fixed Assets[2] (%) – Consolidated	48.1%	51.8%	67.5%
74.0%	78.3%	76.5%	79.4%	Debt / (Debt + equity (including reserves)) – (%) Consolidated	57.1%	74.6%	79.4%
-	-	-	-	Fixed Asset Turnover[3] – Consolidated	0.2	0.2	0.2
5.7	5.3	5.4	3.9	Interest Cover[4] (EBITDA Times) - Consolidated	4.7	5.4	5.0

Notes:

1. Return on Assets (%) = [EBIT/Average of opening & closing assets]. (Assets = "Total Assets")
2. Debt to Fixed Assets (%) = Debt/[Net PP&E]
3. Fixed Asset Turnover = [(Sales + grid services revenue)/Average PP&E]
4. Interest Cover (EBITDA Times) = [EBITDA/(Finance Charges]

Source: Ergon Energy Statement of Corporate Intent 2015-16

Table 2: AER – Ergon Energy distribution determination – 2016-17 return on debt update

Ergon - Cost of Capital Parameters - DNSP PTRM - version 3

Year		2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Inflation Rate	Constant	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Value of Imputation Credits (gamma)	Constant	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%
Proportion of Equity Funding	Constant	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%
Proportion of Debt Funding	Constant	60%	60%	60%	60%	60%	60%	60%	60%	60%	60%
Post-tax Nominal Return on Equity	Constant	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%
Post-tax Real Return on Equity	Constant	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%
Corporate Tax Rate	Varying	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%
Nominal Pre-tax Return on Debt	Varying	5.01%	5.06%	5.06%	5.06%	5.06%	5.06%	5.06%	5.06%	5.06%	5.06%
Real Pre-tax Return on Debt	Varying	2.45%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
		Formula approximations of WACC									
Nominal Vanilla WACC	**Varying**	**6.01%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**
Real Vanilla WACC	Varying	3.42%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%
Post-tax Nominal WACC	Varying	5.47%	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%
Post-tax Real WACC	Varying	2.89%	2.92%	2.92%	2.92%	2.92%	2.92%	2.92%	2.92%	2.92%	2.92%
Pre-tax Nominal WACC	Varying	6.54%	6.57%	6.57%	6.57%	6.57%	6.57%	6.57%	6.57%	6.57%	6.57%
Pre-tax Real WACC	Varying	3.94%	3.97%	3.97%	3.97%	3.97%	3.97%	3.97%	3.97%	3.97%	3.97%
Nominal Tax Allowance	Varying	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%
Real Tax Allowance	Varying	1.05%	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%

Source: Australian Energy Regulator

The dividend policy in Ergon Energy's 2015-16 Statement of Corporate Intent states that:

"The board will ensure that Ergon Energy's dividend policy also takes into account the return its shareholders expect on their investments. Ergon Energy's policy is to recommend and pay a dividend amount equivalent to 100% (or the percentage approved by shareholding Ministers, if different) of Ergon Energy's adjusted consolidated profit for 2015/16. The Board adopts such a policy on the basis of its shareholders agreeing to provide the necessary funding for projects which have received Board and shareholding Ministers' approval or for the maintenance of Ergon Energy's approved capital structure or for ensuring the operational viability of Ergon Energy. Ergon Energy's Board undertakes to adhere to the dividend policy."

The Australian Energy Regulator has made it clear that the 60/40 ratio is only a 'guide' and therefore cannot force Ergon Energy to reduce its borrowings. The AER has also confirmed that once a final decision has been made regarding the regulated revenue cap of a distribution network, the owner can spend the regulated revenue cap as it sees fit.

For the 2015-2020 regulatory period, Ergon Energy is laden with debt and is continuing to experience falling overall consumption and a need to service increasing peak demand from its regional Queensland customers.

Australian Energy Regulator - Process for Reviewing the Rate of Return Guidelines

In the AER's Better Regulation - Rate of Return Guideline Factsheet published in December 2013, the AER states:

"We consider that efficient network businesses would fund their investments by borrowing 60 per cent of the required funds, while raising the remaining 40 per cent from equity."

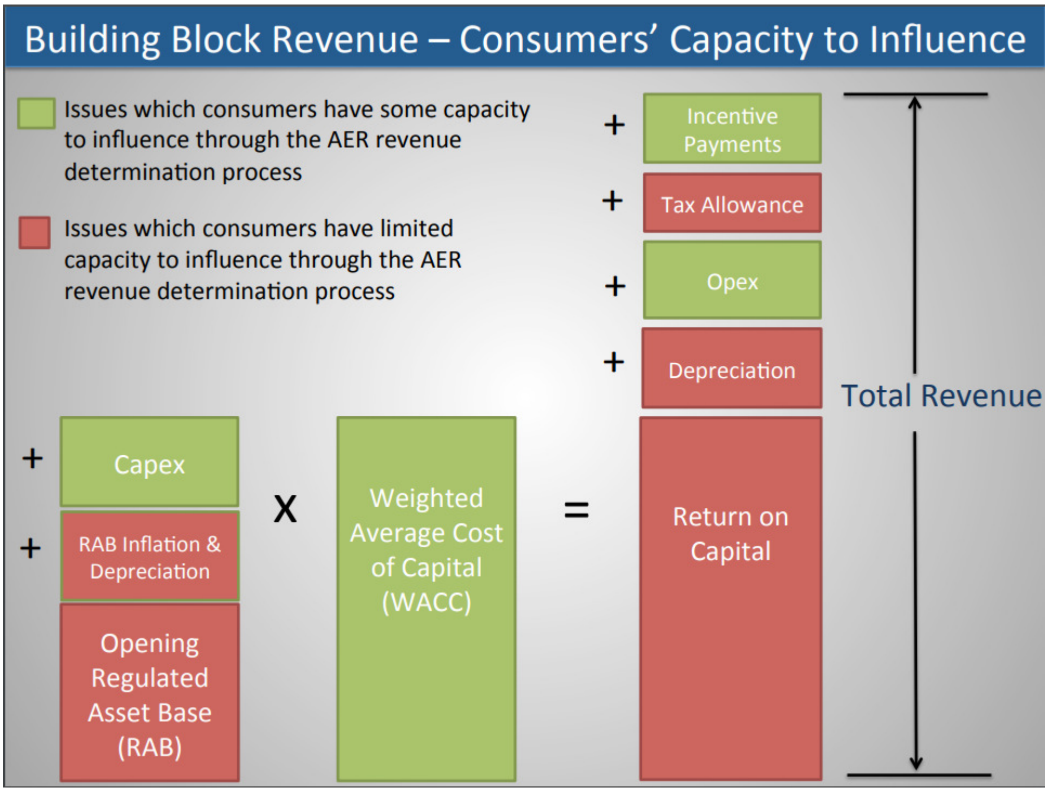
Further on the AER's Fact Sheet states:

"The guideline sets out the approach we use to estimate the returns on equity and debt for a benchmark efficient business. This approach supports the rate of return objective in the national electricity and gas rules. This is for the overall rate of return to correspond to the efficient financing costs of a benchmark efficient business.

By setting a rate of return based on a benchmark, rather than the actual costs of individual businesses, network businesses have incentives to finance their business as efficiently as possible. We define the benchmark efficient business as one who only provides regulated electricity or gas network services, operating within Australia. This applies to both electricity and gas as the risks across both industries are sufficiently similar such that a single benchmark is appropriate."

The AER need to ascertain if a benchmark efficient network business in Australia is using a 60/40 WACC (debt to equity ratio) as a lower WACC significantly reduces regulated revenue for a network business as evidenced in Figure 1.

Figure 1: Building Block Revenue – Consumers' Capacity to Influence



Source: Presentation by Hugh Grant – AER Consumer Challenge Panel Member, AER's Public Forum on Ergon and Energex Revenue Proposals, 9th December 2014

The Australian Energy Regulator determined the regulated revenue for Ergon Energy in 2016-17 using a 60/40 ratio resulting in a WACC of 6.04% (see Table 2):

60% Debt / 40% Equity = 60% x 5.06% + 40% x 7.5% = 6.04%

If the Australian Energy Regulator had utilised an 80/20 ratio the resulting WACC would be 5.54%.

80% Debt / 20% Equity = 80% x 5.06% + 20% x 7.5% = 5.54%

The Australian Energy Regulator accepts Ergon Energy's valuation of its Regulated Asset Base at around $11 Billion. Therefore if the AER had utilised an 80/20 WACC ratio Ergon Energy's regulated revenue would have fallen by around $55 million in 2016-17.

This would have reduced the network component of a power bill. The network component is the largest component of a power bill in regional Queensland representing around 42% of a power bill.

The Australian Energy Regulator's review of the Rate of Return Guideline needs to investigate what is the Weighted Average Cost of Capital ratio employed by a benchmark efficient network business in Australia and if the ratio is a 'guideline' and if the ratio should be set for the five year period of a network determination.

The review needs to investigate incorporating a utilisation factor when determining the RAB

The utilisation of a network's capacity (ie customer demand for a network asset) is a strong indicator of the value of a network business and therefore should be considered in the Rate of Return.

The gross under-utilisation of the Queensland Government owned distribution networks; Ergon Energy and Energex, is a tragedy. Under the methodology employed by the Australian Energy Regulator the combined Regulated Asset Base of Queensland's distribution networks is around $23 Billion.

In 2015-16, the overall utilisation of Ergon Energy's distribution network capacity was 38%, falling from 40% in the previous year. The Energex network had an overall utilisation of 25%, compared to 23% in the previous year.

Since the Rate of Return is highly dependent on the value of a network's Regulated Asset Base, the Australian Energy Regulator's review of the Rate of Return Guideline should investigate including a utilisation factor when determining the value of a network's Regulated Asset Base. A utilisation factor would take into account the overcapitalisation of a network and the efficiency of the network business in providing a service that is affordable to its customers.