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Total Environment Centre

Submission to the AER on the Preliminary Decisions on the QLD DBs' Regulatory Proposals 2015-20

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Total Environment Centre's National Electricity Market advocacy

Established in 1972 by pioneers of the Australian environmental movement, Total Environment Centre (TEC) is a veteran of more than 100 successful campaigns. For nearly 40 years, we have been working to protect this country's natural and urban environment, flagging the issues, driving debate, supporting community activism and pushing for better environmental policy and practice.

TEC has been involved in National Electricity Market (NEM) advocacy for ten years, arguing above all for greater utilisation of demand side participation — energy conservation and efficiency, demand management and decentralised generation — to meet Australia's electricity needs. By reforming the NEM we are working to contribute to climate change mitigation and improve other environmental outcomes of Australia's energy sector, while also constraining retail prices and improving the economic efficiency of the NEM — all in the long-term interest of consumers, pursuant to the National Electricity Objective (NEO).

Introduction

TEC has participated in all stages of the distribution price reset process underway in Queensland and is now responding to the AER's preliminary decision on the regulatory proposals submitted by Energex and Ergon for the 2015-20 regulatory period. In our previous submission to the AER on these proposals, we expressed the view that the level of required expenditure on augmentation capital, replacement capital, and operational maintenance had been overstated. We also agreed with the argument put forward by the Consumer Challenge Panel (CCP) and others that approved levels should be more comparable to the businesses' expenditure in the two regulatory periods prior to 2010-15, rather than the inflated levels of the most recent regulatory period.

We are therefore disappointed with the level of reductions proposed by the AER in the draft decisions, and also the very limited impact on prices that will result for Queensland Consumers. The overall reduction in the DBs' requested revenue of 23% to 27% is less than justified by the evidence, and we are disappointed that the AER seems to have retreated from earlier positions adopted in the NSW preliminary decision. Further, the draft decision does not demonstrate that the AER has heard and considered the advice, concerns and views provided by stakeholders and in particular the evidence presented by its own expert CCP. Had the AER done so, we would expect to not only see more significant reductions, but also considerably more reference to those views throughout the decision. In relation to TEC's specific feedback asking the AER to take a stronger role in ensuring the Distribution Businesses (DB) use Demand Management (DM) to meet the long term interests of consumers, we are disappointed that there has been no significant change in the AER's approach since we first responded to the Framework and Approach papers more than 18 months ago.

Demand Management

TEC's interest has been primarily in DM and in how the DBs' regulatory proposals reflect their use of DM to meet the long-term interests of consumers. This focus is driven by a concern for both the need to reduce network capital expenditure and increase the affordability of energy for consumers, and to improve the environmental performance of the electricity system. TEC has cited evidence showing that DM utilisation in Australia, at less than 2% of total peak demand, is extremely low compared to international best practice¹,

¹ Productivity Commission, 2013, Electricity Network Regulatory Frameworks, Report No.62, Canberra.

and has expressed concern about the speed of reform of the regulatory framework to incentivise more appropriate levels of DM in the future. Our expectation continues to be that the AER should do its utmost within the current framework to reflect the importance of DM through the various ways it features in the regulatory determination process, namely, through the AER's consideration of:

- The Demand Management Incentive Allowance (DMIA) plans submitted by the businesses.
- The Business As Usual (BAU) expenditure proposals for DM activities (usually opex)
- The AER's assessment of both the capex and opex components of the revenue block approach, and in particular their consideration of "the extent the Distribution Network Service Provider has considered, and made provision for, efficient and prudent non-network alternatives..."²

TEC's previous comments were largely directed to ways to strengthen the framework for DM in the context of the current round of regulatory determinations. In particular we suggested that the AER could provide better commentary and guidance to the DBs on:

- The requirement to consider non-network alternatives in developing capex proposals and better demonstration of how this occurs through pre RIT-D planning processes;
- The expectations of DM plans, including how the AER will assess 'business-as-usual' DM as well as the DMIA, and;
- The expectation to report targets, outcomes and benefits in a consistent way.³

We submitted that this direction to the businesses could be provided by the development of a broad guideline on DM, similar to the Consumer Engagement Guideline and separate to the Demand Management and Embedded Generation Incentive Scheme (DMEGIS) which is due to be revised and strengthened. Until this could be done, we suggested that the AER should give network businesses a greater indication of how they could design and present effective DM strategies. This advice should go well beyond the narrow interpretation of the DMEGIS to cover targets, outcomes and performance metrics, and project detail and could be achieved through appropriate commentary in issues papers and draft determinations.

However, such guidance explanation and commentary features only in a limited way in the Queensland decisions. This concerns TEC as it suggests DM is being treated as a low priority for the AER. DM did not feature as a separate consideration in either the overview or attachments. DM was considered primarily in the context of Augex, and also as part of setting the DMIA. There was also limited commentary in relation to parts of the businesses DM Opex proposals that were treated by the AER as a "step change" in Appendix C of Attachment 7 on opex expenditure.

In these areas the AER have largely restated positions on DM that were outlined in the draft NSW determinations. The AER has barely acknowledged, much less responded to, the suggestions put forward by TEC and other stakeholders who have commented on DM. TEC note that in the context of approving DMIA expenditure of \$1 million per annum for each of the businesses the AER notes TEC's support for the AER deferring reform of the DMEGIS until the completion of the related AEMC rule change and our proposal for the introduction of performance measures, annual reporting and demand management guideline.⁴

² National Electricity Rules Version 64, 2014, Chapter 6, Cl. 6.5.7 (e) (10).

³ TEC acknowledge that guidance is currently provided for the DMIA funds under the Demand Management Incentive Scheme 2008. We suggest the future revised scheme would be referred to and integrated with a broader DM guideline.

⁴ AER Preliminary Decision Energex Distribution Determination – Attachment 12 Demand Management Incentive Scheme, April 2015, p 12-8.

However the AER makes no comment on its views on these proposals. Similarly the AER acknowledge that some stakeholders have voiced concern about the AER's confidence in tariff reform to drive reductions in peak demand, however again the AER does not respond to these views.

The AER has restated its position that it is appropriate to rely on so called 'incentives' in the regulatory framework to drive DM activity by the businesses – the RIT-D process and the Capital Expenditure Sharing Scheme (CESS) in particular. TEC believe this hands off approach is irresponsible. It fails to consider the strong evidence that the regulatory framework has failed to incentivise DM to date, and exhibits an unreasonable level of faith in newly introduced incentives that remain untested.

AER's Response to Energex and Ergon's DM expenditure proposals

While Energex and Ergon's proposed expenditure on DM of \$95.3 million and \$70.5 million respectively, the AER commentary on their DM plans only related to those proposals that were considered a 'step change' in opex. For Energex the AER allowed only \$5.8 million of the \$37 million treated as a step change. The AER view was that this was the only project where the benefits in terms of deferred capex were clear. The AER stated that

“since Energex was unable to identify the precise capex projects that were deferred for its existing demand management it would not be reasonable for us to incorporate opex for demand management when the capex reductions are not clear.”⁵

In particular, the AER considered the assumed augex deferral benefits of Energex's Broad Based Demand Management (BBDM) program were optimistic. In relation to these programs they noted that the proposed direct customer incentive payments comprise the majority of Energex's total demand management expenditure and offered the view that Energex had understated the ability of mandated tariff reform to deliver benefits. The AER also did not support targeted demand management projects that were defined as medium to long-term and where the benefits would present themselves beyond the forthcoming regulatory period and the direct opex/capex trade-off was not clear.

Ergon fared similarly. The AER did not include any of the \$17.5 million step change related to DM in its opex decision stating that it was not satisfied that this step change results in an efficient opex/capex trade-off. The AER stated that Ergon had not established what programs or projects would be funded or the overall benefit of the demand management program in terms of capex reductions. It also found that the calculations identifying the value of the benefit contained several errors.

In relation to Ergon's DM plan the AER clearly articulates its view that BBDM programs do not adequately target capex deferral. The AER stated,

“We consider that demand management should be targeted and should only include costs where customers directly benefit. The benefits of BBDM on deferred capex is not clear and we consider only opex that directly translates to a quantified decrease in capex should result in an efficient opex/capex trade-off. We also note that only a portion of BBDM will have a benefit in deferring augex because the reduction in maximum demand may not be where the augex is required.”⁶

We support the AER in its efforts to ensure all expenditure is efficient and benefits consumers, including opex for DM, and we appreciate the AERs efforts to ensure the businesses' proposals and calculations

⁵ AER Preliminary Decision Energex Distribution Determination – Attachment 7 Operating Expenditure, April 2015, p 7-302.

⁶ AER Preliminary Decision Ergon Distribution Determination – Attachment 7 Operating Expenditure, April 2015, p 7-306.

regarding are robust. We have also supported greater levels of effort by the businesses in undertaking targeted DM programs to provide an alternative to costly augmentation. However we are troubled by the AER's emphasis on the need to identify specific capex deferrals before it considers DM investment beneficial, and its dismissal of the value of BBDM. It is also worrying that the AER refuses to see the value of approaches that yield results in a timescale that stretches beyond the regulatory period under consideration.

If the businesses are prevented from approaching DM from the perspective of long-term network and investment planning this will promote a short-term focus that is unlikely to be in the interests of consumers. If the businesses must wait for the need for an augmentation to arise before they can justify DM expenditure, then much DM opportunity will be missed. Some DM solutions, particularly those involving innovation, will require a longer period to implement than can be afforded when the constraint giving rise to the need for augmentation needs to be urgently addressed. DMIA funds are currently too limited in value to be considered a serious alternative to investment in long-term load management schemes. We feel that there is urgent work to be done on the development of a guideline for DM and within this adopting a framework that promotes long term planning and DM strategies for the benefit of consumers and the environment.

We also wish to reiterate our view that BBDM and tariff reform are not mutually exclusive strategies. In our previous submission we cited evidence suggesting that complementary approaches may provide better results than tariff reform alone. It also seems contradictory that the AER will not value DM benefits arising outside the regulatory period in the case of Energex's targeted DM proposals, while it is prepared to wait on the benefits of a reform process that is barely underway and which requires considerable further expenditure on metering infrastructure before being implemented. It is extremely optimistic to assume wide spread adoption of tariff reform, much less the benefits, will be in place within the regulatory period in question.

CAPEX

In our previous submission we observed that previous levels of capex investment by the businesses had resulted in a massive increase in the combined Regulated Asset Base (RAB) of the Queensland businesses from \$15 billion in 2010/11 to \$21.9 billion in 2014/15.⁷ It is now acknowledged that this growth was based on grossly overestimated demand forecasts and enabled by a flawed regulatory process which economically incentivises DBs to build the network. The resulting expansion was not only unnecessary and costly for consumers during the period, but has also locked in high prices for many years to come. TEC argued that the AER should substitute lower allowances than proposed for the Queensland DB's augmentation and replacement capex in view of evidence regarding demand trends, asset age, network utilisation, efficacy benchmarks and reliability standards.

For these reasons we support the AER's proposed reductions of 27% and 36% respectively for Energex and Ergon's capex proposals. However, we are not convinced these reductions are significant enough. We are persuaded by the evidence presented by the CCP, that the actual level of capex should be even lower given the unprecedented step change in expenditure in the 2010-15 period. The CCP believes the AER has not adequately taken into account the excess capacity issue, and that it has based its decisions on unreliable load forecasts. In relation to repex, the CCP argues there has been an over reliance on trend analysis of past asset replacement practices, and that these may not reflect efficient levels of repex.⁸

⁷ 2014/15 figures are estimates, based on information provided in the businesses' regulatory proposals.

⁸ Bruce Mountain and Hugh Grant, Presentations at the AER preliminary decision conference on 12 May 2015, Brisbane.

Demand Forecasts

We are concerned that the demand forecasts might also be overestimated, and that the AER has at this stage accepted the forecasts submitted by the businesses. As the AER is aware, the businesses have a poor record in forecasting demand and an incentive to overstate it. Hugh Grant points out that Energex and Ergon were rewarded with windfall profits of \$1 billion for their forecasting errors in the previous period.⁹

TEC acknowledge that the AER's consultant Energy Market Consultants associates (EMCa) has considered how the spatial demand forecasts have been used and how they reconcile with top-down system-wide forecasts. We note that EMCa have identified some discrepancies through this process that the businesses are expected to explain. However this does not appear to have made any material difference to the decisions at this stage. In the case of Energex the AER appears to be satisfied that it has made the changes to its forecasting methodology that were previously recommended by the AER, and the AER has accepted the advice provided by Frontier Economics that Energex's methodology meets AER criteria for good demand forecasting.

In making this determination we do not believe the AER has adequately taken account of, or responded to, the critique of the businesses' proposed forecasts by the CCP or the Queensland Council of Social Service (QCOSS) whose analysis was referenced in our own submission. We note that the AER feels that it has not been offered assistance in the form of alternative forecasts by stakeholders. Our view is that this is neither a realistic expectation given the resources available to these consumer advocates, nor an adequate response given the responsibilities of the AER.

The AER has decided that before acting further it should wait for the July forecast figures from AEMO and also for Energex and Ergon's reconciliation of the AEMO forecasts with their substation level forecasts. Given that AEMO has had difficulty making accurate demand projections in the past, the businesses' incentive to overestimate, and the fact that demand forecasts impact on the allowed revenue across all of the building blocks, TEC does not feel confident that this approach provides a sufficient level of scrutiny. TEC believes the AER needs to invest additional effort and resources in assessing the demand forecasts of the businesses, whether this is through building its own capacity or procuring that capacity from elsewhere.

Augex

We note that the AER has proposed a reduction in augex for Energex and Ergon of approximately 21% and 15% respectively. EMCa reviewed the businesses' forecasting methodology for capex including their demand and risk assessment processes, cost components, and evidence of whether alternatives to augex were considered. In doing so the consultants identified that the businesses' forecasting process involves insufficient 'top down' restraint, poor project justifications and conservative risk assessment with a bias to overestimating risk and project scope.¹⁰ EMCa concluded the need for growth and reliability augex is overestimated between 5% to 15% and the AER has applied the mid point of this range to establish substitute figures, i.e. 10%.¹¹

The CCP persuasively argue that the AER has not adequately considered the excess capacity of the networks in identifying whether the forecasts are what is reasonably required to meet demand and reliability standards. As Bruce Mountain demonstrated in his presentation at the AER forum on the

⁹ Hugh Grant, Presentation at AER Preliminary decision conference, 12 May 2015, Brisbane.

¹⁰ AER Preliminary Decision Energex Distribution Determination – Attachment 6 Capital Expenditure, April 2015, p 6 – 50.

¹¹ *ibid*, p 6 -51.

preliminary decision, there was no evidence of capacity shortage in the networks in 2006, and yet, on the basis of flawed demand projections, additional capacity was built such that the ratio of capacity to peak demand has considerably widened and there is now enormous additional capacity in the system. Mountain also points out that it has been built at a cost per MVA that is higher than that incurred by any other distributor operating across the NEM.¹²

TEC also believe there is evidence that the augex reductions for Ergon should have gone further. We note that Ergon proposed a 20% increase in Augex expenditure in the current process based on the existence of targeted pockets of growth. We also note the views by the CCP that Ergon has not established evidence to support this in its regulatory proposal. We are not convinced that there has been sufficient 'bottom up' assessment of the justification for this augex spending.

We are also concerned that there does not appear to be sufficient scrutiny of Ergon's proposed \$279.5 million for new connections. These costs are almost ten times that allowed for Essential Energy who operates a somewhat comparable low-density rural network.¹³ Given this, and the fact that Ergon's estimate is based on historical costs and a forecasting methodology that resulted in significantly overestimated costs in the previous period, we would like to see further scrutiny of this expenditure by the AER.

Consideration of non-network options

We have previously expressed the view that the AER should 'ground-truth' its capex benchmarking by doing a 'bottom up' analysis of some planned augex and repex projects, to determine whether networks have adequately considered non-network options. While we appreciate the EMCa finding that Ergon's augex planning does not reflect the "application of risk analysis to consider opportunities to defer some projects with demand management or hybrid augmentation and demand management solutions"¹⁴, we understand this view has largely been informed by a 'top down' analysis of Ergon's capex forecast. We believe that further examination of the businesses' actual project proposals, as well as their planning processes, is required to determine the adequacy of their use of non-network options.

The current process also places considerable reliance on the RIT-D process to test the businesses' proposals at a subsequent date. We consider that the AER needs to scrutinise the RIT-D process carefully rather than simply relying on benchmarks. For example the AER could review their RIT-Ds over the previous determination period to identify how effective the process actually is in generating alternative and innovative non-network alternatives.

Repex

TEC notes that of the \$878.1 million of capex cut for Energex, over 70% of this related to a reduction in repex. We support the AER's view that Energex had not made a case for the significant increase proposed on repex compared to its historical repex spending pattern and that Energex is overly conservative in its risk management approach. The AER has proposed a reduction in the repex forecast for Ergon for similar reasons.

¹² Bruce Mountain, Presentation at the AER preliminary decision conference, 12 May 2015, Brisbane.

¹³ QCOSS, Response to AER Preliminary Decision, July 2015, p16.

¹⁴ AER Preliminary Decision Ergon Distribution Determination – Attachment 6 Capital Expenditure, April 2015, p 6-54

However we note and support the CCP's view that the AER has insufficiently considered the networks' recent repex spend and that over the past decade they have effectively 'pre installed' a large proportion of their repex needs for the next period.¹⁵

Capitalised Overheads

We further note the CCP view that the AER has not made deep enough reductions in the businesses' capitalised overheads, particularly in relation to Information and Communication Technology (ICT) costs.¹⁶ This is despite the AER acknowledging that the businesses' ICT costs are significantly above the efficient levels, and that the businesses have not yet implemented recommendations arising from the Independent Review Panel (IRP) report in relation to the jointly owned ICT business SPARQ.¹⁷

Opex

TEC is concerned that the AER has made only minimal revisions to the opex expenditure proposals in the preliminary decision. The AER has reduced the opex for Ergon Energy by only 10.5% or -191.3 million, while Energex's opex has been approved as submitted.

While we support the AER's view that Ergon is not and has not operated efficiently based on the results of the result of the benchmarking work done by Economic Insights and the report of the Independent Review Panel in Queensland, we do not believe that the AER's approach to setting the comparison benchmark is sound. In particular we question the use of the 5th most efficient operator as the benchmark from which to assess Ergon and Energex's efficient costs. In the NSW preliminary determination the AER used the average performance of the top quartile as the benchmark, an approach that we thought was generous to the businesses but which we supported. We cannot see the justification for reducing the standard further and believe doing so rewards the businesses and penalises customers for their inefficiency. In addition, TEC note that the AER has generously applied 'environmental adjustments' of 17.1 per cent for Energex and 24.4 per cent for Ergon.¹⁸ We agree with the views expressed by PIAC in their challenge to the AER's final decision in NSW that the case for these adjustments has not been made out.

While we would expect a smaller reduction in the opex forecast for Energex because the benchmarking exercise suggests they have become more efficient over time and also because they exercised more restraint in their opex forecasts, application of a higher comparison benchmark would have also resulted in a lower forecast opex for Energex. We support the views of the CCP presented at the forum on the AER draft decision that opex levels have been driven by overinflated capital expenditure, and that customers should pay for the network they are actually using, rather than that which has been built.¹⁹

Rate of Return

TEC notes that the AER has approved a Weighted Average Cost of Capital (WACC) of 5.85% rather than the rate of return proposed by Energex and Ergon of 7.75% and 8.02% respectively. Consistent with the AER's previously stated intentions, the AER has applied the rate of return guidelines developed as part of the Better Regulation Program. While we appreciate that the AER decision is a considerable improvement and

¹⁵ Hugh Grant, Presentation at AER Preliminary decision conference, 12 May 2015, Brisbane.

¹⁶ Bruce Mountain, Presentation at AER preliminary decision conference, 12 May 2015, Brisbane.

¹⁷ AER Preliminary Decision Energex Distribution Determination – Attachment 6 Capital Expenditure, April 2015, p 6-94

¹⁸ AER Preliminary Decision Energex Distribution Determination – Attachment 7 Operational Expenditure, April 2015, p7-27

¹⁹ Bruce Mountain, Presentation at AER preliminary decision conference, 12 May 2015, Brisbane.

that it is the rate of return which has the single most significant impact on the prices paid by consumers, as we have noted previously we believe that the AER would be justified in departing from the guidelines in view of the significant number of submissions from consumer representatives providing evidence that the guidelines are too generous. In particular we agreed with the advice provided by CCP, arguing that real world data about profitability and actual costs of borrowing should and could be considered,²⁰ and we are concerned that the rate of return approved in the preliminary decision is still higher than the rates allowed in similar circumstance by State regulators, and considerably higher again than the rates applied in international jurisdictions including New Zealand and the UK.²¹ We are disappointed that the AER did not respond in more detail why it had rejected the arguments made by the CCP in this regard.

Conclusion

TEC would like to see the AER respond, in its final decision, to TEC's views that:

- That the AER should develop a guideline, separate to the DMEGIS, to provide guidance on both DM and capex plans in the regulatory determination process;
- That the effectiveness of new mechanisms (including the CESS, RIT-D, and tariff reform) to incentivise DM is not yet clear, and therefore should not be solely relied on to drive effort in adopting non network solutions;
- The AER should review a selection of RIT-D processes to determine the extent to which the businesses are considering non network alternatives as well as the effectiveness of the process in facilitating such options; and,
- The AER should 'ground-truth' its capex benchmarking by doing a "bottom up" analysis of some planned augex and repex projects, to determine whether networks have adequately considered non-network options.

We would also like the AER to provide detailed commentary on the matters raised by the CCP, namely that:

- Levels of excess capacity have not been adequately taken into account;
- The AER has based its augex and connections capital decisions on unreliable load forecasts;
- The AER has overly relied on trend analysis in establishing the repex requirements, and in particular has relied on past asset replacement practices which may not be efficient;
- The AER has given insufficient consideration to the fact that the networks have effectively 'pre-installed' a large proportion of their repex needs for the next period; and,
- The comparison point for efficient opex for Energen and Ergon should be set closer to the efficiency frontier, rather than at the 5th most efficient (bottom of the top quartile) operator.

Yours sincerely,



Jeff Angel
Executive Director

²⁰ Consumer Challenge Panel, *Smelling the roses and escaping the rabbit holes: the value of looking at the actual outcomes in deciding WACC*. July 2014.

²¹ *ibid.*