

AER Public Forum - 9th December 2014

Preliminary Perspectives

Energex & Ergon Revenue Proposals

Hugh Grant

AER Consumer Challenge Panel Member

**WHO SAID NETWORK
REGULATION IS BORING?**

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



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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 shuddered at the sight 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 head 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 of the activities planned for the executives but said the bill was expected to be less than \$6000, including "ac-

commodation, 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 \$290.70 to \$2275.67.

In a written statement, an Energex spokesman yesterday said the retreat was an

important part of the company's planning process and was a similar distance from Brisbane as past events.

"As a \$2 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 do

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.

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 31-year-old Energex treasury analyst Cally Wilson would this week burst into the public arena with explosive claims of corporate



INVOICE COMES AS BIG SHOCK

PAGE CARFRAE

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

Single mum Alyce Stratthie, 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 Stratthie 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 Stratthie was automated 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

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

PROFIT FROM PAIN

KELMENY FRASER

Government reaps record gains from power bills

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

REVENUE PROPOSALS

PRELIMINARY

CONSUMER FEEDBACK

Preliminary Consumer Feedback

➤ **Prices**

Suggestions that current prices are excessive and significant reduction are justified

Concerns that Energex and Ergon's proposals consider that ongoing price increase are acceptable

➤ **Return on Capital (WACC)**

Objections to the proposed departures from the *AER Rate of Return Guideline*, and the "very high" proposed WACCs

Suggestions that the parameters in the *AER Rate of Return Guideline* have been set too high and will deliver excessive profits to Energex and Ergon

Suggestions that the Queensland government should accept lower returns more reflective of their actual financing costs

Suggestions that the QCA's 'Reasonableness Review' didn't appropriately consider the 'reasonableness' of the WACC claims

Preliminary Consumer Feedback

➤ **Regulatory Asset Bases (RABs)**

Concerns regarding the current/proposed RAB levels, and suggestions that inefficient past investments are locking in excessive future prices

Suggestions that major write-downs to the RABs are required

➤ **Capex**

Concerns that the proposed levels of augmentation capex are inconsistent with flat/declining demand trends and reduced reliability standards

Suggestions that the proposed levels of replacement capex are significantly above the underlying needs

Critiques of the networks' demand and energy forecasts

Critiques of the networks' claims regarding "ageing assets"

➤ **Opex**

Suggestions that the networks' past and proposed opex levels are inefficient

Expectations that benchmarking will determine significantly lower allowances

Suggestions that the previous opex allowances were excessive and that the associated efficiency incentive payments are inappropriate

Preliminary Consumer Feedback

➤ **Reliability**

Challenges to the networks' claims regarding consumers' feedback on reliability

Concerns that price/reliability trade-offs were not discussed at a level of detail that enabled informed feedback

Concerns regarding Ergon not meeting current reliability standards in FNQ

➤ **Consumer Engagement Programs**

Concerns that the key issues raised during the consumer engagement programs have not influenced, or been reflected in, the revenue proposals

Challenging some conclusions that Energex and Ergon are claiming from their consumer engagement programs

Criticisms of the high level nature of the engagement programs, and the difficulty in obtaining information during the process

Feedback that the sessions “fell short of conducting meaningful consultation”

Preliminary Consumer Engagement

➤ **Regulatory Rules/AER**

Concerns with the AER's inability to challenge the efficiency/need of past investments

Suggestions that the AER's *'Better Regulation Guidelines'* inappropriately reduce the AER's flexibility

Suggestions that the parameters in the AER ROR guideline are too high, and concerns that the AER did not reduce those parameters in its recent draft determinations

Suggestions that the AER needs to determine WACCs for government owned network that are more reflective of their actual cost of capital

Challenging the appropriateness of a Revenue Cap as the Control Mechanism


➤ **Other**


Concerns with the volume of the revenue proposals and the the "level of spin"

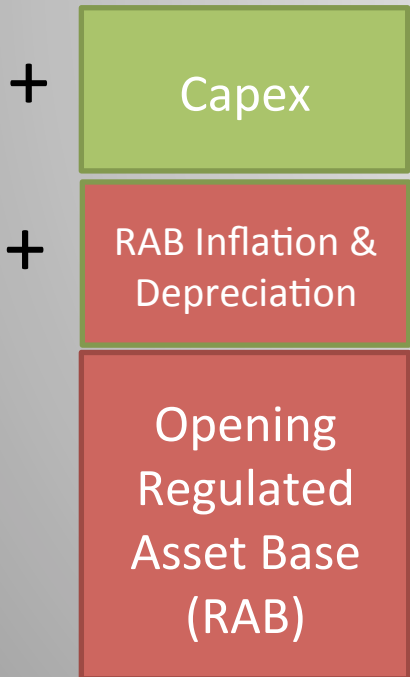
Concerns with the difficulty in finding details important to consumers

Concerns that the revenue proposals "deflect the emphatic nature of concerns around unsustainable prices by burying it amongst other secondary issues"

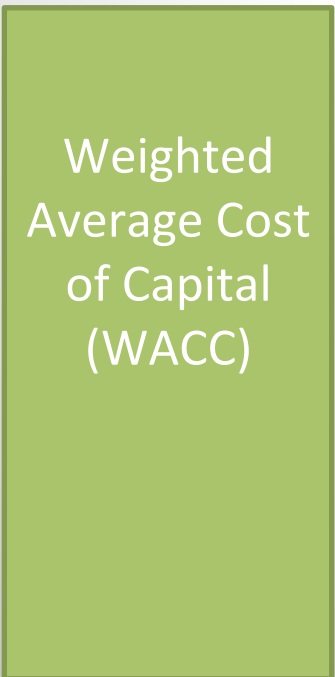
Building Block Revenue – Consumers' Capacity to Influence

 Issues which consumers have some capacity to influence through the AER revenue determination process

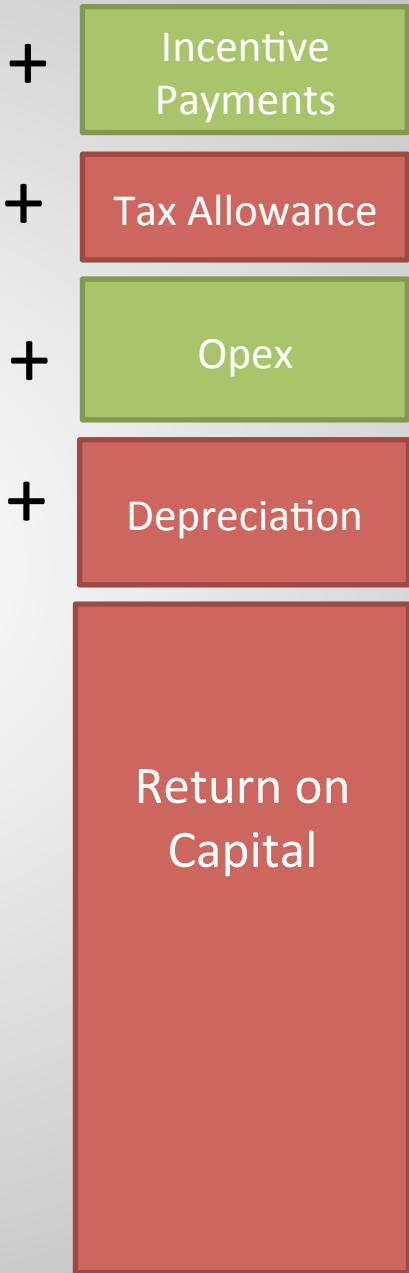
 Issues which consumers have limited capacity to influence through the AER revenue determination process



X



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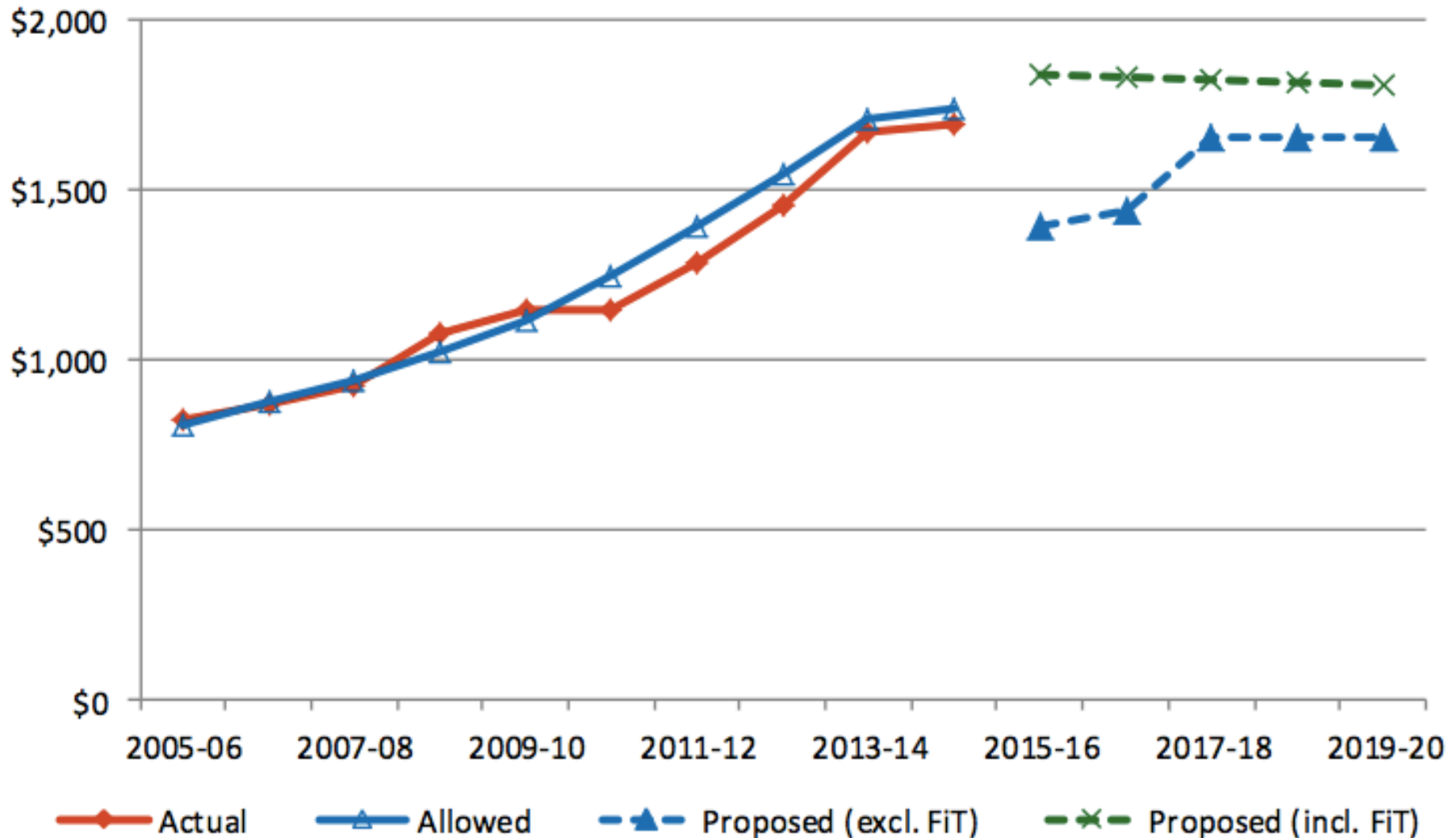


PROPOSED REVENUES

Energex - Proposed Revenue

Figure 1

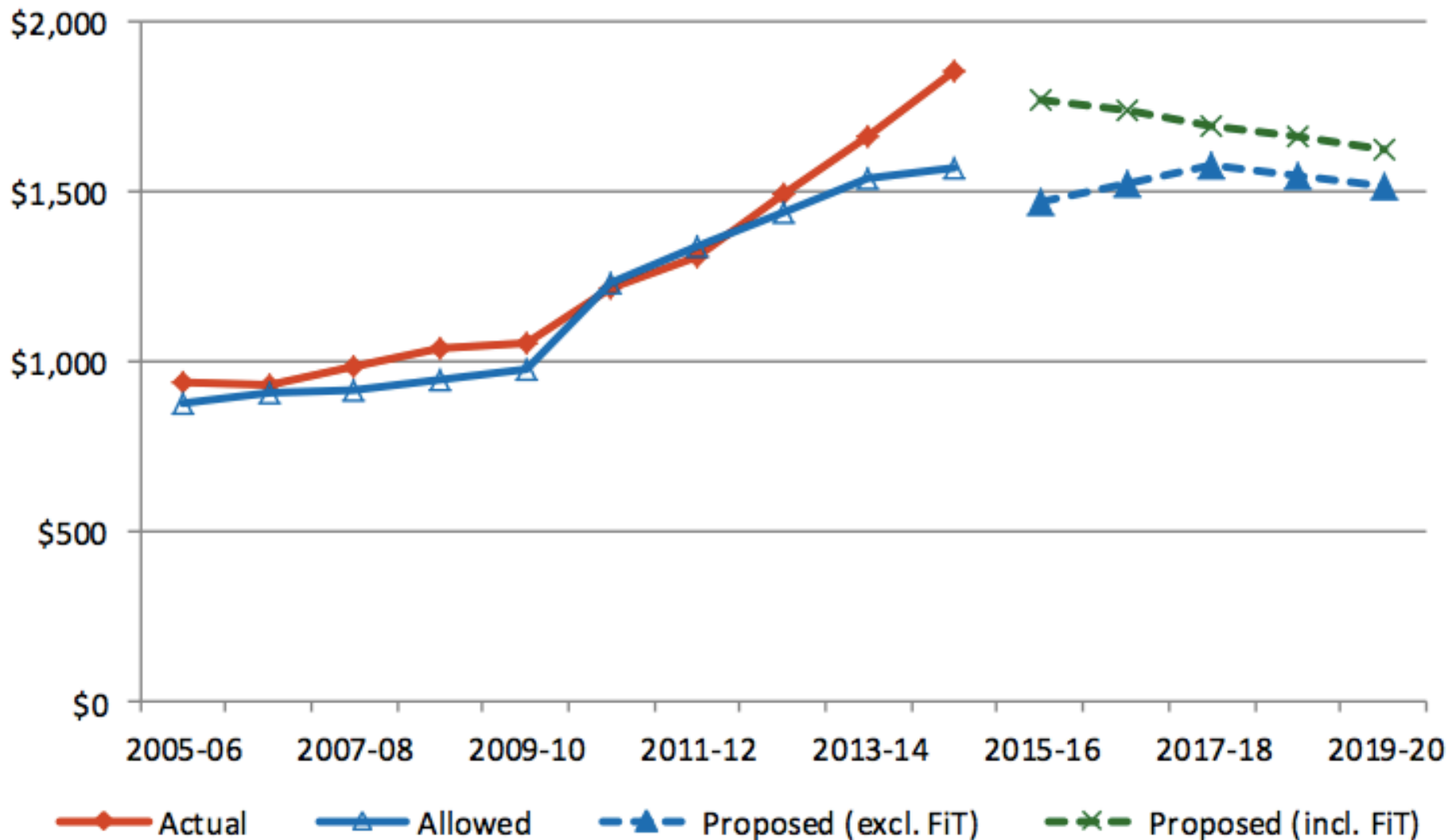
Energex – proposed total revenue (\$million, 2014–15)⁹



Ergon - Proposed Revenue

Figure 2

Ergon Energy – proposed total revenue (\$million, 2014–15)¹⁰



Estimated Price Impacts

- Energex claims that its proposed revenue would result in annual price increases of around 2%
- Ergon claims that its proposed revenue would result in annual price increase of around 0.5%

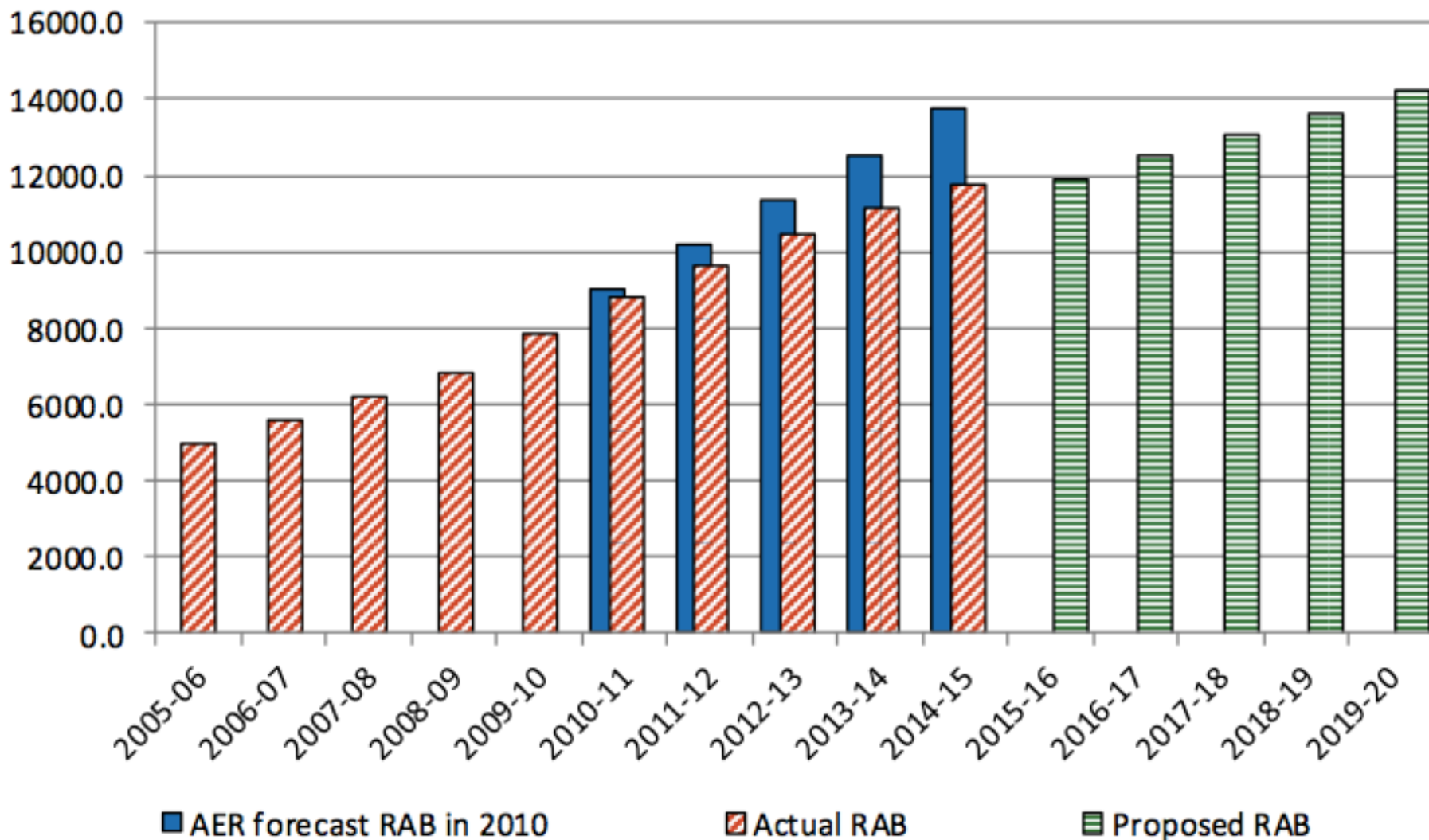
AER Draft Determinations - NSW/ACT DNSPs

	DNSPs' Proposed Revenue	AER Draft Determination 2014/15 - 18/19	Reductions	Key Areas of Reduction
ActewAGL	\$1,062 M	\$761 M	28 %	<ul style="list-style-type: none"> 28% WACC Reduction 37% Capex reduction 42% Opex Reduction
Ausgrid	\$12,212 M	\$8,850 M	27.5 %	<ul style="list-style-type: none"> 24% WACC Reduction 43% Capex reduction 39% Opex Reduction
Essential Energy	\$6,824 M	\$5,038 M	26 %	<ul style="list-style-type: none"> 23% WACC Reduction 36% Augex Reduction 38% Opex Reduction
Endeavour Energy	\$5,256 M	\$4,016 M	24 %	<ul style="list-style-type: none"> 23% WACC Reduction 27% Capex Reduction 23% Opex Reduction

GROWTH IN REGULATORY ASSET BASES (RABs)

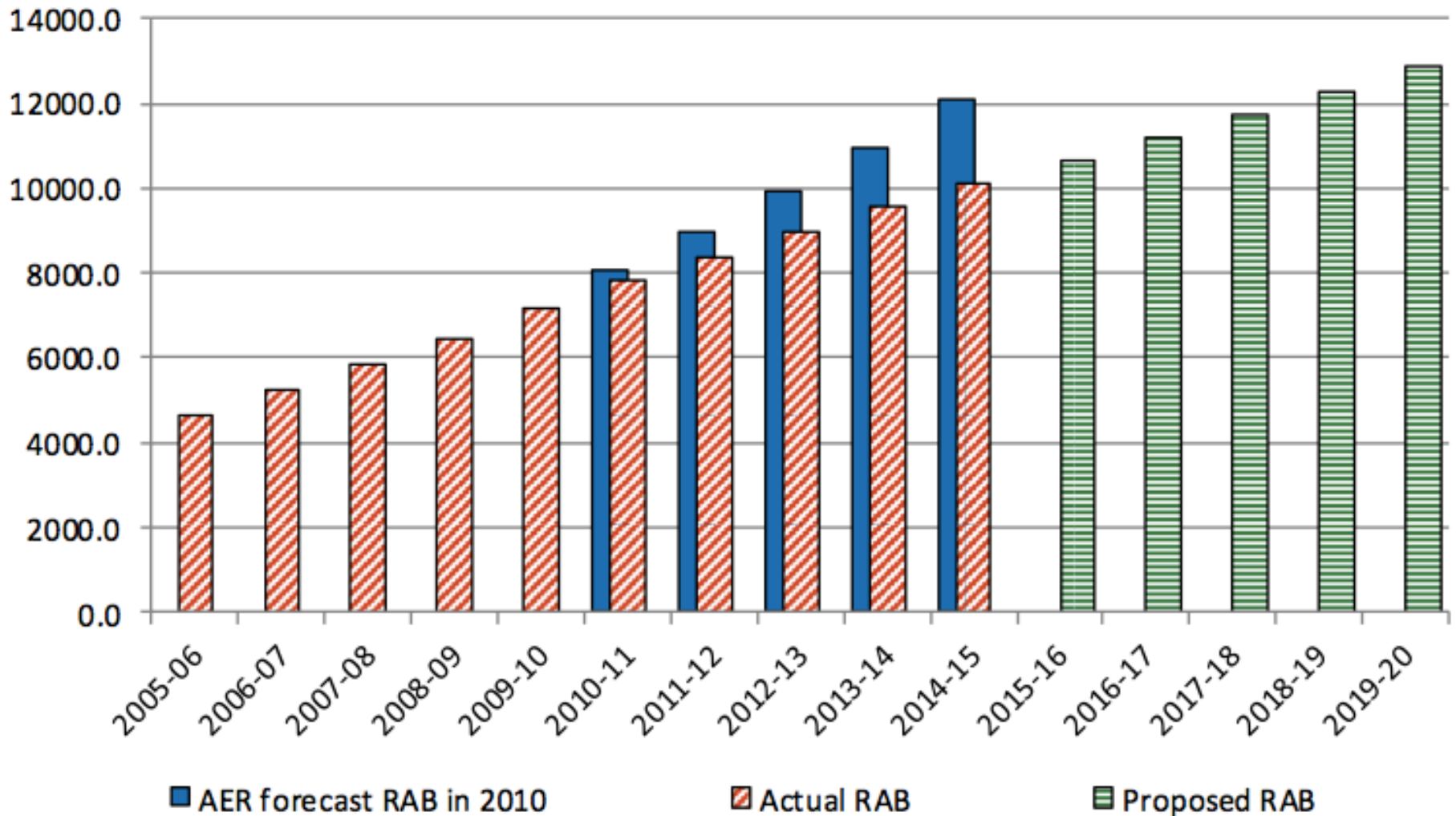
Energex - Historical and Proposed RAB Growth

Figure 9 Energex – regulatory asset base (RAB) values



Ergon - Historical and Proposed RAB Growth

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



Return on Capital (WACC)

- Energex has proposed a total WACC of 7.75%. Ergon has proposed a total WACC of 8.02%
- Refer to CCP Papers to the AER on the AER's approach to determining the Rate of Return
<http://www.aer.gov.au/sites/default/files/CCP%20Letter%20to%20the%20AER%20Board%20-%20Rate%20of%20Return%20Paper.PDF>
<http://www.aer.gov.au/sites/default/files/CCP%20report%20prepared%20for%20AER%20Board%20-%20Rate%20of%20Return.pdf>
- **Applying the CCPs' recommendations should result in overall WACCs of below 6% (assuming the current risk free rate)**
- That would still deliver generous returns to Energex and Ergon and better reflect consumers' long term interest

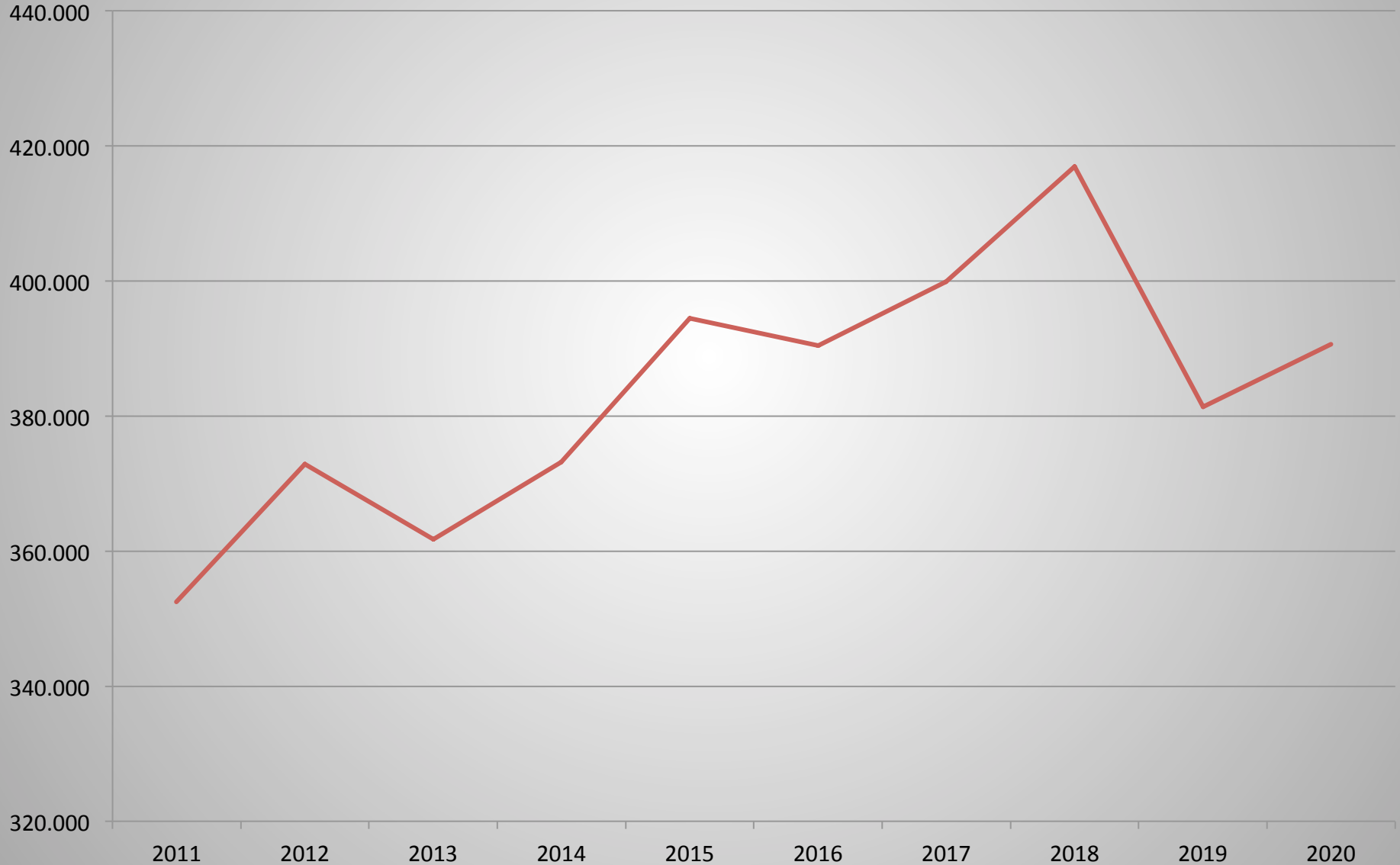
AUGMENTATION CAPEX

Augmentation Capex

- The proposed levels of augmentation capex appear very high – particularly in light of the flat load forecasts, and reduced reliability standards
- This is particularly the case for Ergon, with:
 - A similar level of 'Corporation Initiated Augmentation' capex to the previous period
 - An increase of around 20% for 'Customer Connection Initiated' capex

Ergon Augmentation Capex Trend

Ergon Total Augmentation Capex (\$2014/15)



REPLACEMENT CAPEX

Proposed Replacement Capex

- **Energex** is proposing a **66% increase** compared to its actual spend in the previous period
- **Ergon** is proposing a **23% increase** compared to its actual spend in the previous period
- These proposed expenditure levels are very high by historical standards and follow substantial replacement capex programs during the previous regulatory periods

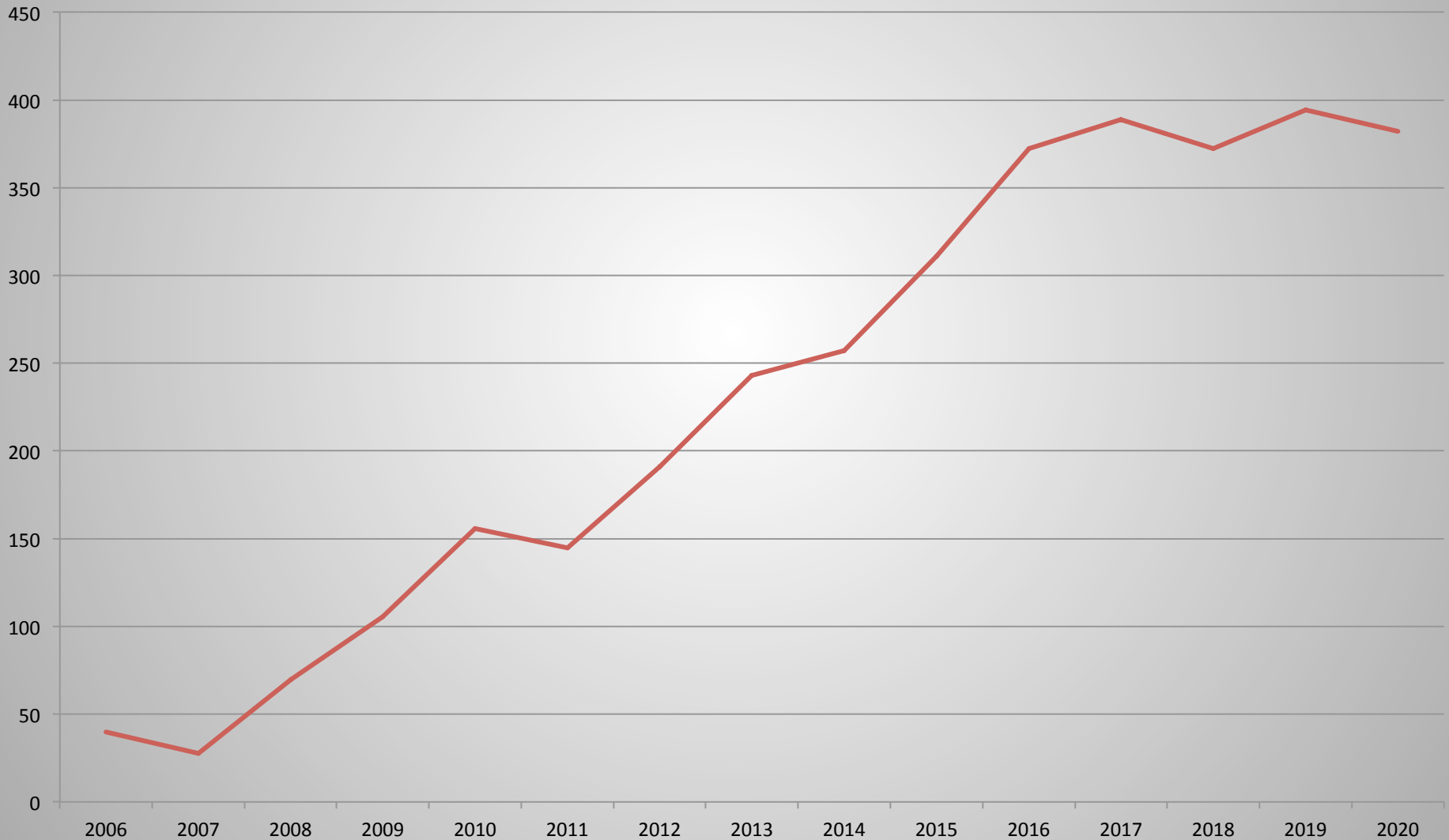
Proposed Replacement Capex

*“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

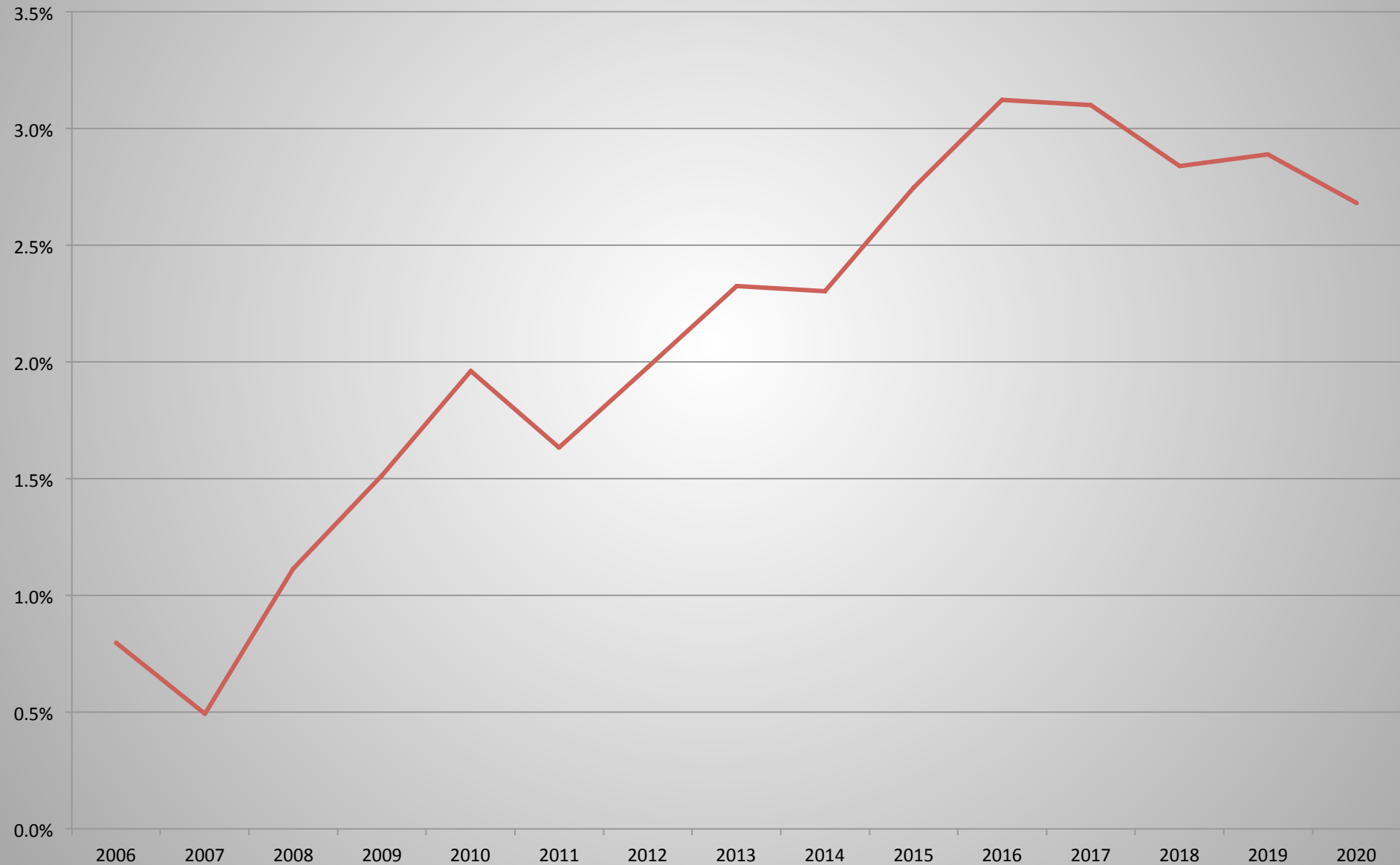
Energex Replacement Capex Trend

Energex Replacement Capex



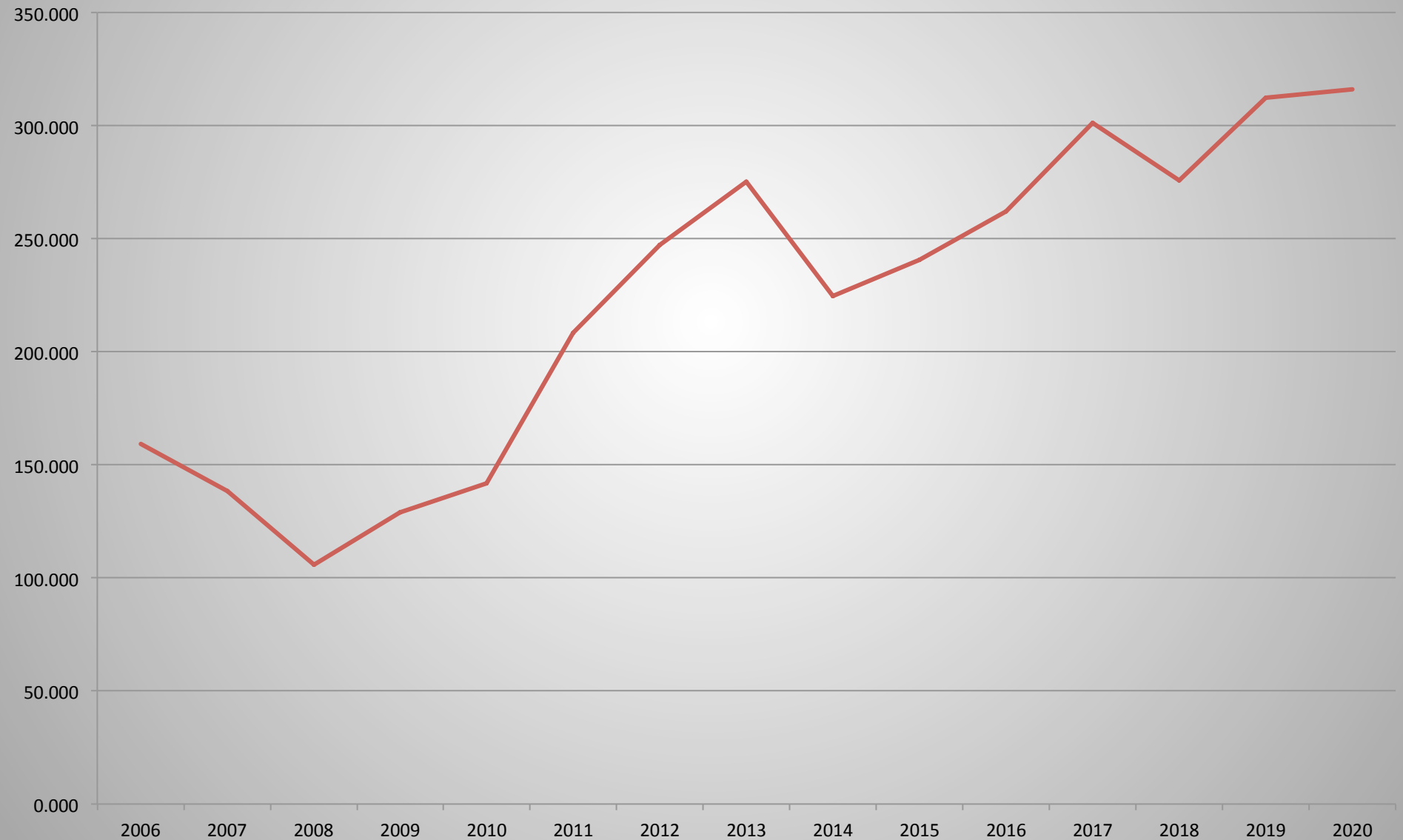
Energex Replacement Capex/RAB

Energex Replacement Capex/RAB



Ergon Replacement Capex

Ergon Replacement Capex



Replacement Capex Justifications?

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

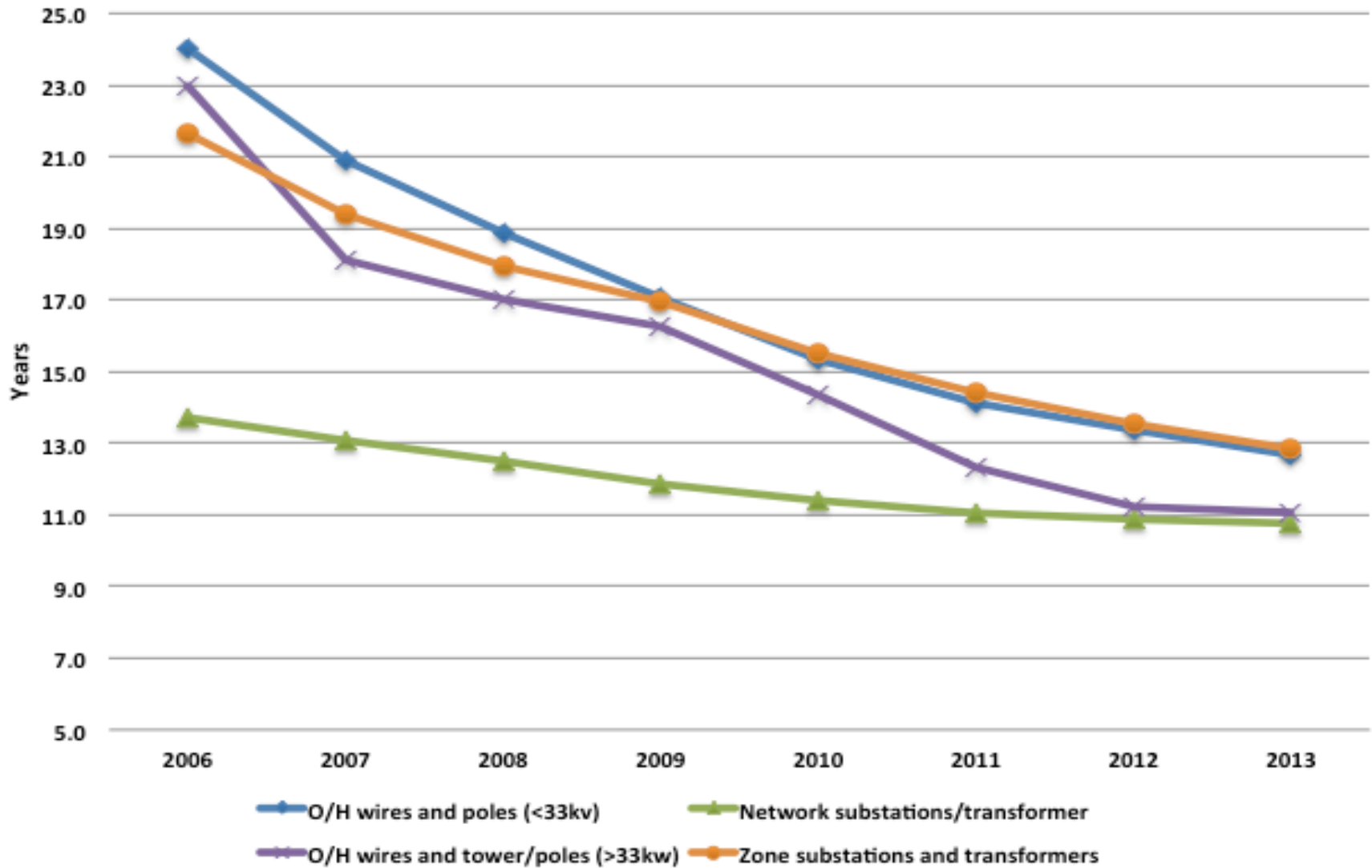
Energex Revenue Proposal, P 82

*“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”*

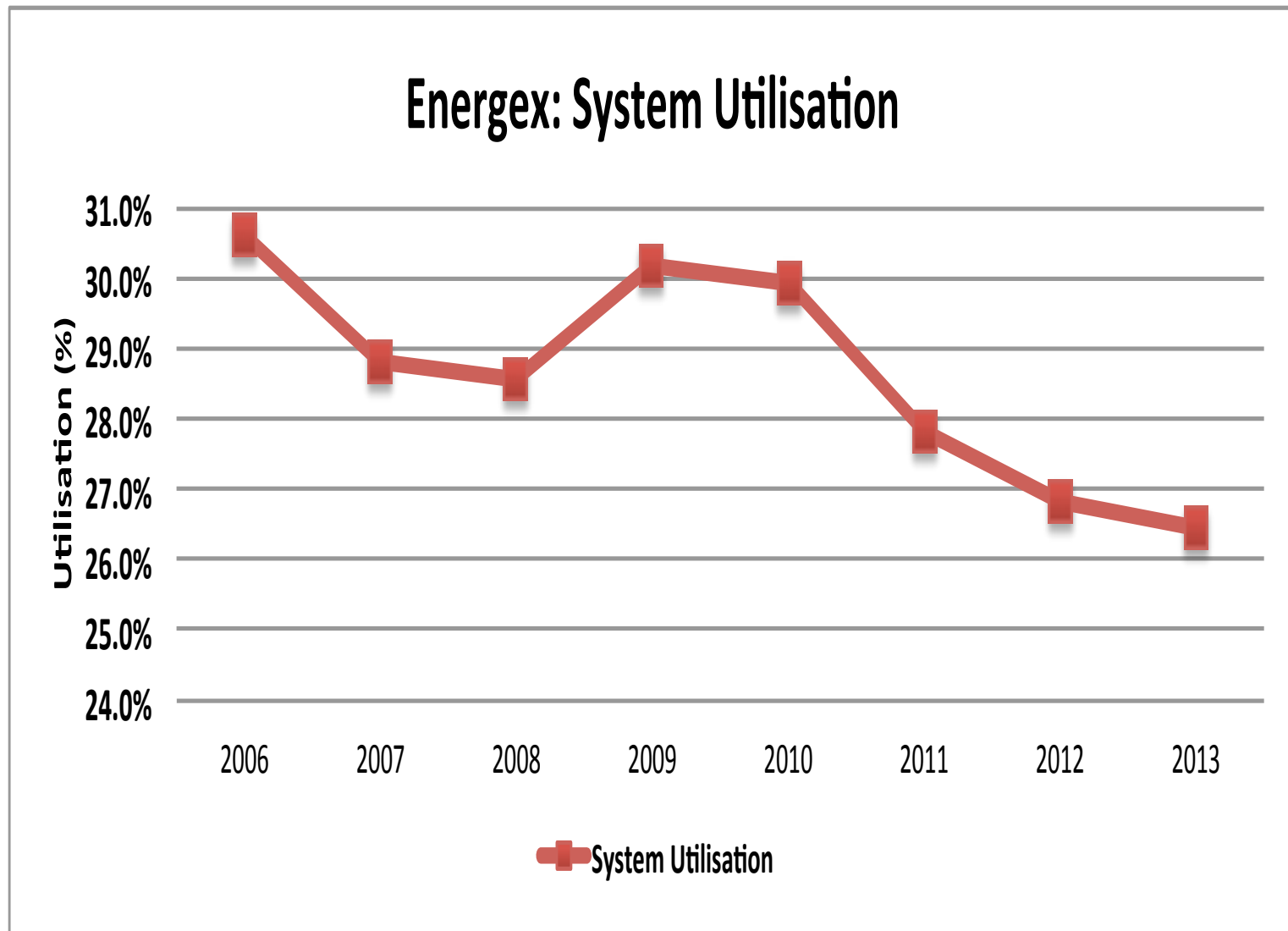
AER Issues paper, P 15

Energex: Asset Age Trends

Energex: Average Age of Assets

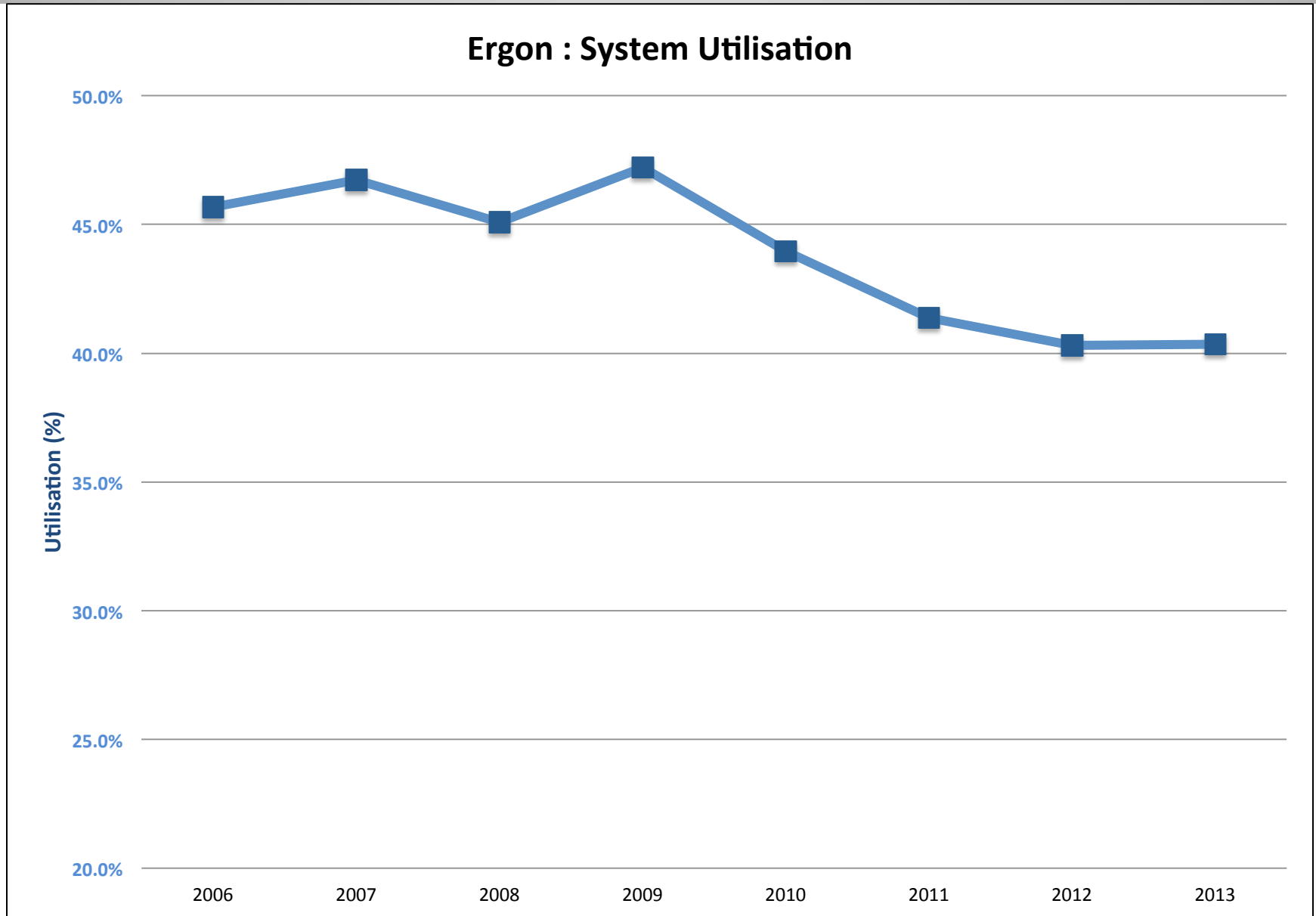


Energex System Utilisation



Source: Bev Hughson Analysis of Energex RINS Data

Ergon System Utilisation



Replacement CapEx - Preliminary Comments

- It is not clear that the networks' average asset age is increasing - analysis of RINS data appears to suggest the opposite
- The proposed levels of replacement capex appear very high, particularly in light of:
 - The substantial replacement capex programs during the previous regulatory periods
 - Asset age and asset utilisation trends
- Irrespective, the networks' proposals have not demonstrated their claimed linkages between the proposed replacement capex and system performance

AER Draft Determinations - Replacement Capex

	Proposed Replacement Capex	AER Draft Determination 2014/15 - 2018/19	Reductions
Ausgrid	\$3,113 Million	\$1,901 Million	39 %
Essential Energy	\$2,515 Million	\$1,552 Million	38.3%
ActewAGL	\$414 Million	\$241 Million	42%

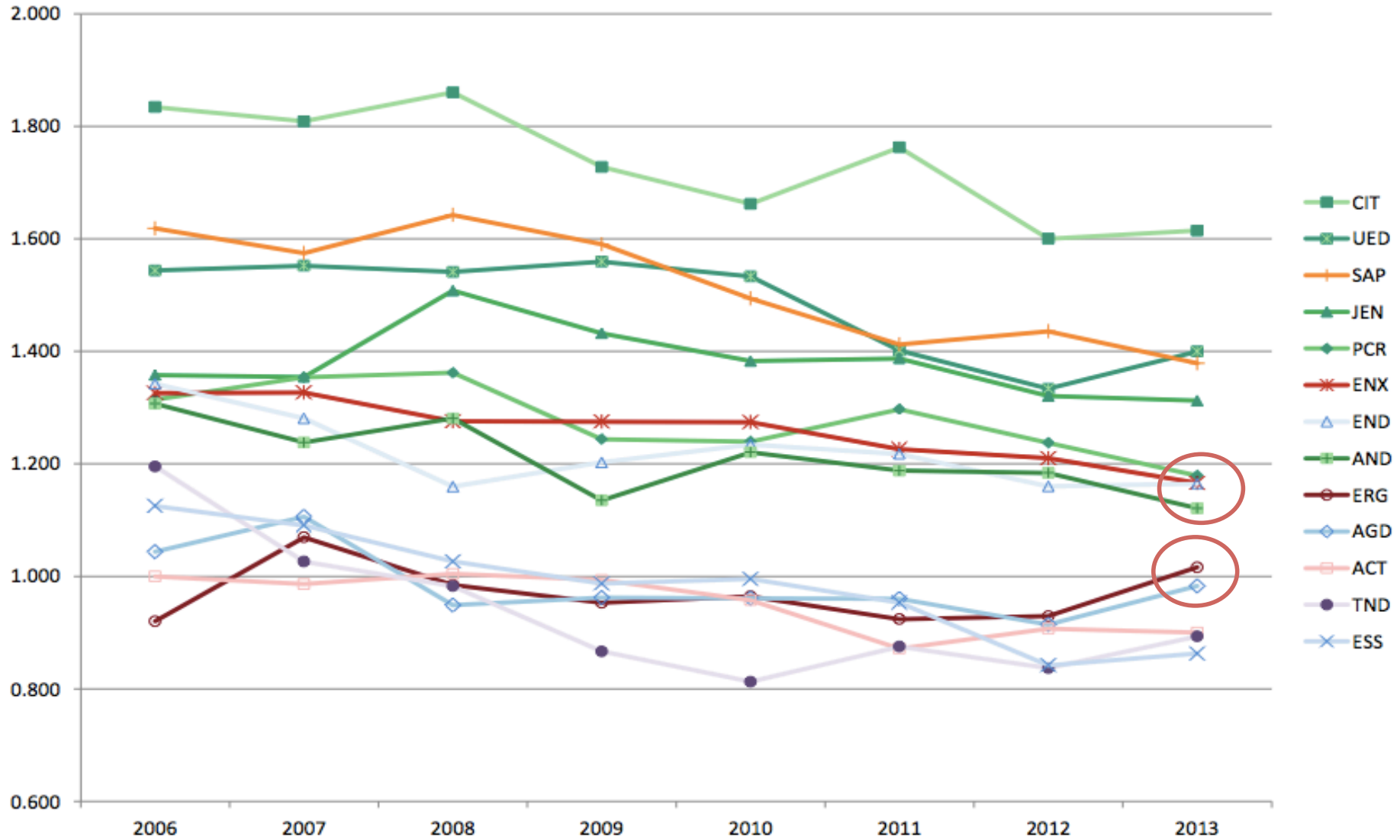
OPEX

Benchmarking

- The new Rules formally require the AER to:
 - Undertake benchmarking to assess the relative efficiencies of network businesses
 - Apply the outcomes to determine efficient costs for the networks
- The AER's first benchmarking reports were released in late November
- The AER has applied benchmarking to determine the opex allowances for the NSW DNSPs

Multilateral Total Factor Productivity

Figure 16 Multilateral total factor productivity for each distributor



Reliability PPIs

Figure 30 Total cost per customer and unplanned minutes off supply per customer (excluding MEDs, average 2009–2013)

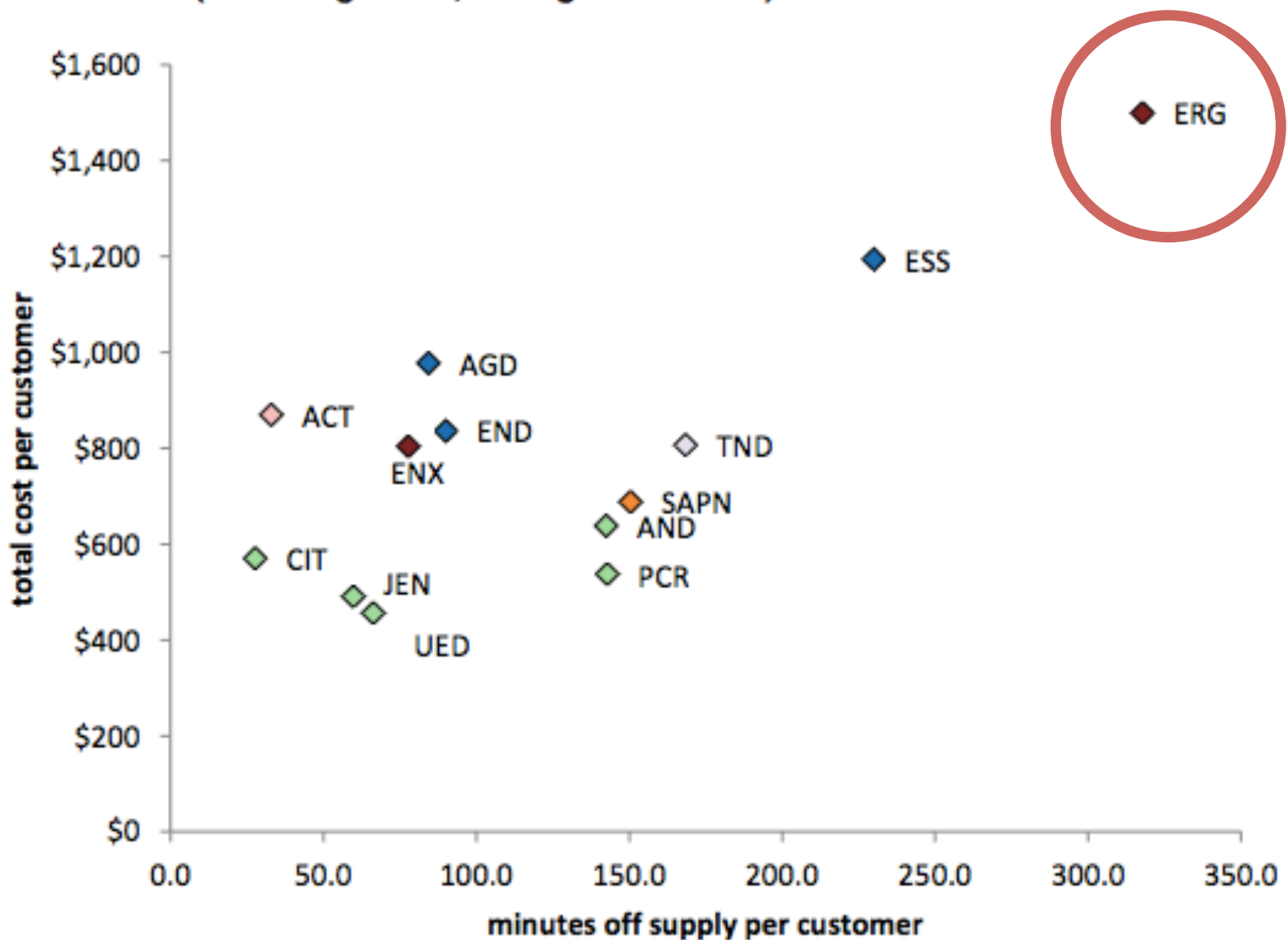
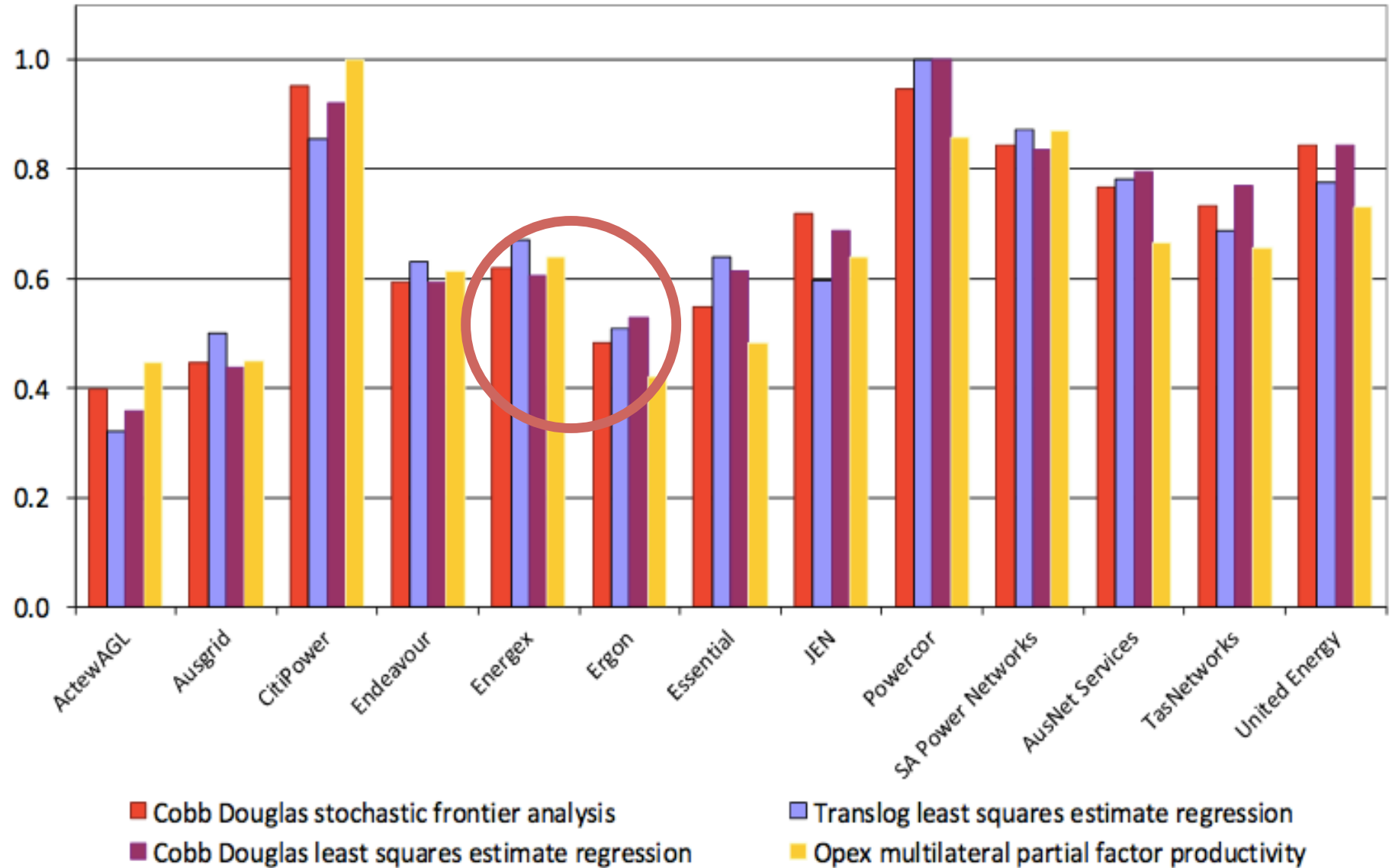


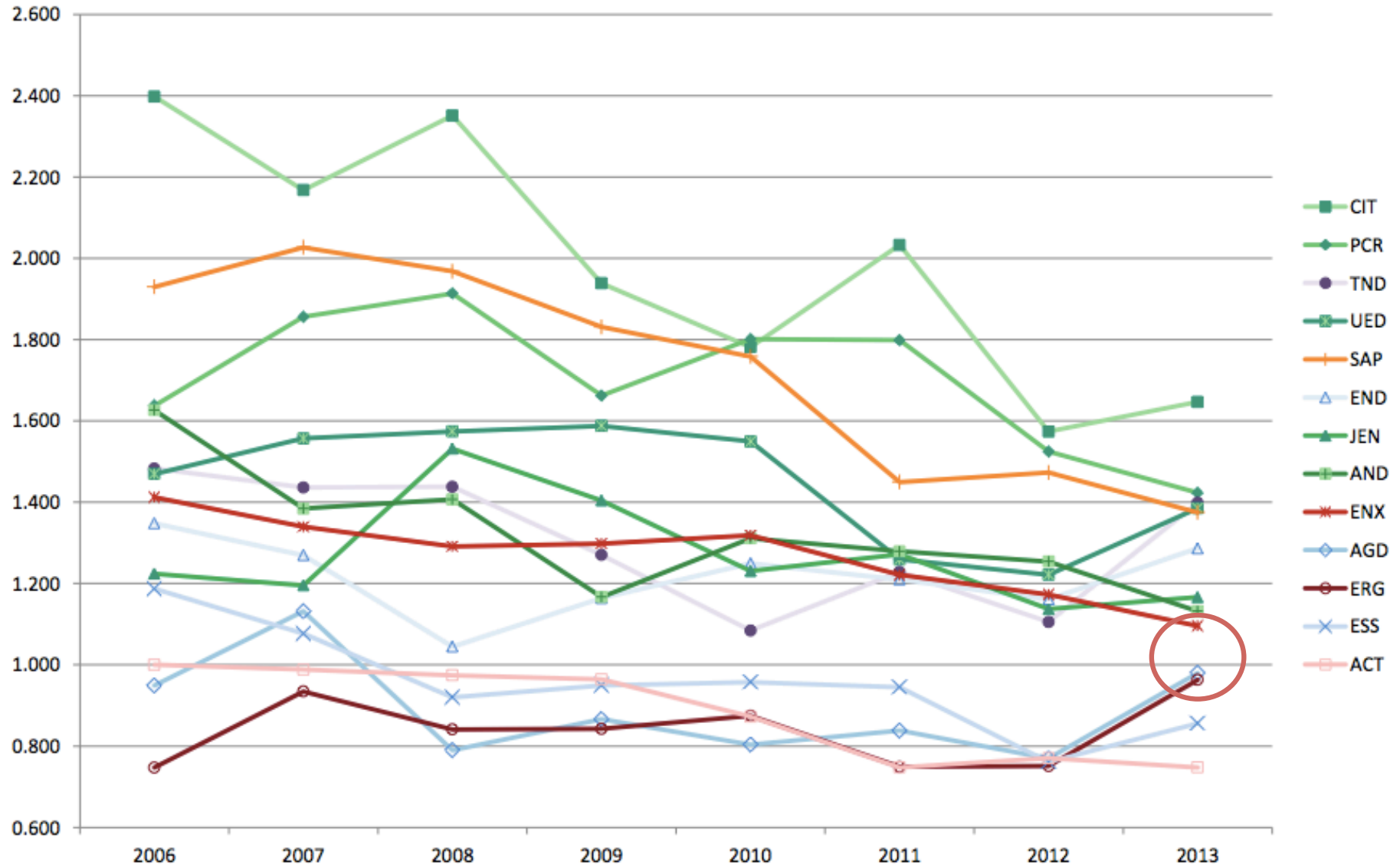
Figure 8-6 Econometric modelling and opex MPFP results



Source: Economic Insights.

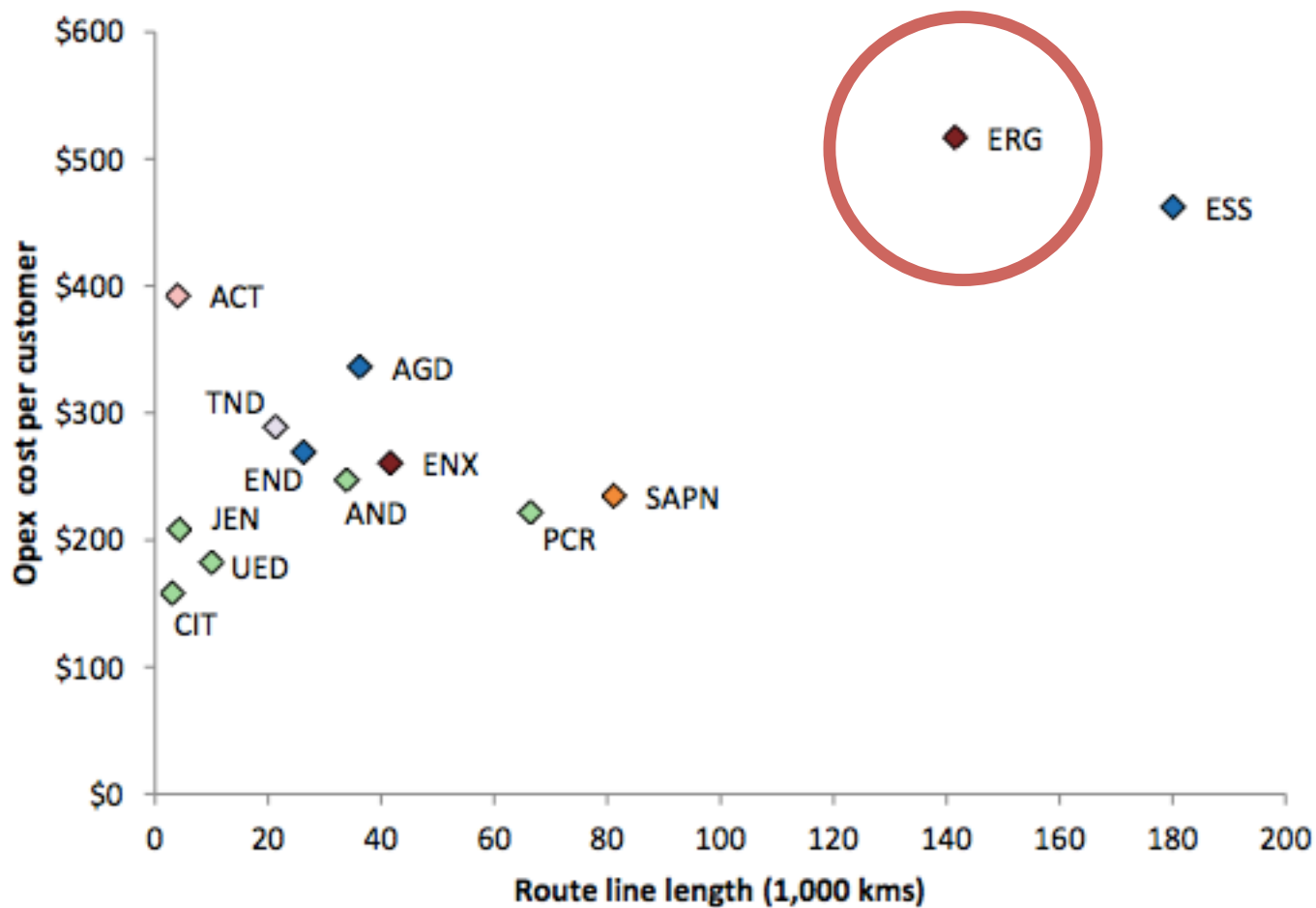
Partial Factor Productivity - Opex

Figure 19 Partial factor productivity of opex



Opex per Customer

Figure 26 Opex per customer compared to line length (average 2009–2013)



AER Draft Determinations - Opex

	Proposal	AER Draft Determination 2014/15 - 2018/19	Reductions
Ausgrid	\$3,113 Million	\$1,901 Million	39 %
Essential Energy	\$2,515 Million	\$1,552 Million	38.3%
ActewAGL	\$414 Million	\$241 Million	42%

Performance Incentive Schemes

- Efficiency Benefit Sharing Scheme (EBSS)
- Service Target Performance Incentive Scheme (STPIS)
- Demand Management Incentive Scheme (DMIS)
- Capital Expenditure Sharing Scheme (CESS)
- Network Capability Incentive Parameter Action Plan (NCIPAP)

Incentive Scheme Outcomes

- The outcomes of the incentive schemes to date suggest that the AER has consistently set allowances and targets above the efficient level
- The AER needs to negotiate targets that deliver genuine efficiency improvements and incentivise best practice

Thank You

Hugh Grant

AER Consumer Challenge Panel Member