QUEENSLAND resources COUNCIL

Working together for a shared future

24 July 2015

Mr Sebastian Roberts
General Manager, Network Regulation
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001
via email (QLDelectricity2015@aer.gov.au)

Dear Mr Roberts

Ergon Energy's revised regulatory proposal

Thank you for the opportunity to comment on Ergon Energy's revised (3 July 2015) regulatory proposal for the period 2015-2020.

The Queensland Resources Council (QRC) is the peak representative body of the Queensland minerals and energy sector. The QRC's membership encompasses minerals and energy exploration, production, and processing companies, and associated service companies. The QRC works on behalf of members to ensure Queensland's resources are developed profitably and competitively, in a socially and environmentally sustainable way.

As you would know, for resource companies electricity accounts for a significant portion of their costs, and network charges are a substantial and growing share of that delivered cost of electricity. QRC's previous submission emphasised that the practical experience of QRC members is that, on balance, Ergon Energy is not an efficient operation and has not undertaken the sort of highly effective cost reduction and efficiency measures that many firms in competitive markets have been forced to implement. In the absence of a competitive market for Ergon's services, QRC looks to the AER's regulatory decisions to apply this relentless pressure to find efficiency savings.

While QRC has appreciated the opportunity to comment on Ergon Energy's revised proposal, the complexity and range of the revisions combined with Ergon using their original proposal as a baseline rather than the AER's draft decision has complicated the process of working through the detail. We have also included additional context for industrial users as provided by the submission from the Alliance of Electricity Users.

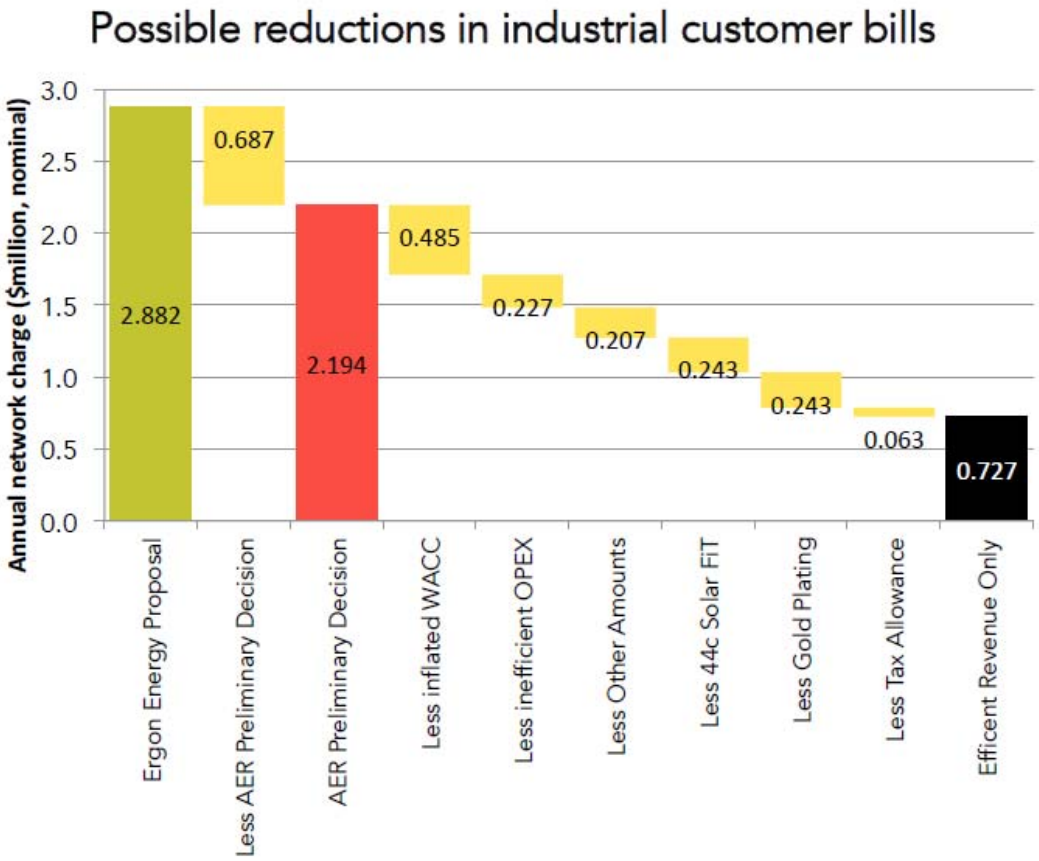
In addition to the comments provided on Ergon Energy's original regulatory proposal, QRC provides the following additional comments on the revised (3 July) regulatory proposal:

1. Ergon Energy's resistance to benchmarking efficient operations in setting their operational expenditure remains an issue of real concern to their customers;
2. It is difficult to see Ergon energy's proposed weighted average cost of capital (WACC) as anything other than another aggressively ambit claim; and
3. Ergon Energy's forecasts of sharp and sustained increases in demand are difficult to reconcile with customer's expectations and require a much more rigorous justification.

Context for industrial users

The submission from the Alliance of Electricity Consumers provides a stark illustration of the substantial scope of the savings that are potentially available to the AER and the Queensland Government to deliver to Ergon Energy's customers. The waterfall graph from page 11 of the Alliance submission (Chart 1 below), suggests that for industrial customers, the typical customer could see their annual network charge reduced from $2.9 million down to as low as $0.7 million, or an annual saving of 75% over the 5 year regulatory period.

Chart 1: Alliance of Electricity Consumer – all possible reductions in industrial customer bills.



Source: the Alliance of Electricity Consumers, page 11

While the graph from the Alliance of Electricity Consumers very clearly shows the savings of some $0.6 million or 23.8% implied by the AER's preliminary decision, the graph is also a useful rebuttal to the Ergon Energy thesis that the AER's draft decision has been too parsimonious. QRC suggests that in particular, the analysis from the Alliance around Ergon Energy's inflated cost of capital (WACC), inefficient operating expenditures (OPEX) and savings by optimising the regulated asset base (RAB) suggest that there is a further saving of up to $0.955 million or 42.5% to be made on the AER's draft decision.

While the Alliance submission perhaps sets out the maximum possible savings which could be achieved by the AER, QRC recommends that the AER revisit their analysis of these three critical issues of WACC, Opex and RAB as set out below (Table 1).

Table 1: Additional reductions in Ergon Energy's costs from the AER's draft decision

	Ergon's annual revenue requirements	Annual network charge - industrial user
AER's preliminary decision	$7,075 million	$2,194 million
Reduced cost of capital (WACC)	$1,562 million	$ 485,000
Efficient operating expenditure (Opex)	$ 732 million	$ 227,000
Optimised asset base (RAB)	$ 782 million	$ 243,000
Total saving (percentage)	$3,076 million **(43.5%)**	$ 955,000 **(43.5%)**

Source: Figures drawn from the Alliance of Electricity Consumers, pages 9 & 11

Additional comments

1. Customers expect benchmarked efficiency

- Ergon Energy have refuted the use of benchmarking by the AER noting,

  "*there are serious limitations that need to be taken into account when comparing our performance against businesses who operate in a very different network footprint*".

- The comparison between October and the revised proposal is shown in Table 2 below.

Table 2: Comparison between Ergon's original and revised regulatory proposals for operating expenditure, 2015-2020

$'000 (real 2014-15)	October Regulatory Proposal	Revised Regulatory Proposal	% difference
Total forecast operating expenditure	1,821,130	1,779,010	(2.31%)

Source: Table 38 Ergon Energy revised proposal, page 78

- It remains concerning to QRC that Ergon Energy continue to measure the forecast expenditure based on their performance in the prior period.

  "Our revised forecast of operating expenditure requirements is substantially lower than our actual and estimated spend in the regulatory control period 2010-15 and lower than our October Regulatory Proposal" (see Appendix A, page 76).

- QRC also notes the comments from Ergon Energy (page 96),

  'While the AER has made some changes to its approach, Ergon Energy is still of the view that the AER has not applied itself properly to the task of assessing our forecast operating expenditure.'

  QRC disagrees with Ergon Energy's conclusions.

- Further, QRC is concerned that Ergon Energy's revised proposal does not seem to be updated to reflect the clear direction of the Queensland Government that the three government owned transmission and distribution businesses will be merged. This was an election commitment made during the campaign in January and has been reiterated by the

responsible Ministers on a number of occasions, including the Treasurer's budget speech. In this context, QRC was concerned to read,

'In June 2015, the directors of Ergon Energy reviewed the key assumptions and confirmed their continued application for this revised Regulatory Proposal.' (page 122)

Table 52: Capital expenditure assumptions, 2015-20

Assumption	Application
Our current company structure, ownership arrangements and service classification will continue.	The capital expenditure forecasts are based on continuing the current company structure. Any future restructuring could change Ergon Energy's cost structure and would require changes to our CAM.

2. Customers expect a realistic cost of capital

- Ergon Energy have put forward a reduced WACC of 7.41% (previously 8.02%), but still much higher than the AER's preliminary decision of 5.85%. The annual revenue requirement, 2015-2020 has not changed significantly in the revised proposal as the amounts are higher in years 2017-18 and 2018-19 than previously indicated.

Table 3: Annual Revenue Requirement, 2015-2020

$m (nominal)	2015-16	2016-17	2017-18	2018-19	2019-20
Return on capital	744.94	790.77	831.60	870.44	907.65
Return of capital	162.28	179.16	168.04	171.13	148.53
Operating expenditure	354.73	377.44	399.89	418.91	439.39
Corporate income tax	96.16	119.06	126.00	132.45	127.63
Other adjustments	87.48	44.58	62.84	(26.39)	(6.29)
Building Block Revenue (unsmoothed)	1,445.58	1,511.01	1,588.38	1,566.54	1,616.90
Annual Revenue Requirement (smoothed)	**1,137.71**	**1,522.33**	**1,709.11**	**1,712.72**	**1,716.33**

Source: Table 11 Ergon Energy revised proposal, page 34.

- QRC disagrees with the Ergon Energy statement,

  'It is more important than ever for Ergon Energy to ensure we have an appropriate rate of return to attract funds should we be required to' (page 130).

  Given the falling network demand and the significant over-investment that occurred in the previous regulatory period, QRC can see little reason for Ergon to need a premium return or risk weighting on their cost of capital.

- As noted in QRC's earlier submissions, customers remain concerned that Ergon Energy have departed from the AER Guidelines without adequate justification.

  Since Ergon lodged their revised proposal, another of their key assumptions around the cost of capital has been tested. QRC notes that Ergon Energy's proposal says,

"Ergon Energy has developed our rate of return proposal with the objective of obtaining the best possible estimate under the NER, which reflects prevailing conditions in the market for funds. Assuming 60% gearing, the proposed estimate for the first year of the regulatory control period is provided in Table 56 below", (page 141)

Table 4: Summary of key rate of return parameters, 2015-2020

Key parameter	Ergon Energy's calculation
Return on equity	10.00%
Return on debt	5.68%
Rate of return	7.41%

Source: Table 56 Ergon Energy revised proposal, page 141.

However, the Treasurer's budget speech announced that "*The Government's Debt Action Plan will refocus the State's balance sheet through three initiatives. A $4.1 billion reduction in General Government debt is achieved from re-gearing our energy network businesses*", (page 15, Budget Speech, 14 July 2015). Budget Paper 2, Strategy and Outlook confirms that Ergon's gearing ratio will be 70% of net debt as a proportion of the regulated asset base not 60% (page 5).

QRC suggests that this substantial change in gearing is further basis for the AER to revisit, and further reduce, Ergon Energy's weighted average cost of capital.

3. Customers expect realistic forecasts

- QRC remains concerned that Ergon Energy have not adequately justified the forecast increase in demand by usage volume or customer connections. Ergon Energy make the point that,

  'while Queensland's economy has declined, post the boom in resource investment, growth is still expected as LNG exports ramp up and industries outside of mining, like tourism, and the housing market improve'.

  QRC questions the accuracy of forecasting a substantial increase in the numbers of large industrial users in the tourism and housing sectors.

  The use of average per annum figures for prior period performance is misleading. For example, the non-residential customer numbers decreased in 2013-14 but the higher growth rates in 2010-11 disguise the recent trend in falling connections (see table 5 below).

Table 5: Customer numbers, 2010-14

	2010-11	2011-12	2012-13	2013-14
Residential customer numbers	577,958	585,538	595,439	607,276
Annual residential customer growth rate	1.24%	1.31%	1.69%	1.99%
Non-residential customer numbers	111,001	113,726	114,992	114,654
Annual non-residential customer growth rate	4.61%	2.45%	1.11%	(0.29%)
Total customer numbers	688,959	699,264	710,431	721,930
Annual growth rate	1.77%	1.50%	1.60%	1.62%

Source: Table 49 Ergon Energy revised proposal, page 112

Ergon's revised proposal is silent on the customer engagement for large industrial users.

'Based on our customer engagement activities we understand the majority of residential customers would prefer to see prices unchanged and for small businesses to see an immediate reduction in electricity prices'. (Page 83)

QRC is concerned this feedback is being implemented at the expense of large industrial users. QRC preliminary reading of the revised Ergon Energy proposal notes the significant indicative price increases for large users (see Table 20, page 50) without reasonable explanation.

In conclusion, QRC supports the efforts of the AER in identifying material savings in the preliminary decision but recommends that further reductions are necessary in order to reflect an efficient price for the transmission of electricity in Queensland. In particular, QRC recommends that the AER closely scrutinise Ergon Energy's proposals around operating expenditure, cost of capital and demand forecasts.

QRC welcomes ongoing engagement with the AER on any of the issues raised in this submission and would be happy to host detailed discussions with QRC members particularly around reliability and demand forecasting for resource projects. For any further information please feel free to contact QRC's Andrew Barger, (07) 3316 2502 or andrewb@qrc.org.au

Yours sincerely

Michael Roche
Chief Executive