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Working together for a shared future

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

Dear Mr Roberts

### **Preliminary Decision - Ergon Energy Determination 2015-2020**

Thank you for the opportunity to comment on the Australian Energy Regulator (AER's) preliminary decision on Ergon Energy's regulatory proposal for 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.

QRC was very disappointed to learn that Ergon Energy has initiated a judicial review against the AER. A legal appeal process should be the absolute last resort for a regulatory process and only used in the most extreme circumstances. Unfortunately, despite the focus on customer consultation in Ergon's submissions, Ergon has not engaged with QRC or our members, so we are unaware of the grounds for Ergon's application. Both their decision and the lack of consultation in communicating their decision to customers are very disappointing.

QRC's January submission made six specific recommendations for the AER to consider:

1. the rigorous use of benchmarking to compare Ergon's *actual* costs with the costs of an *efficient* optimised network and not simply the historical performance of Ergon;
2. the views of the local regulator (the Queensland Competition Authority) when determining Ergon's weighted average cost of capital (WACC);
3. requesting that Ergon justify each departure from the AER's rate of return guideline;
4. revising Ergon's demand forecasts given the (a) actual decline in demand, (b) Ergon's history of over estimating demand and (c) the network's low asset utilisation;

5. not permitting Ergon to increase their regulated asset base (RAB) and requiring that Ergon only invest in augmentation when it is absolutely necessary using a contingent project approach; and
6. the much higher opportunity costs of poor quality energy supply for Ergon's resource customers. While network reliability is important to the resources sector, Ergon must be able to demonstrate that it is delivered efficiently.

The preliminary decision makes it clear that the AER has considered each of these issues and QRC regards the AER's preliminary revenue allowance as far more realistic than Ergon Energy's proposal. On that basis, QRC has welcomed the AER's preliminary decision which pared back 27% from Ergon's proposed revenue.

Despite our overall support for the AER's preliminary decision, QRC would suggest that there are a few areas where the final decision would benefit from the AER's renewed and intensive scrutiny, specifically:

- i. benchmarking Ergon's *actual* costs with the costs of an *efficient* optimised network;
- ii. not permitting Ergon to increase their regulated asset base unless they can demonstrate that any network investments are efficient and necessary using a contingent project approach; and
- iii. the much higher opportunity costs of poor quality energy supply for Ergon's resource customers. While network reliability is important to the resources sector, Ergon must be able to demonstrate that it is delivered efficiently.

**i. Benchmarking**

QRC's reading of the AER's consultant reports on benchmarking suggested that Ergon Energy still has some further work to do in order for Ergon's customers to be confident that their costs were truly efficient. Ergon had requested a level of operating expenditure over the next five years, which was broadly in line with their level of actual opex over the past three years. The AER's preliminary decision has reduced that proposal by 10.5%.

The experience of QRC members suggest that Ergon are further than 10% away from efficient operations and we believe that the evidence of this experience is called out in the AER's benchmarking report. For example, the Deloitte Access Economics [report](#) found

"However, in our view, the scale of the efficiency difference shown between the Queensland DNSPs and the most efficient ('frontier') businesses during the 2009-13 period is material enough to raise questions about Energex's and Ergon's opex efficiency, regardless of the technical debate." (page vi)

"The key factor driving the opex efficiency gap, particularly for Ergon, appears to be its large labour force relative to its network size, which implies relatively low productivity." (page xix)

QRC members would be interested to understand why the AER have elected not to use more of the findings of the consultant's reports in informing the draft determination.

Further, analysis of reliability benchmarks from [Hugh Grant](#), Executive Director of ResponseAbility, suggest that for the period 2009-2013, Ergon was the most expensive network service provider to fix outages by a margin of around a third. Similarly, the duration of outages enduring by their customers was the most protracted at around 320 minutes (five and a half hours). While the cost and time to

restore lost power will be affected by the regional and remote nature of Ergon's networks, these statistics do not provide customers with confidence in Ergon's productivity and capital efficiency.

QRC requests that the AER revisit the question of Ergon's efficiency in terms of detailed performance benchmarking against other network service providers to ensure that Ergon's revenue request is as efficient as possible. We stress the importance in not using the previous period as a reasonable baseline or starting point for determining the next determination period given the inaccuracies of that period.

## **ii Regulated Asset Base**

Ergon's regulated asset base sits at \$10 billion in FY 2014-15, up in real terms from around \$4.5 billion less than a decade earlier. Ergon's proposal would see their regulated asset base grow by an extra three billion dollars (around 30%) over the regulatory period to FY 2019-20. The return on this asset drives around 70% of the final cost of electricity distribution, so the single most important decision that the AER can make is to ensure that asset base has been optimised to reflect an efficient investment program. Treating past investment decisions as sacrosanct and simply awarding Ergon a guaranteed rate of return on the resulting asset base is a recipe for institutionalising inefficiency.

While QRC acknowledges that Ergon's customers are more widely dispersed than for other distribution networks, nevertheless QRC is concerned that CME data, cited by [Hugh Grant](#) of ResponseAbility suggests Ergon has 40% more asset value per connection than the next most asset-intensive distributor, and that Ergon has asset levels 7.5 times higher than the most efficient distributor.

This bleak picture of capital inefficiency was confirmed by the Queensland Government's Independent Review findings that Ergon ran "...a deficient capital model..." and that this capital in efficiency was compounded by the "...consistent over estimation of demand...".

QRC recommends that the AER optimise Ergon's asset base to accurately reflect the minimum value of assets needed to deliver the actual (not forecast) level of demand. Paying Ergon a guaranteed rate of return on a bloated regulatory asset base is needlessly driving up electricity prices and delivering windfall profits to Ergon. As Ergon is publically owned, these dividends take the form of a highly inefficient tax levied on Queensland electricity users by the Queensland Government. In 2013-14, Ergon delivered almost \$1.4 billion in revenue to Government through dividends, competitive neutrality fees and income tax equivalent payments.

In recent years Ergon has delivered return on equity of over 30% or three times the level the AER assessed. These enviable rates of return are being delivered on a network business that carries almost no risk and importantly, at the expense of its customers, including QRC members who are struggling with international cost competitiveness pressures with limited or no ability to pass on cost increases.

## **iii Reliability and the quality of energy supply**

The issue of energy reliability and the quality of energy supply remain as perhaps the one area where the AER's preliminary decision has not had the opportunity to balance up a considerable weight of evidence. As much of the public debate on retail electricity price has focussed on how distribution prices have affected household energy costs, QRC remains concerned that the needs of large regional energy users like resource companies may be overlooked in the AER's deliberations.

The resource sectors' focus on volumes to reduce marginal costs places great importance on the reliability of the network. It is important for the AER to distinguish between the tolerances for residential customers to an increase in network disruptions in comparison to the consequences and costs for businesses. For this reason, QRC members emphasise to the AER the importance of maintaining the reliability of Ergon's network services; however, this economic importance should not be misconstrued by Ergon as cue for exuberant over-investment.

Ergon have embarked on a major campaign of capital expenditure since 2006 to ensure that they satisfied jurisdictional security and reliability standards. These standards have now been relaxed and Ergon now easily exceeds them. The legacy for customers is an asset base of underutilised and stranded assets with a capacity utilisation as low as forty per cent. QRC members will always give serious consideration to any proposal to invest in better services – improved reliability and quality of power – but any such proposal needs be considered in the context of efficient and appropriate investment against a background of a history of overinvestment and the resulting capacity overhang. In addition, QRC would be interested to view more information on how the increased activity in the gas sector is directly contributing towards the demand growth for Ergon Energy as opposed to being captured by Powerlink.

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](mailto:andrewb@qrc.org.au)

Yours sincerely



Michael Roche  
**Chief Executive**