Alliance of Electricity Consumers

Submission on Ergon Energy's Regulatory Proposal 2015-2020

VERSION 1 – 30/1/15

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About this submission

This submission has been prepared on behalf of The Alliance of Electricity Consumers (The Alliance), as a part of the Australian Energy Regulator (AER)'s Regulatory Reset of Ergon Energy's regulated distribution services and the revenue and prices associated with them for the Regulatory Control Period commencing on 1 July 2015 and ending on 30 June 2020.

Rapidly rising retail electricity prices, primarily caused through escalating network prices, is one of the most important issues facing all Queenslanders. Increases in network prices over the last five years have had a compounding impacted every Queensland household and business. Higher electricity prices erode competitiveness within the economy, reduce investment attractiveness and diminish employment opportunities for all Queenslanders. High electricity prices place the largest burden on the cost of living and are felt not just through monthly electricity bills, but also through the price of all goods and services as increased electricity costs are passed back through the supply chain.

The last five years of record network price increases shows that Ergon Energy has failed to focus on the short or long-term interests of consumers. The AER Regulatory Reset is a rare opportunity for Queensland electricity consumers to have their say on Ergon Energy's revenues and subsequent electricity prices over the next five years.

This submission has been prepared to critically analyze the core elements of Ergon Energy's Regulatory Proposal, such as Ergon's proposed operational and capital expenditure, and cost of capital parameters for the duration of the next regulatory period. The analysis conducted by The Alliance, contained in this submission, demonstrates that the efficiency of operation and investment in Ergon Energy's distribution network could be significantly improved. The large improvements in investment and operational efficiency proposed by The Alliance will lead to significant network price reductions for all of Ergon Energy's customers.

Unless otherwise stated, all data used in this submission has been sourced from AER Regulatory Information Notices (RINs), Regulator Decisions and/or Ergon Energy's Regulatory Proposal.

About The Alliance of Electricity Consumers

The Alliance was formed to ensure consumers' demands for lower electricity prices could be formally made in the AER's Regulatory Reset process.

The Alliance's simple message to Ergon Energy and the AER is that network prices are too high and they must be substantially reduced over the next regulatory period (2015 to 2020).

Members of The Alliance have reserved their right to make their own submissions to the AER on Ergon Energy's Regulatory Proposal, which will detail their organisation's own specific issues, views and preferences. The Alliance's submission has been prepared to represent the views of "electricity consumers in general" – not the specific views of members of The Alliance.

Members of The Alliance of Electricity Consumers

townsville enterprise

CCIQ Powering business potential

QUEENSLAND resources COUNCIL

QUEENSLAND TOURISM INDUSTRY COUNCIL
The Voice of Tourism

QFF
QUEENSLAND FARMERS' FEDERATION

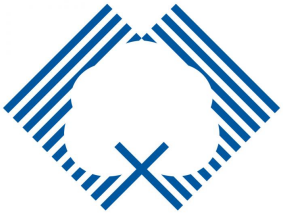
ADVANCE CAIRNS
OUR REGION • ONE VOICE

UDIA Urban Development Institute of Australia QUEENSLAND

NRA
National Retail Association

CANEGROWERS

MITEZ ECONOMIC DEVELOPMENT



COTTON AUSTRALIA

Advancing Australian Cotton

National Irrigators' Council

AGFORCE

AUSTRALIAN Prawn Farmers ASSOCIATION

Mareeba District Fruit and Vegetable Growers Assoc.

Summary of the submission

- Record electricity price increases over the last five years have been a major concern for all types of electricity consumers, across Queensland.
- Consumers are calling on Ergon Energy and the Australian Energy Regulator to significantly reduce network prices in the forthcoming Regulatory Control Period (2015-2020).
- Keeping Ergon Energy's prices and revenues at record high levels is not an acceptable outcome for consumers and not in compliance with the National Electricity Objective.
- Analysis conducted by The Alliance shows Ergon Energy's Annual Revenue Requirement should fall by 40% and network prices by 36% in 2015-16 and remain at the reduced level throughout the Regulatory Control Period, to 2020.
- To achieve significant price reductions, The Alliance calls on the AER to:
    - Reduce Ergon Energy's Annual Revenue Requirement by at least 40% from levels proposed by Ergon Energy;
    - Significantly revise downwards Ergon Energy's proposed System Demand and Energy Delivered forecasts;
    - Reduce Ergon Energy's capital expenditure by at least 41% over the Regulatory Control Period. This includes the following specific reductions:
        - Asset Renewal – less 50%;
        - Corporation Initiated Augmentation – less 55%;
        - Customer Connection Initiated Capital Works – less 6%;
        - Application of a capital productivity dividend of 2.96% to Ergon Energy's revised capital expenditure allowance, to bring Ergon Energy's capital productivity into line with its major customers by the end of the next Regulatory Control Period;
    - Reduce Ergon Energy's operational expenditure by at least 31% over the Regulatory Control Period.
        - The Alliance's proposed reduction in operational expenditure allowance includes a includes a 13.72% labor productivity requirement, to bring Ergon Energy's labour productivity into line with its major customers by the end of the next Regulatory Control Period;
    - Adopt the Alliance's preferred Weighted Average Cost of Capital (WACC) Parameters, which amount to a WACC rate of no more than 4%. The individual WACC parameters include:
        - Applying a AA notional credit rating to Ergon Energy debt financing costs, as opposed to the AER Benchmark of BBB+ or the rate proposed by Ergon Energy's in its Regulatory Proposal – BBB;
        - Reducing Ergon Energy's equity beta to the lowest possible end of the AER's spectrum. A rate any higher than 0.3 is not in the short- or long-run interests of consumers;
        - Adopting a Market Risk Premium that is inline with the expectations of other Queensland Government Owned Corporations – around 0.2%;
    - Not apply the incentive schemes to Ergon Energy in the next Regulatory Control Period. Further, the AER should revoke Ergon Energy's existing EBSS and STPIS "payments".

Cumulative potential for price reduction

The Alliance has reviewed Ergon Energy's Regulatory Proposal and analyzed Ergon Energy's claims for maintaining operational and capital expenditure levels at record high levels, artificially high WACC parameters and overly optimistic demand and energy forecasts. This submission critically reviews Ergon Energy's claims and provides a realistic, viable alternative for the AER to consider, as a part of its deliberations.

The Alliance strongly believes that Ergon Energy is not an efficient network operator and its future investment and operational plans are not in the short or long-run interests of consumers. The analysis conducted by The Alliance and detailed in this submission demonstrates an average 40% reduction in Ergon's network revenues can be achieved over the next regulatory period. The Alliance calls on the AER to adopt this proposed revenue reduction.

Forecasts

The Alliance believes that Ergon Energy's proposed forecasts are too optimistic and calls on the AER to accept revised forecasts, detailed in this submission. As observed in the current Regulatory Control Period, overly optimistic forecasts are not in the short or long-run interests of consumers.

The Alliance proposes that Ergon Energy's System Annual Maximum Demand forecasts be reduced.

System demand (MW)	*2015-16*	*2016-17*	*2017-18*	*2018-19*	*2019-20*
Ergon Energy Regulatory Proposal	*2,662*	*2,657*	*2,731*	*2,802*	*2,906*
Alliance Proposal	*2,420*	*2,430*	*2,440*	*2,450*	*2,460*

The Alliance proposes that Ergon Energy's Energy Delivered forecasts be significantly reduced.

Energy Delivered (GWh)	*2015-16*	*2016-17*	*2017-18*	*2018-19*	*2019-20*
Ergon Energy Regulatory Proposal	*14,367*	*14,511*	*14,662*	*14,807*	*14,955*
Alliance Proposal	*13,381*	*13,292*	*13,204*	*13,115*	*13,027*

The Alliance proposes that Ergon Energy's customer number forecasts be slightly reduced.

Customer numbers	*2015-16*	*2016-17*	*2017-18*	*2018-19*	*2019-20*
Ergon Energy Regulatory Proposal	*747,565*	*759,880*	*772,138*	*784,589*	*797,306*
Alliance Proposal	*746,628*	*758,389*	*770,150*	*781,911*	*793,672*

Regulatory Asset Base

The Alliance believes that full quantum of Ergon Energy's proposed capital expenditure over the next regulatory period is unnecessary and will unnecessarily increase the size of the Regulated Asset Base (RAB). Any unnecessary increase in the RAB is not in the short or long-run interests of consumers.

The Alliance proposes that Ergon Energy's forecast RAB be reduced in accordance with reductions in Ergon Energy's reduced capital expenditure allowance, as detailed by the Alliance in this submission. The Alliance calls on the AER to adopt the Alliance's alternate RAB proposal.

Alliance proposed RAB ($'m nominal)	2015-16	2016-17	2017-18	2018-19	2019-20
Opening RAB	10,042	10,652	11,233	11,748	12,311
Plus Alliance CAPEX (net of disposals and capital contributions)	505	478	429	402	381
Less regulatory depreciation	-174	-192	-208	-161	-170
Alliance Closing RAB	**10,373**	**10,938**	**11,454**	**11,989**	**12,522**
Ergon closing RAB	**10,652**	**11,233**	**11,748**	**12,311**	**12,867**
RAB reduction ($)	**-279**	**-295**	**-294**	**-323**	**-345**
RAB reduction (%)	**-2.62%**	**-2.62%**	**-2.50%**	**-2.62%**	**-2.68%**

Annual Revenue Requirement

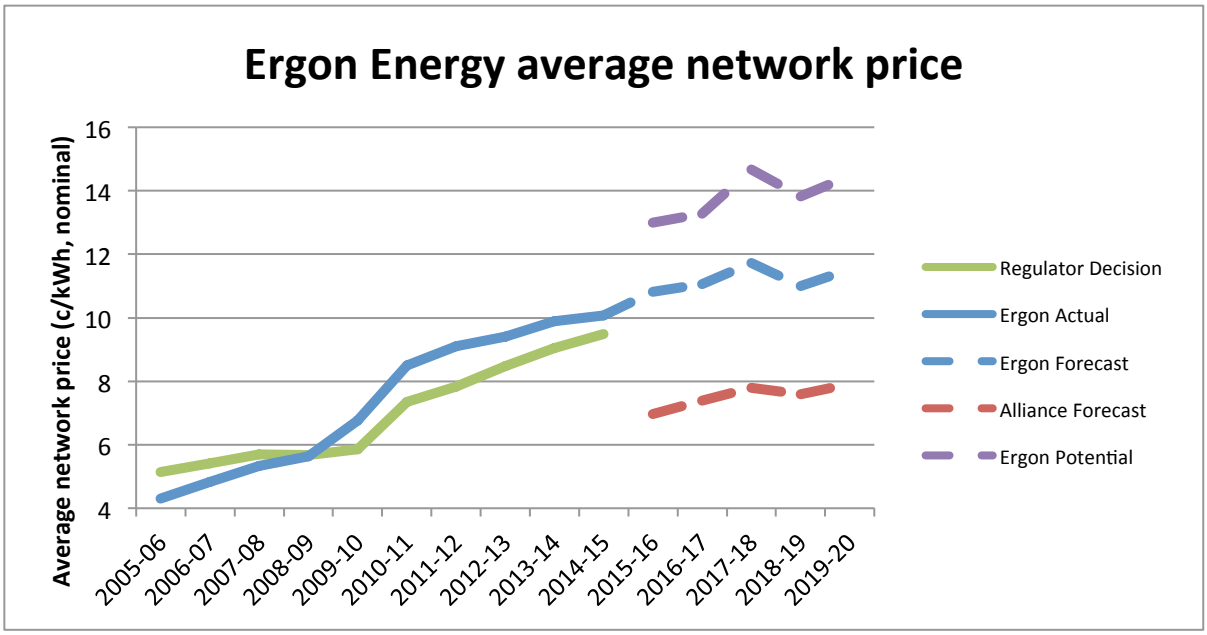
The Alliance believes that Ergon Energy's Annual Revenue Requirement (ARR) is too high and is not in the short or long-run interests of consumers. The Alliance believes that Ergon Energy's ARR be reduced to reflect The Alliance's critical analysis of Ergon Energy's Regulatory Proposal detailed in this submission. The Alliance calls on the AER to adopt the Alliance's alternate ARR proposal.

Alliance Annual revenue requirement ($'m nominal)	2015-16	2016-17	2017-18	2018-19	2019-20
Alliance Return on capital	368	390	412	431	451
Plus Alliance regulatory depreciation	174	192	208	161	170
Plus Alliance Operating expenditure	278	280	281	283	284
Plus Corporate income tax	116	122	132	124	128
Plus Alliance revenue adjustments	-6	-6	-6	-7	-7
Alliance Building block revenue (unsmoothed)	929	978	1,026	991	1,027
Ergon Building block revenue (unsmoothed)	1,556	1,605	1,720	1,629	1,725
Revenue reduction ($)	**-626**	**-627**	**-694**	**-638**	**-697**
Revenue reduction (%)	**-40.26%**	**-39.07%**	**-40.34%**	**-39.15%**	**-40.43%**

Impact of reducing allowed revenues on network prices

Analysis conducted by The Alliance shows that through Ergon Energy's Regulatory Proposal, average network prices will increase over the next regulatory period. Further, Ergon Energy's average network prices could increase beyond Ergon Energy's expectations, due to forecasting errors in Ergon Energy's energy forecasts – as experienced in the current Regulatory Period. The Alliance believes that this outcome is unacceptable and not in the interests of consumers.

Average network price (c/kWh nominal)	*2015-16*	*2016-17*	*2017-18*	*2018-19*	*2019-20*
Ergon Energy Regulatory Proposal	10.828	11.059	11.728	11.000	11.532
Alliance Proposal	6.944	7.356	7.769	7.557	7.886
Price reduction ($)	**-3.88**	**-3.70**	**-3.96**	**-3.44**	**-3.65**
Price reduction (%)	**-35.86%**	**-33.48%**	**-33.75%**	**-31.30%**	**-31.61%**



The Alliance's proposals to reduce Ergon Energy's ARR and revised energy forecasts will result in better pricing outcomes for Ergon Energy's customers. The Alliance calls on the AER to adopt the revised ARR and energy forecasts in this submission to ensure better pricing outcomes for electricity consumers.

Demand, energy and customer forecasting

Review of current regulatory period

Analysis conducted by the Alliance shows that Ergon Energy's approved System Annual Maximum Demand and Energy Delivered forecasts were too optimistic. The overly optimistic natures of these forecasts have had serious implications for the efficient investment in and operation of Ergon Energy's network in the current regulatory period.

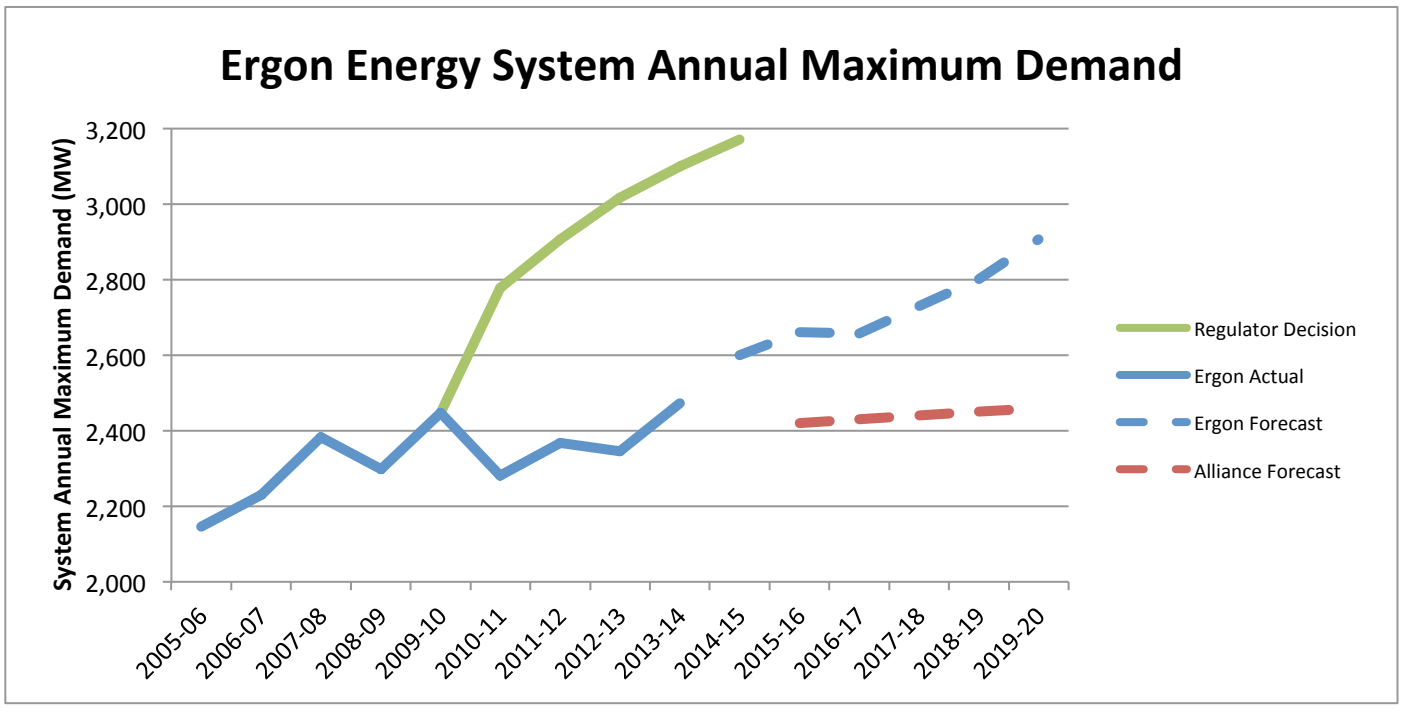
The inaccuracy of Ergon Energy's System Annual Maximum Demand forecasts at the last Regulatory Determination has resulted in a larger than required capital expenditure allowance and has caused Ergon's RAB to expand at a rate greater than required to provide safe, reliable and efficient network services to its customers. The unnecessary increase in the RAB has been a cost born by consumers through higher network charges.

The inaccuracy of Ergon Energy's Energy Delivered forecasts at the last Regulatory Determination has resulted in higher than average network prices, as Ergon Energy has needed to charger higher than anticipated prices to recover its ARR. The cost of the forecasting errors have been born entirely by consumers, as Ergon Energy's ARR has remained unchanged throughout the Regulatory Control Period.

System Annual Maximum Demand

Due to the very limited information about Ergon Energy's forecast methodology or its inputs and the lack of information about how Ergon Energy has changed its forecasting techniques from those used in the current regulatory period, the Alliance does not believe that Ergon Energy's System Annual Maximum Demand forecasts have been prepared with the short- and long-term interests of consumers in mind.

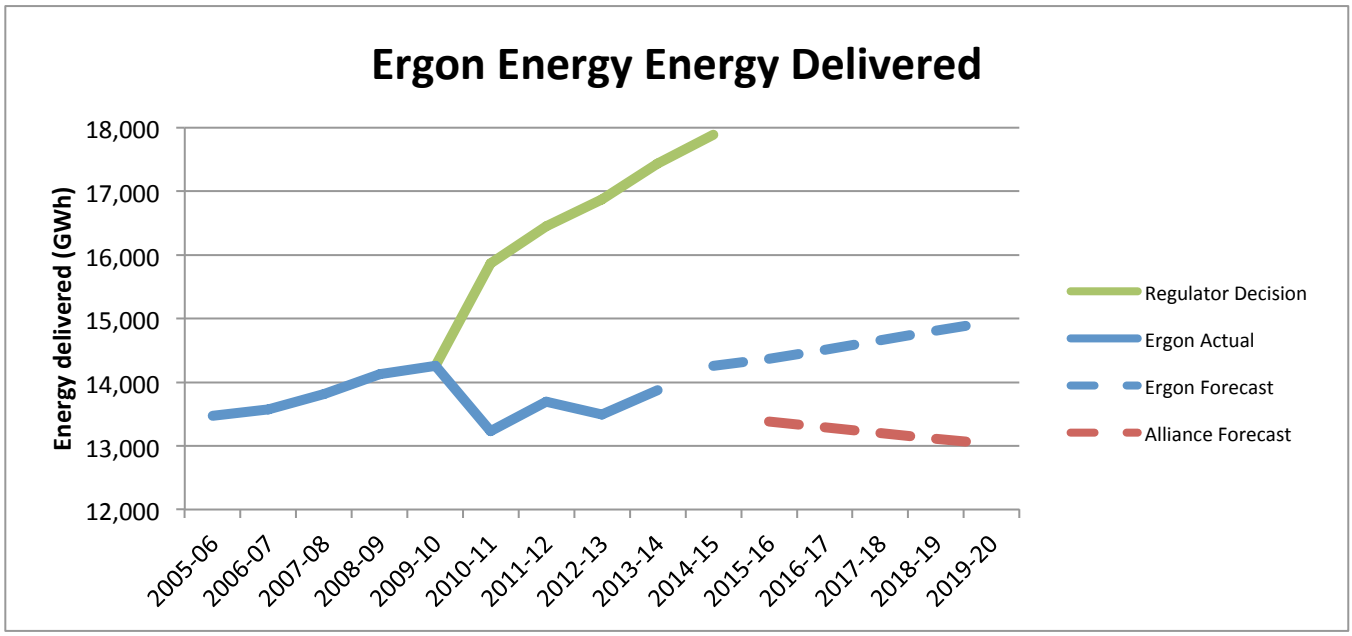
The Alliance has forecast System Annual Maximum Demand, based on the forward forecast of the linear function of Ergon Energy's actual System Annual Maximum Demand between 2009-10 and 2013-14. The Alliance forecast predicts Ergon Energy's System Annual Maximum Demand will remain effectively flat over the next Regulatory Control Period.



Energy Delivered

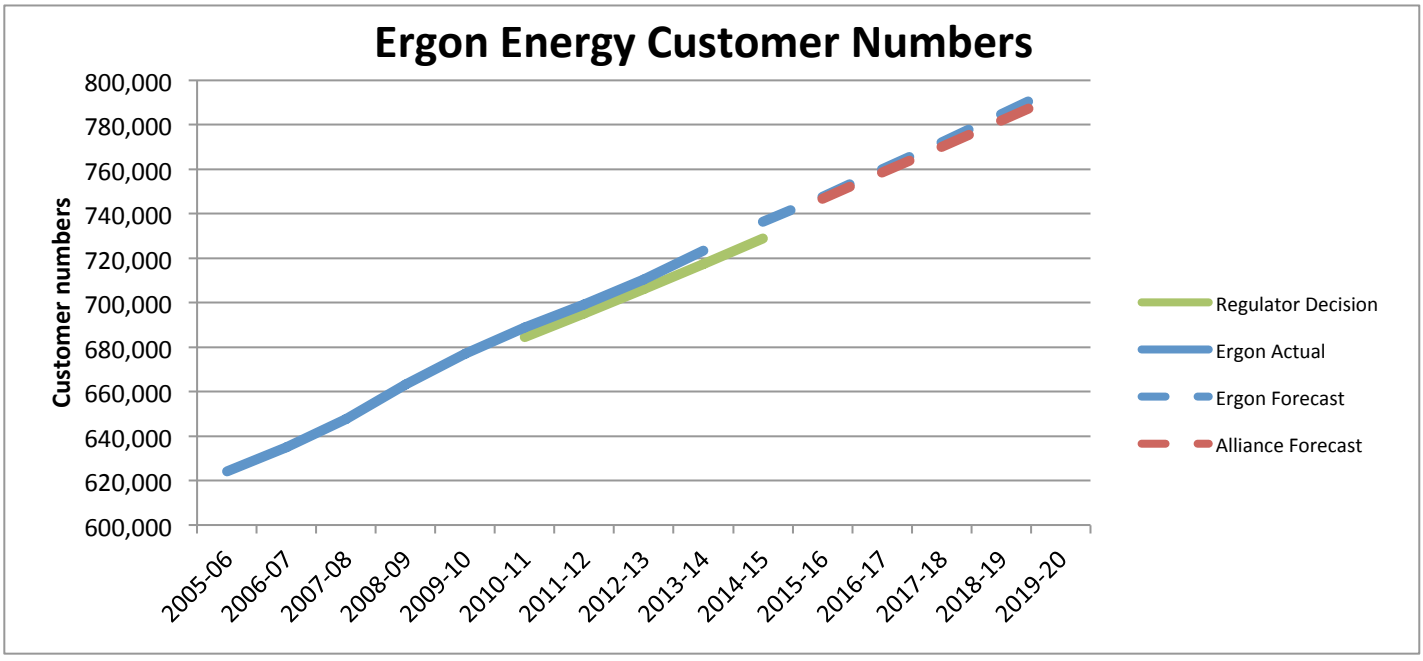
Due to the very limited information about Ergon Energy's forecast methodology or its inputs and the lack of information about how Ergon Energy has changed its forecasting techniques from those used in the current regulatory period, the Alliance does not believe that Ergon Energy's Energy Delivered forecasts have been prepared with the short- and long-term interests of consumers in mind.

The Alliance has forecast Energy Delivered, based on the forward forecast of the linear function of Ergon Energy's actual Energy Delivered between 2009-10 and 2013-14. The Alliance forecast predicts Ergon Energy's Energy Delivered will decline in every year over the next Regulatory Control Period.



Customer numbers

The Alliance has developed an alternative customer number forecast, based on the forward forecast of the linear function of Ergon Energy's actual customer numbers between 2009-10 and 2013-14. The Alliance forecast predicts Ergon Energy's customer numbers will increase at a marginally slower rate than Ergon Energy's current forecasts.



Capital expenditure

Review of current regulatory control period

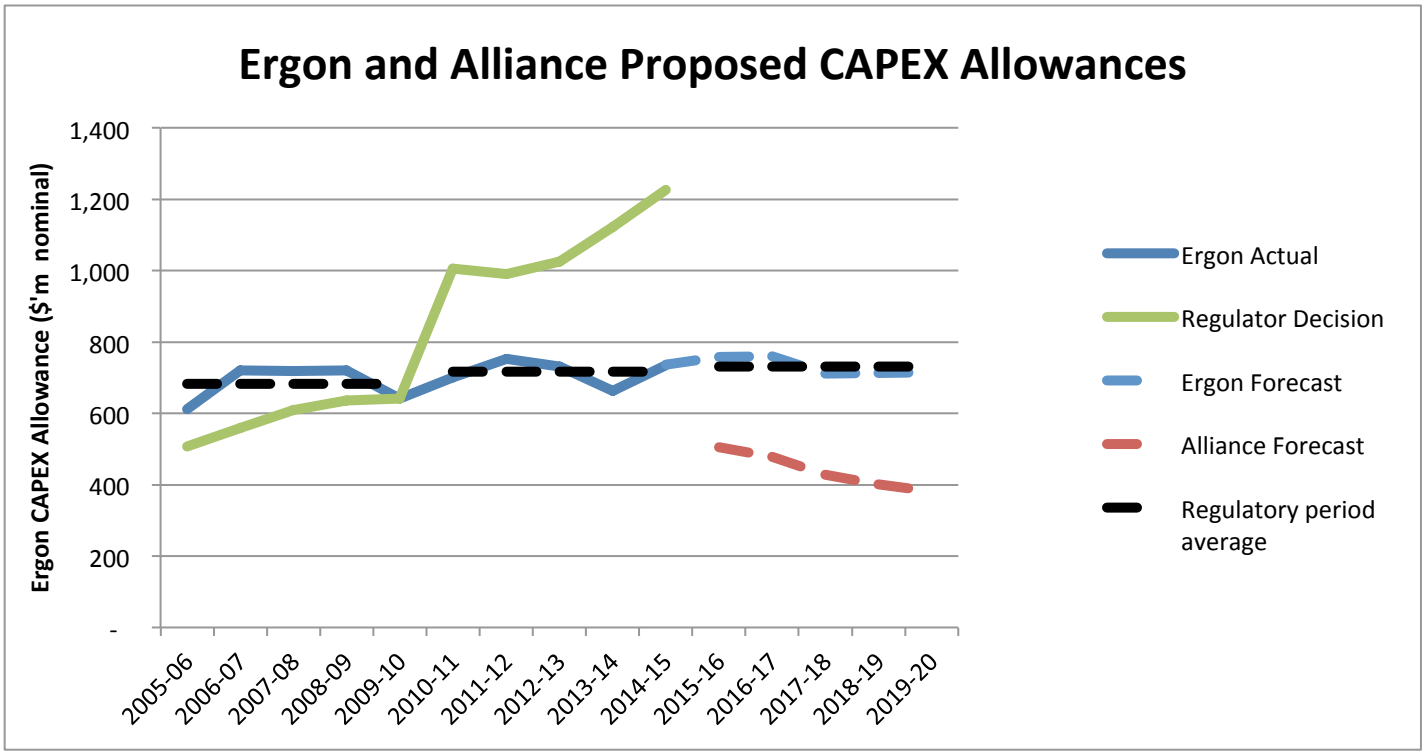
Analysis conducted by the Alliance shows that Ergon Energy has significantly underspent its capital expenditure allowance in the current regulatory period. The Alliance believes that the AER's capital expenditure allowances were too generous, as Ergon Energy was able to substantially reduce its capital expenditure without any impacts on the safety, reliability or quality of supply electricity to its customers.

As such reductions were able to be made, the Alliance believes that the level of capital expenditure allowed by the AER in the current Regulatory Control Period were not efficient nor in the short- or long-run interests of consumers.

Overview

The Alliance urges the AER to stop improve efficiency of Ergon Energy's capital expenditure program. Historic rapid increases in Ergon Energy's allowed capital expenditure has not been in the interests of consumers and has been a major contributor to record network price increases over the current Regulatory Control Period.

The Alliance does not support Ergon Energy's proposals for continued increases in its capital expenditure allowance. Instead of allowing further increases, The Alliance believes that the AER should significantly reduce Ergon Energy's capital expenditure allowance.



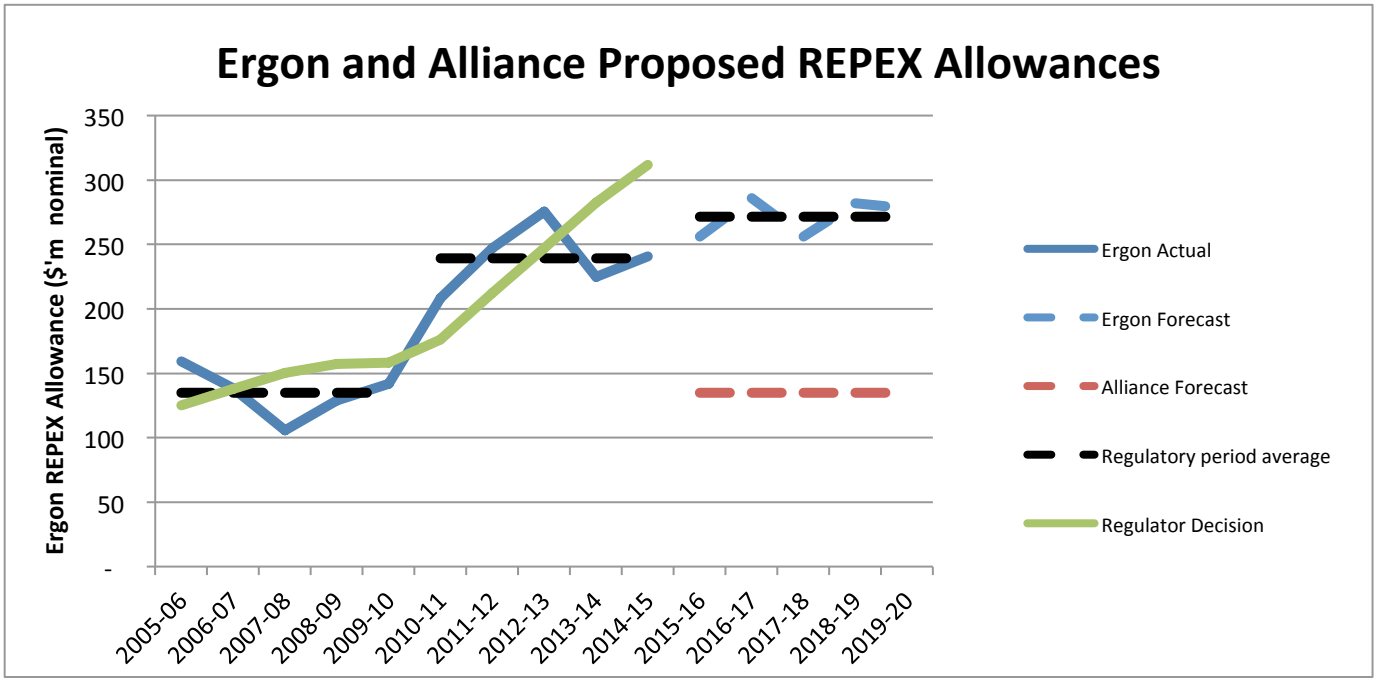
The Alliance believes that the underlying incentives in the National Electricity Rules, such as higher than actual WACC rates and regulated returns on all assets (whether the assets are used and/or useful), encourage distributors to seek approval for capital expenditure programs greater than required to meet efficient investment in and operation of their distribution network.

High levels of underutilization across Ergon Energy's network, combined with a different approach to minimum service standards, set by the Queensland Government, suggest that there will be scope to further reduce capital expenditure in next Regulatory Control Period.

Asset Renewal

Analysis conducted by The Alliance shows that Ergon Energy's expenditure on asset renewal in the current Regulatory Control Period has significantly increased from the previous Regulatory Control Period. Interestingly, the increase in Ergon Energy's asset renewal expenditure has coincided with anecdotal evidence from consumers about large-scale, frequent and premature replacement of well-functioning or recently constructed network assets. The claims of over-servicing have only been made in the current Regulatory Control Period and suggest Ergon Energy's asset renewal allowances, approved by the AER in the last Regulatory Decision were not efficient and not in the short- or long-run interests of consumers.

The Alliance agrees with the AER's statement in its *Qld Electricity Distribution Regulatory Proposals 2015-16 To 2019-20 Issues Paper* that, "REPEX levels should remain relatively constant over time."



Ergon Energy is seeking further increases in its asset renewal allowance in its Regulatory Proposal. The Alliance does not support Ergon Energy's proposal for an increased asset renewal allowance.

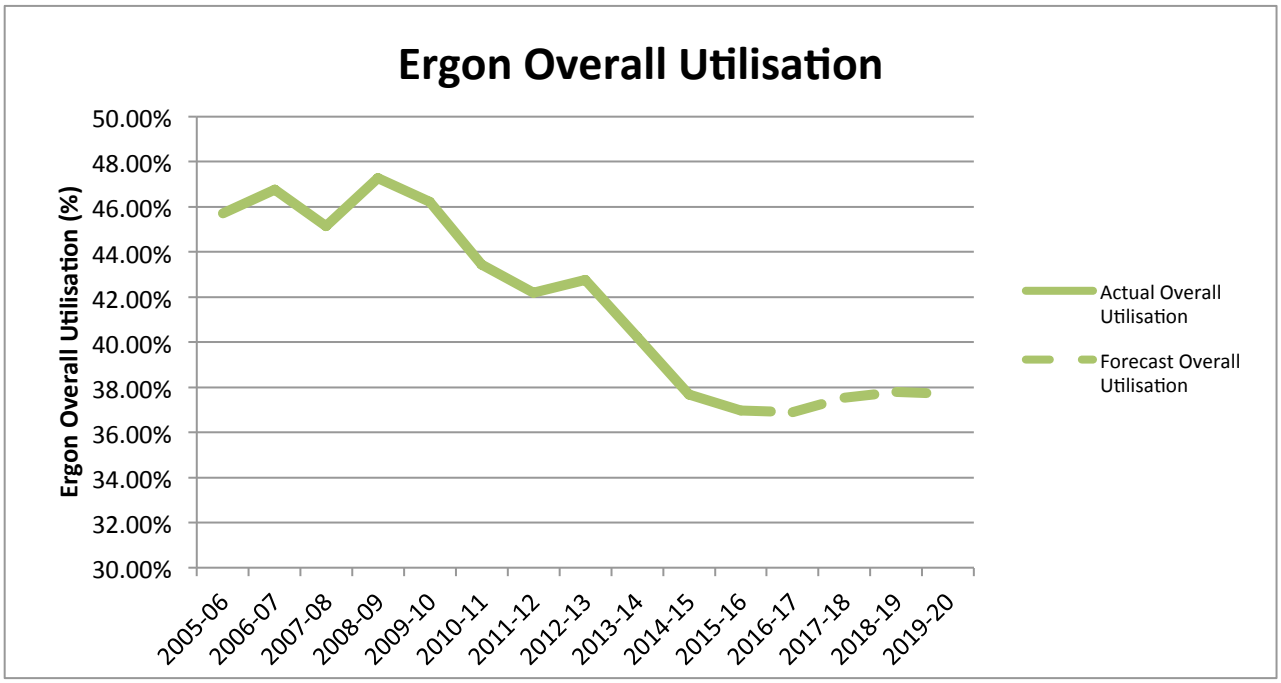
The Alliance calls on the AER to reduce Ergon Energy's asset renewal allowance to the 2005-2010 Regulatory Control Period average of $135 million per year, for the duration of the next Regulatory Control Period.

Asset Renewal ($'m nominal)	*2015-16*	*2016-17*	*2017-18*	*2018-19*	*2019-20*
Ergon Energy Regulatory Proposal	256	286	256	282	278
Alliance Proposal	*135*	*135*	*135*	*135*	*135*
Allowance reduction ($)	***-121***	***-151***	***-121***	***-147***	***-143***
Allowance reduction (%)	***-47%***	***-53%***	***-47%***	***-52%***	***-51%***

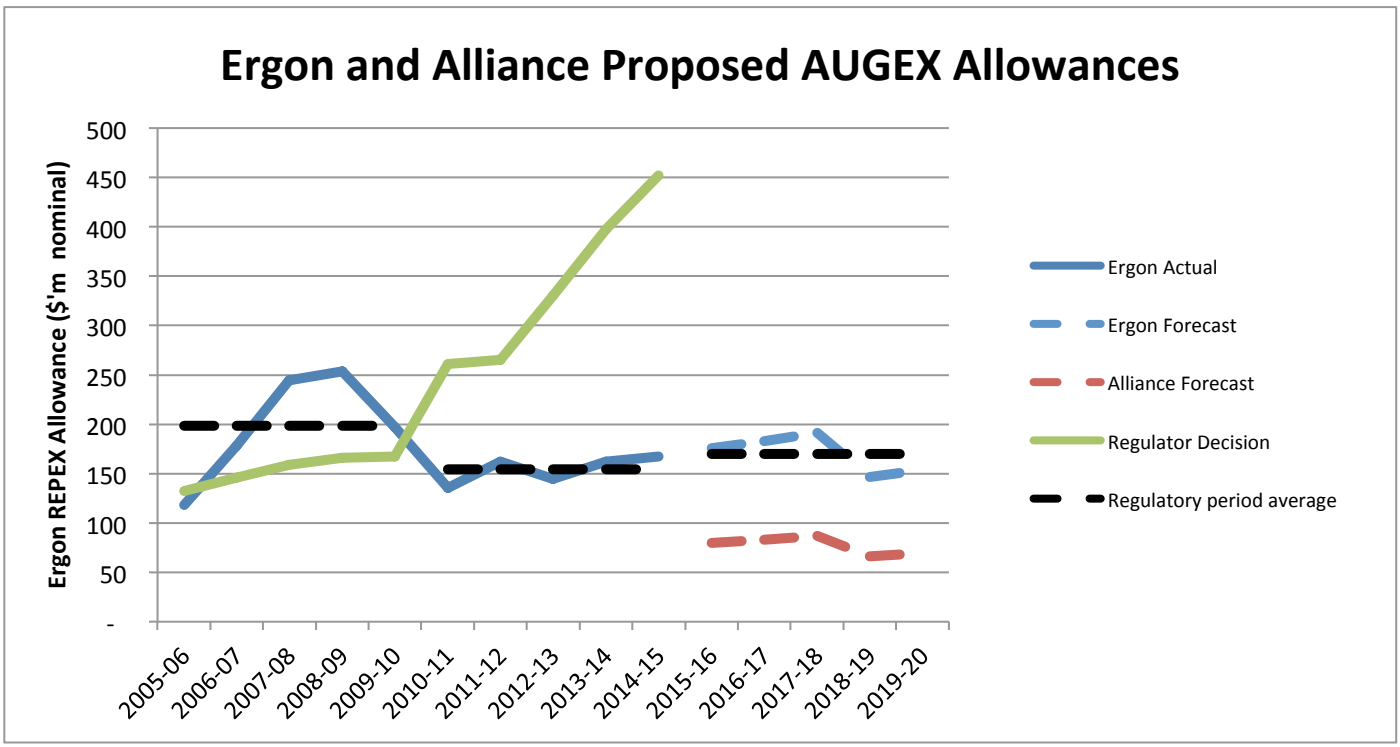
Corporation Initiated Augmentation

Ergon Energy is seeking an increase in its corporation initiated augmentation allowance over its current expenditure levels, in the next regulatory control period. Ergon Energy is seeking an increase in this allowance, despite falling electricity consumption across its network. The Alliance believes that Ergon Energy's proposed level of augmentation expenditure would unnecessarily expand Ergon Energy's RAB, which is not in the short- or long-run interests of consumers.

The Alliance also rejects Ergon Energy's claims of "pockets of growth" across its network, as Ergon Energy has not provided sufficient evidence to reinforce their claims. Analysis of Ergon Energy's RIN data shows declining levels of utilization across Ergon Energy's network, which should add extra evidence of a need to reduce Ergon Energy's plans to further augment its network.



During the current Regulatory Control Period, Ergon Energy was able to reduce its augmentation expenditure by 55% from its allowed expenditure. Due to negative consumption growth and flat system peak demand growth, The Alliance believes that there is sufficient scope to reduce Ergon Energy's augmentation expenditure by a similar extent in the next Regulatory Control Period.

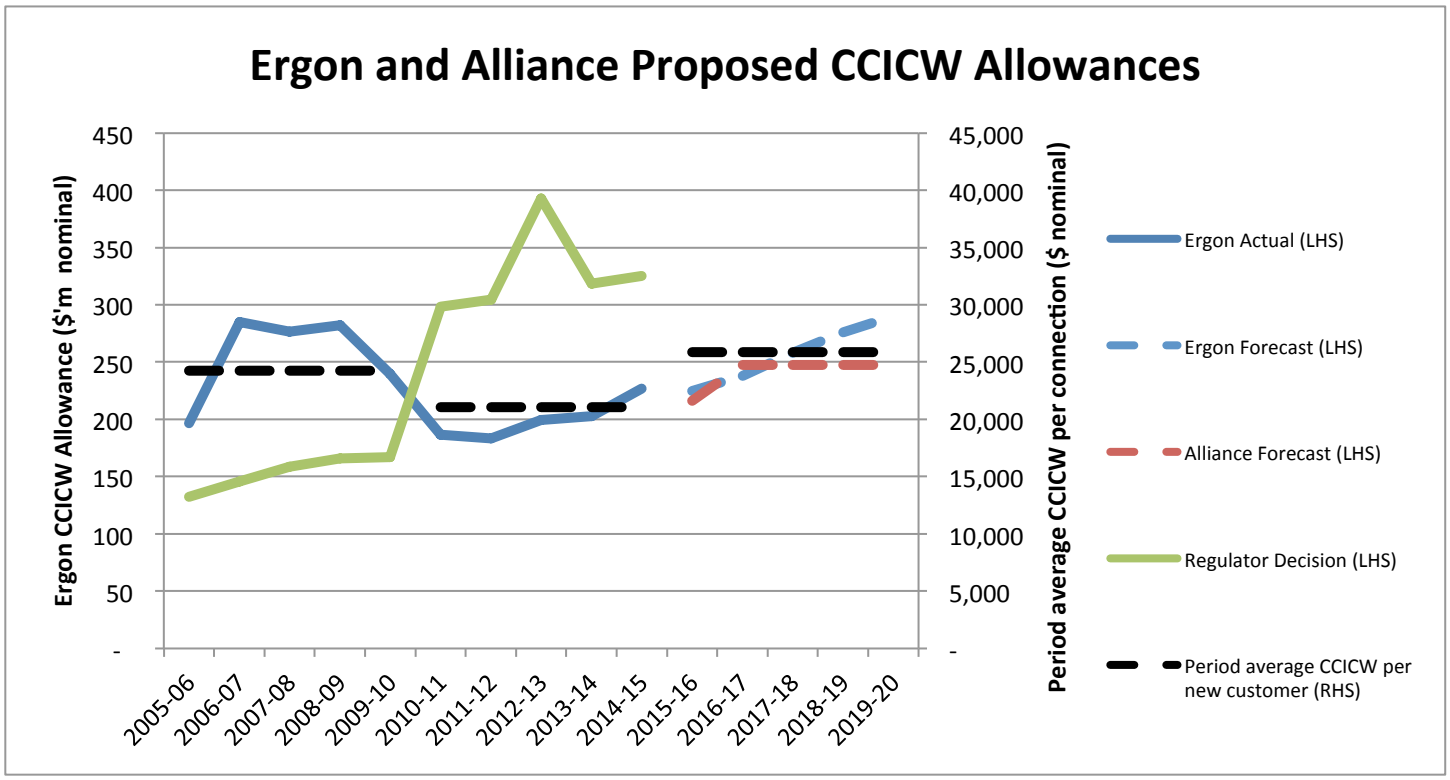


The Alliance calls on the AER to reduce Ergon Energy's corporation initiated augmentation allowance by 55% of levels proposed in Ergon Energy's Regulatory Proposal, for the duration of the next Regulatory Control Period.

Augmentation ($'m nominal)	*2015-16*	*2016-17*	*2017-18*	*2018-19*	*2019-20*
Ergon Energy Regulatory Proposal	176	183	192	146	154
Alliance Proposal	80	83	87	66	70
Allowance reduction ($)	***-96***	***-100***	***-105***	***-80***	***-84***
Allowance reduction (%)	***-55%***	***-55%***	***-55%***	***-55%***	***-55%***

Customer Connection Initiated Capital Works

In the current Regulatory Control Period, Ergon Energy has reduced its expenditure per new connection, compared to the previous Regulatory Control Period. However, Ergon Energy's Regulatory Proposal shows Ergon Energy is seeking an increase its expenditure per new connection throughout the next Regulatory Control Period.

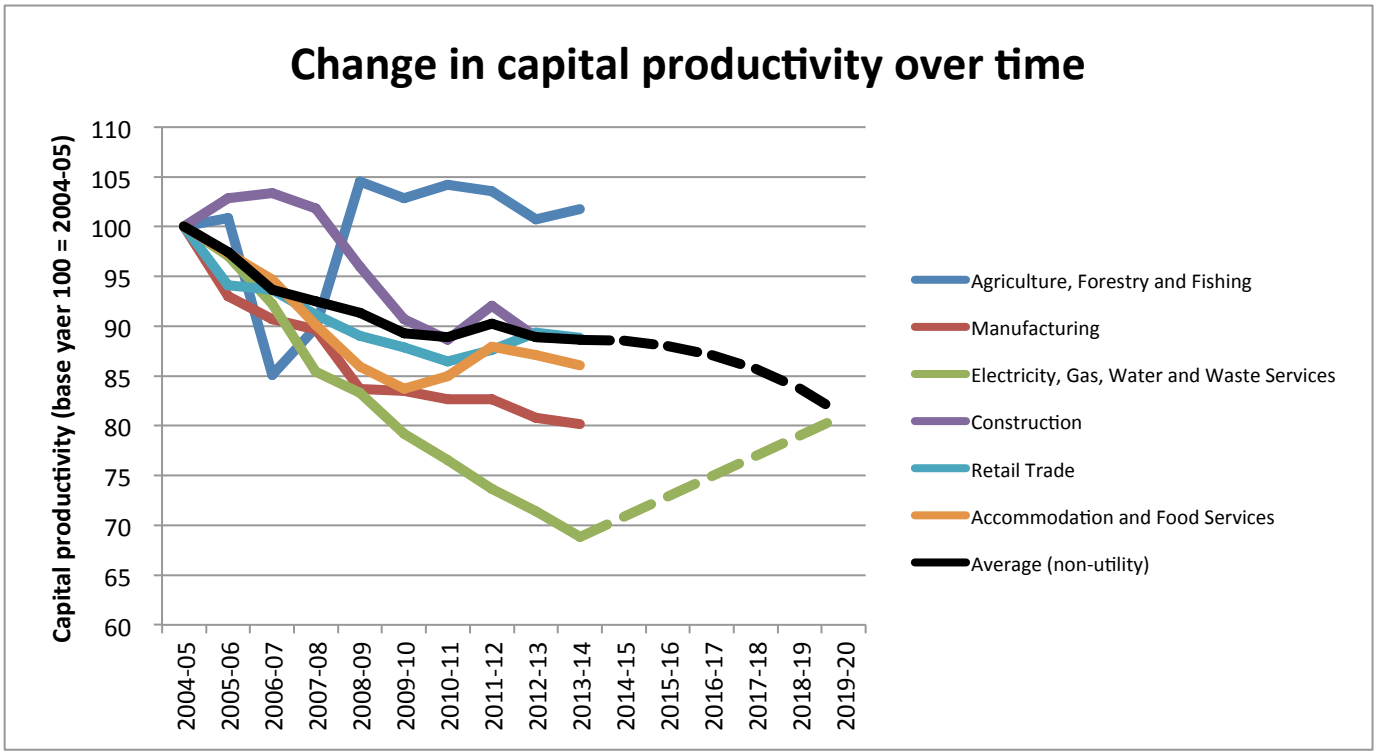


As Ergon Energy has not provided sufficient evidence to demonstrate why the average cost per new connection needs to increase in the next Regulatory Control Period, the Alliance calls of the AER to limit Ergon Energy's customer connections allowances to the levels experienced in the current Regulatory Control Period.

Connections ($'m nominal)	*2015-16*	*2016-17*	*2017-18*	*2018-19*	*2019-20*
Ergon Energy Regulatory Proposal	225	238	258	276	290
Alliance Proposal	*216*	*248*	*248*	*248*	*248*
Allowance reduction ($)	***-9***	***10***	***-11***	***-28***	***-42***
Allowance reduction (%)	***-0.03%***	***0.04%***	***-0.04%***	***-0.11%***	***-0.16%***

Additional increase in capital productivity needed

Analysis of ABS Data by the Alliance shows that capital productivity in the utilities sector has decreased by 45% over the current and previous Regulatory Control Periods. Over the same period, capital productivity in other energy intensive sectors has decreased by a lesser amount, on average 13%. The deterioration in capital productivity in the utility sector, relative to major energy consuming sectors, demonstrates that efficiency of investment in the electricity sector must be increased over the next Regulatory Control Period.



It is important to recognize that electricity consumers have paid for lower capital productivity through higher electricity prices. The Alliance calls on the AER to apply a 2.96% capital productivity dividend to Ergon Energy's capital expenditure allowance in the next Regulatory Control Period, on top of the potential reductions already identified by The Alliance in this submission. The 2.96% productivity dividend will ensure Ergon Energy's capital productivity is consistent with the average rates of productivity employed by its consumers, by the end of the next Regulatory Control Period.

Alliance proposed capital expenditure allowance

Analysis of Ergon Energy's Regulatory Proposal, conducted by The Alliance, shows that Ergon Energy's capital expenditure allowance can be and should be significantly reduced. It is in the short- and long-run interests of consumers that the AER reduce Ergon Energy's future capital expenditure allowance by at least 41% over the next Regulatory Control period.

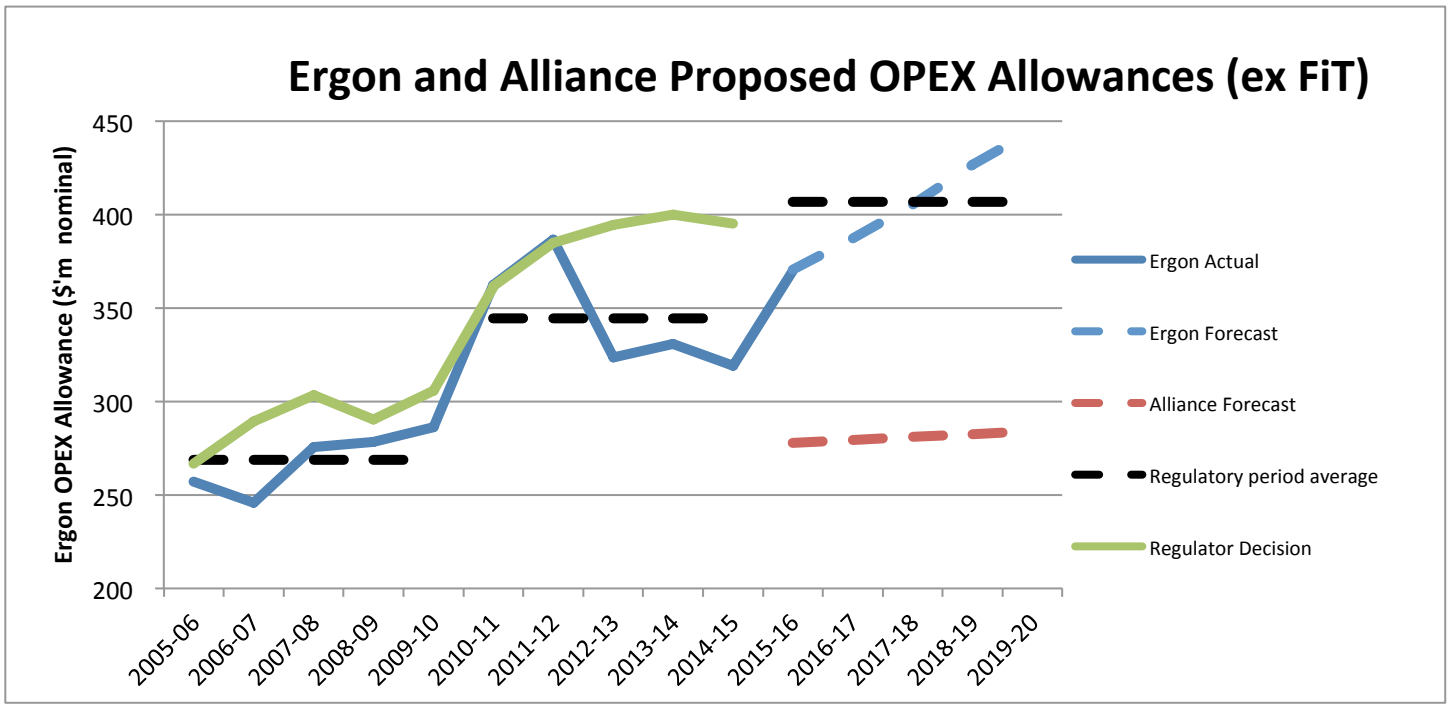
Alliance Proposed CAPEX ($'m nominal)	2015-16	2016-17	2017-18	2018-19	2019-20
Asset Renewal	135	135	135	135	135
Corporation Initiated Augmentation	80	83	87	66	70
Customer Connection Initiated Capital Works	216	248	248	248	248
Reliability and Quality of Supply	4	4	4	4	4
Other System	45	34	23	33	30
Non-System	189	147	117	111	100
Gross capital expenditure	668	650	613	597	586
Less productivity dividend	-20	-19	-18	-18	-17
Less capital contributions	-136	-145	-158	-170	-180
Less disposals	-7	-8	-8	-8	-8
Alliance net capital expenditure	**505**	**478**	**429**	**402**	**381**
Ergon net capital expenditure	**784**	**773**	**722**	**724**	**726**
CAPEX reduction ($)	**-279**	**-295**	**-294**	**-323**	**-345**
CAPEX reduction (%)	**-35.55%**	**-38.13%**	**-40.66%**	**-44.54%**	**-47.48%**

Operational Expenditure

Overview

The Alliance urges the AER to stop the surge in Ergon Energy's operational costs. The rapid increases in Ergon Energy's allowed operational expenditure has not been in the interests of consumers and has been a major contributor to record network price increases over the current Regulatory Control Period.

The Alliance does not support Ergon Energy's proposals for further increases in its operational expenditure allowance. Instead of allowing further increases, The Alliance believes that the AER should significantly reduce Ergon Energy's operational expenditure allowance.



The efficiency of Ergon Energy's operational expenditure must be drastically increased if network prices are to significantly fall in the next Regulatory Control Period. To achieve the required increases in operational expenditure efficiency, The Alliance proposes that the performance of Ergon Energy's operational expenditure be benchmarked against the performance of similar distribution networks' operational expenditure on a range of network indicators.

Benchmark to similar DNSPs

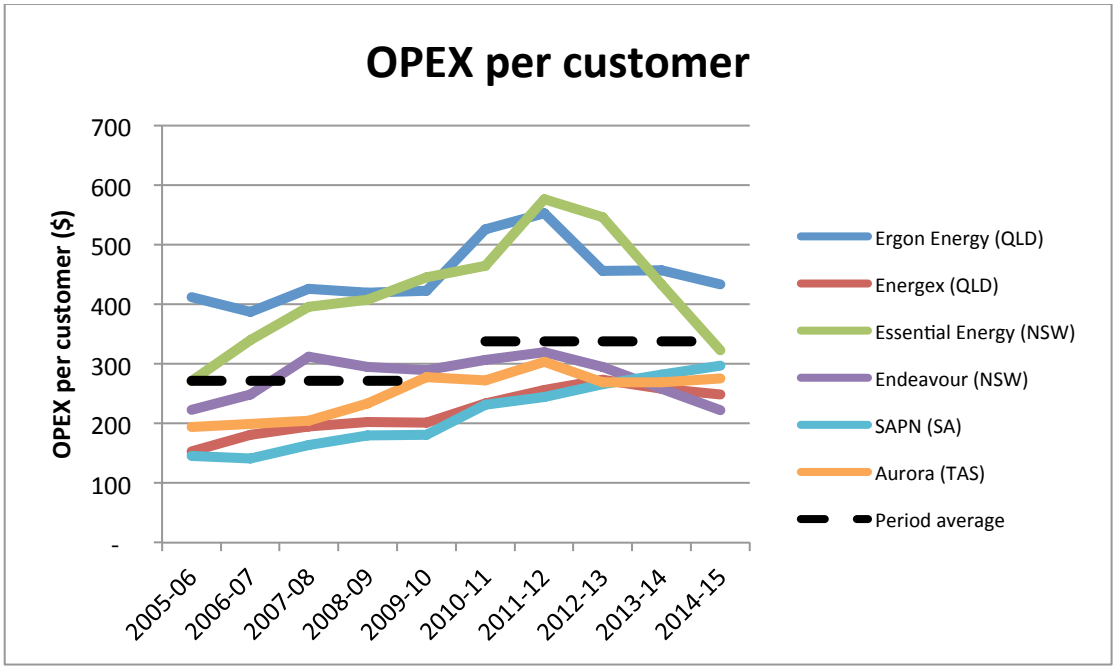
Identifying benchmark efficiency

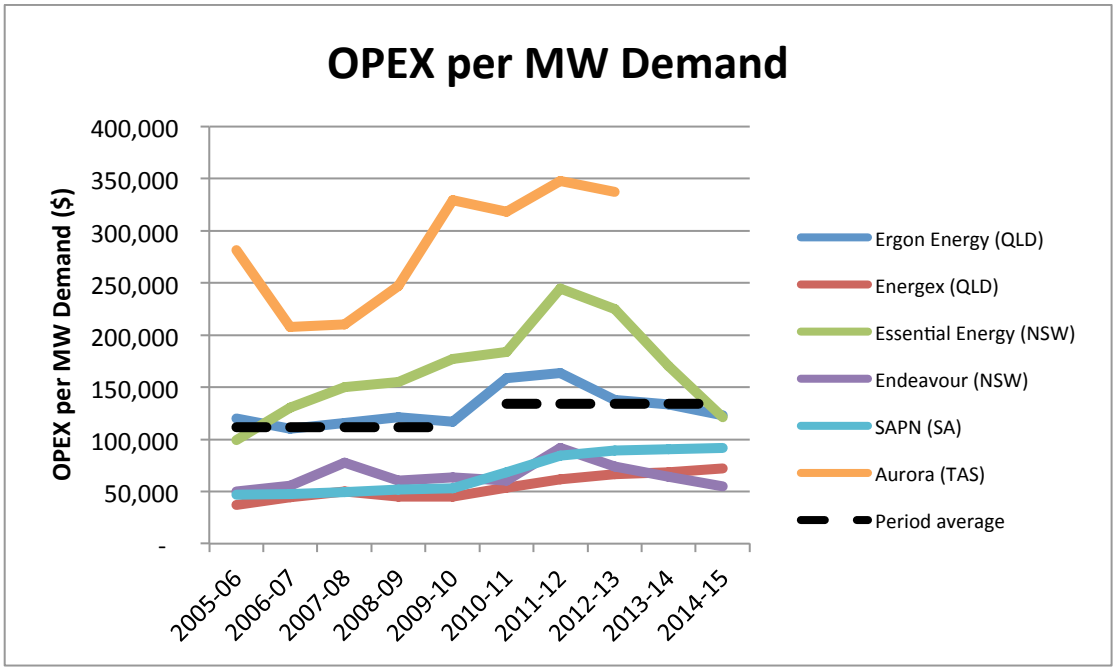
Benchmarking analysis, conducted by the Alliance, shows that Ergon Energy's operational expenditure is significantly less efficient than similar networks in the NEM, on a range of environmental indicators. The indicators include operational expenditure per customer, MW of coincident system peak demand, GWh of energy sold and km of network. These indicators have been selected because they represent the main characteristics of distribution networks and account for the uniqueness of Ergon Energy's operational environment.

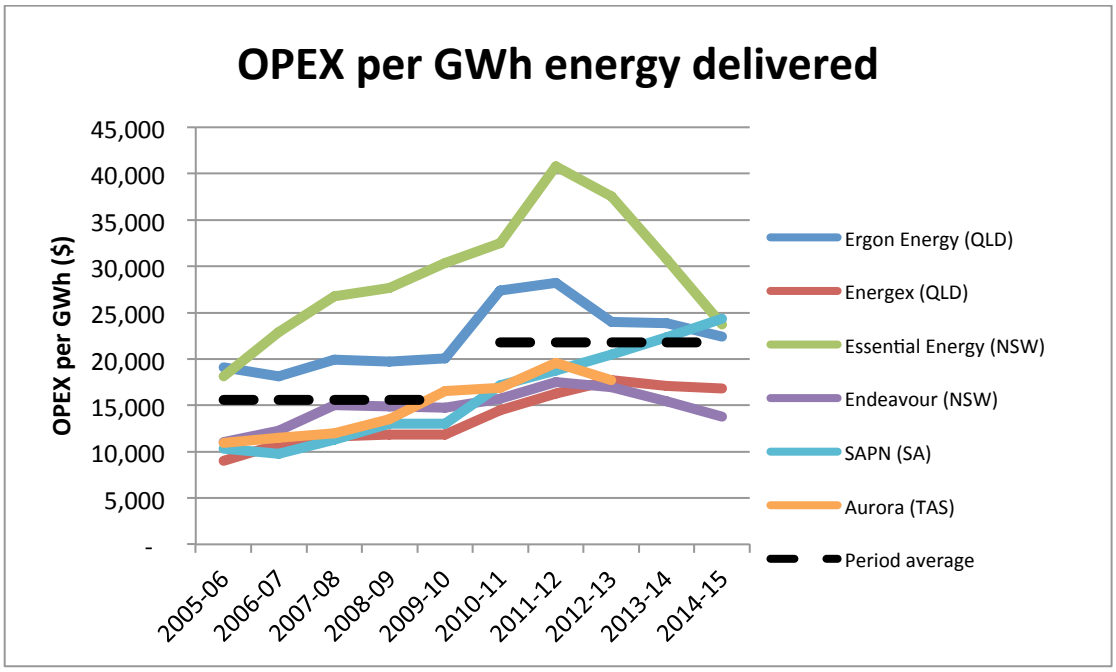
Ergon Energy's operating environment is unique, but not so dissimilar to other NSPs that it can't be compared to other (non-CBD) networks, such as Energex (QLD), Essential Energy (NSW) Endeavour (NSW), SA Power Networks (SA) and Aurora (TAS).

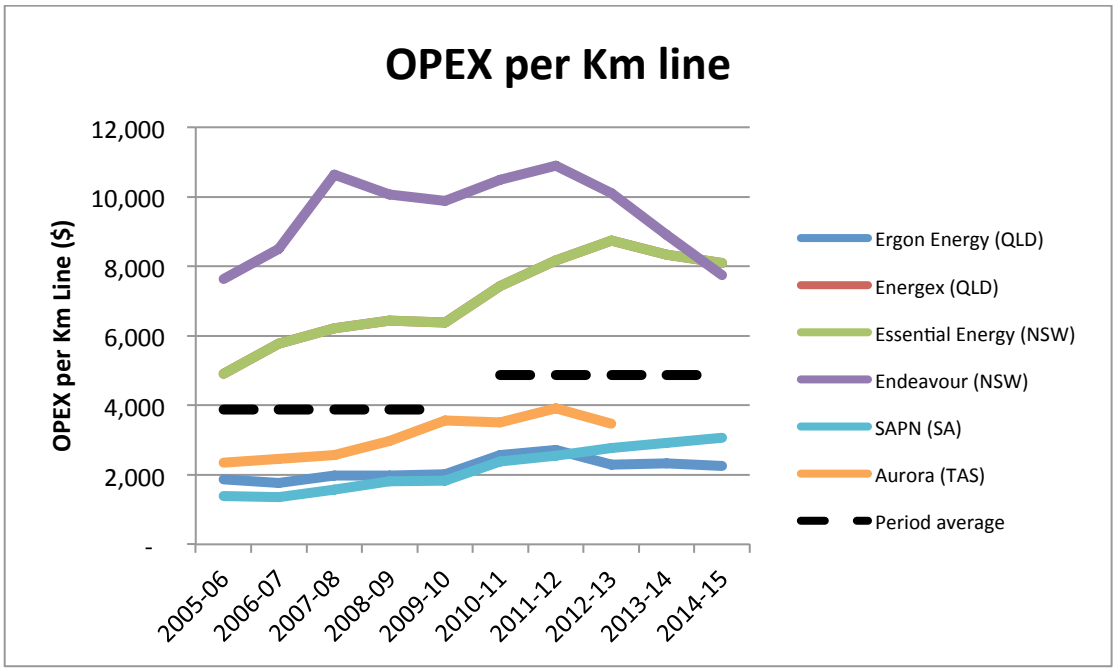
The Alliance believes it is improper for Ergon Energy to claim that its low customer density is reason for its relatively high operational expenses. There are many characteristics of Ergon Energy's operating environment that suggest its operational expenditure should be less than other distribution networks. For example, Ergon Energy has far less regulated assets per km of line and a network less prone to system demand peaks. Ergon Energy also has the most energy dense distribution network in the National Energy Market (NEM).

All of these indicators combined would suggest Ergon Energy's operational expenses should be no more or less efficient than its peer distribution network providers.









The Alliance has developed the following formula to calculate an efficient allowance of operational expenditure for Ergon Energy in any given year, allowing for changes in customer numbers, peak demand growth, energy density and network length.

$$
\begin{aligned}
&OPEX\ Allowance_n \\
&\quad = Efficient\ average\ OPEX\ per\ customer \times customers_n \times 25\% \\
&\quad + Efficient\ average\ OPEX\ per\ MW\ Demand \times MW\ Demand_n \times 25\% \\
&\quad + Efficient\ average\ OPEX\ per\ GWh\ Energy \times GWh\ Energy_n \times 25\% \\
&\quad + Efficient\ average\ OPEX\ per\ km\ line \times km\ line_n \times 25\%
\end{aligned}
$$

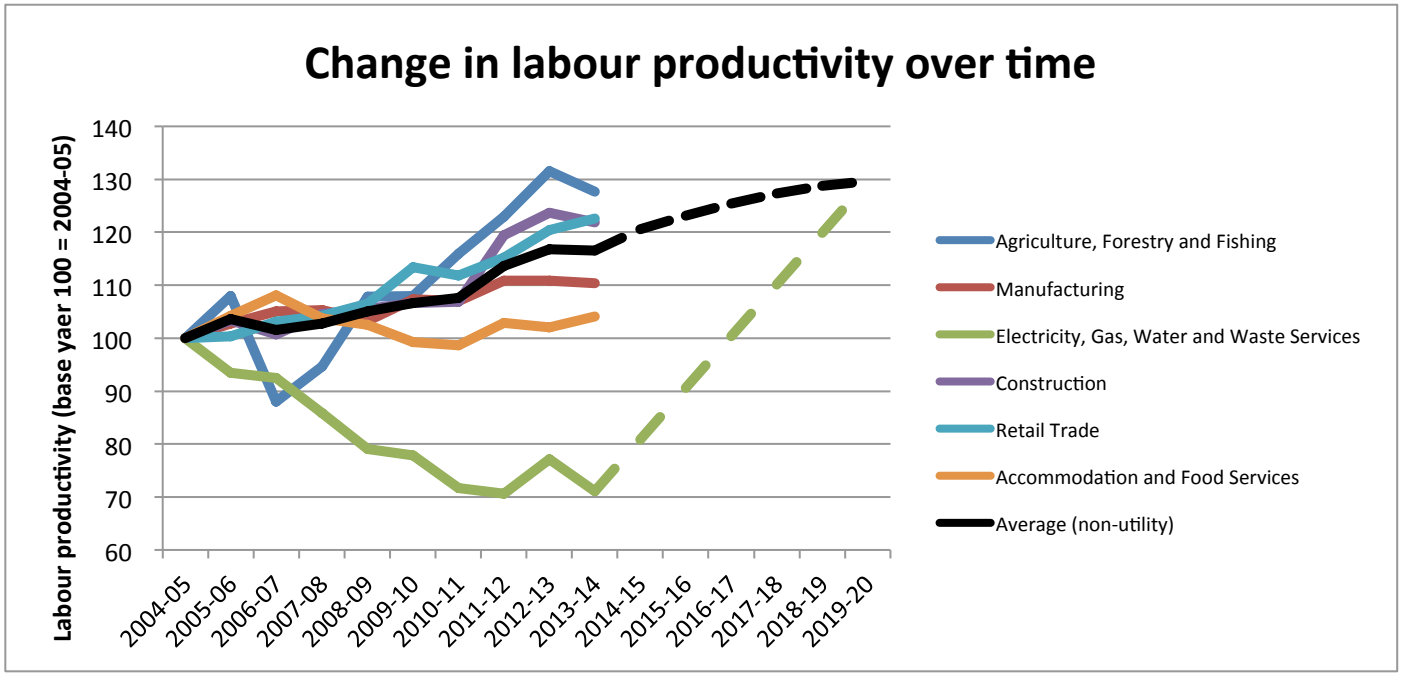
The Alliance has chosen to apply the efficient average of each benchmarking category for the previous Regulatory Control Period, because the benchmarking analysis shows distribution networks across the NEM have become more inefficient over the current regulatory period. Electricity consumers should not be required to pay higher electricity prices because of the deteriorating

efficiency of distribution networks' operational expenditure throughout the current Regulatory Control Period.

The Alliance's revised forecast customer numbers, energy and demand projections have been used in the calculation of Ergon Energy's Benchmark efficient operational expenditure.

Increase in labour productivity needed

Analysis of ABS Data by the Alliance shows that labour productivity in the utilities sector has decreased by 41% over the current and previous Regulatory Control Periods. By contrast, labour productivity in energy intensive sectors has increased 14%. The deterioration in productivity has a detrimental effect on the efficiency of operation of electricity networks, which has a negative impact on prices consumers pay for their electricity.



It is important to recognize that electricity consumers have paid for lower labour productivity through higher electricity prices. The Alliance calls on the AER to apply a 13.72% capital productivity dividend to Ergon Energy's operational expenditure allowance in the next Regulatory Control Period, on top of the potential reductions already identified by The Alliance in this submission. The 13.72% productivity dividend will ensure Ergon Energy's capital productivity is consistent with the average rates of productivity employed by its consumers, by the end of the next Regulatory Control Period.

Alliance proposed operational expenditure allowance

The Alliance calls on the AER to adopt the Alliance's benchmarking formula and productivity dividend to reduce Ergon Energy's operational expenditure allowance by an average of 31% over the next Regulatory Control Period.

Alliance Forecast Operating Expenditure ($'m nominal)	2015-16	2016-17	2017-18	2018-19	2019-20
Alliance Gross operating costs	308	309	311	311	312
Less productivity dividend	-42	-42	-43	-43	-43
Plus debt raising costs	12	13	13	14	15
Total Alliance Operating Expenditure	278	280	281	283	284
Total Ergon Operating Expenditure	370	387	406	427	445
OPEX reduction ($)	**-93**	**-108**	**-124**	**-144**	**-161**
OPEX reduction (%)	**-24.99%**	**-27.80%**	**-30.68%**	**-33.76%**	**-36.13%**

Weighted Average Cost of Capital

Summary

The Alliance calls on the AER to approve a WACC rate that allows Ergon to recover only an efficient rate of return in the next regulatory period. Realistic WACC parameters identified by the Alliance shows that Ergon's return on capital costs should be significantly reduced in the next regulatory period.

Alliance Return on capital	Alliance Value	Ergon Value
Corporate tax rate	30%	30%
Nominal risk free rate	3.63%	3.63%
Inflation rate	2.57%	2.57%
Cost of equity	3.69%	10.52%
Utilisation of Imputation (Franking) credits	25%	25%
Proportion of debt funding	60%	60%
Trailing average cost of debt: 2015-16	3.65%	6.36%
Debt raising cost benchmark	0.197%	0.197%

Review of current regulatory period

Difference in debt rating

The AER's allowance for Ergon Energy to collect a benchmark debt rate, compared to its actual debt costs, has not been in the short- or long-run interests of consumers. The difference in debt costs has artificially inflated electricity prices and increases Ergon Energy's profits at the expense of electricity consumers over the current regulatory period.

If Ergon Energy's notional credit rating (BBB+) were adjusted to reflect its actual cost of debt (AA) over the current regulatory period, Ergon Energy's regulated revenues would have been $24.3 million lower over the current regulatory period.

Put simply, the AER's use of different debt rates has cost electricity consumers in regional Queensland $24.3 million between 2009-10 and 2014-15.

Inflated market risk premiums

Research conducted by the Alliance shows that Ergon Energy has consistently out-performed the return on equity of other Queensland Government Owned Corporations. This analysis demonstrates that the AER's allowed Market Risk Premium in Ergon Energy's regulated WACC parameters were above what was required for Ergon's shareholder to continue investing in the business.

If Ergon Energy's Market Risk Premium were adjusted to match other Queensland GOCs over the previous Regulatory Control Period, Ergon Energy's revenue would have been $78.3 million lower over the current Regulatory Control Period.

Put simply, Ergon Energy's use of an inflated Market Risk Premium has cost electricity consumers in regional Queensland $78.3 million between 2009-10 and 2014-15.

Debt in future regulatory period

Notional credit rating

The Alliance does not support Ergon Energy's proposed notional credit rating of BBB, which is below the AER's notional benchmark of BBB+. The Alliance calls on the AER set Ergon's notional credit rating to reflect the security provided to Ergon Energy's financial position through the current regulatory framework. Ergon Energy is well placed to recover its costs and earn returns for its shareholders.

Based on the Alliance's analysis of information from international credit ratings agencies on the credit worthiness of electricity utility companies around the world, the Alliance urges the AER to ensure that Ergon Energy's notional credit rating be set at a level no lower than AA. The Alliance's perspective is based a discussion paper, released by Moody's Investor Service in September 2013, which considers the credit ratings of regulated utilities be revised upwards to the protections provided to utility operators' capacities to recover costs and earn returns.

The Alliance calls on the AER to consider the following issues with regards to Ergon Energy's notional credit rating:

- Legislative and judicial underpinnings to regulatory framework
    - The National Energy Market is a fully developed framework that is national in scope based on legislation that provides Ergon Energy with an absolute monopoly within its service territory.
    - The National Electricity Law ensures rates of return will be set in a manner that will permit Ergon Energy to make and recover all necessary investments.
    - Ergon Energy has an extremely high degree of clarity as to the manner in which it will be regulated and prescriptive methods and procedures for setting rates.
    - The National Electricity Law is comprehensive and receives a high level of political support from both State and Federal Governments – substantial changes in legislation are not expected.
    - There is an independent judiciary that can arbitrate disagreements between the AER and Ergon Energy. The judicial review mechanism has also often favored the interest of networks over the regulator.
- Consistency and predictability of regulation
    - Ergon Energy's interaction with the AER and the Australian Energy Market Commission (AEMC) has led to a considerable track record of predominantly predictable and consistent Regulatory Decisions.
    - Despite minor changes to the regulatory regime, Ergon Energy can recover its financing costs without difficulty.
    - The Queensland Government is strongly supportive of Ergon Energy's continued profitability and is not expected to change the regulatory regime to impact Ergon Energy's long-term profitability.
- Timeliness of recovery of operating and capital costs
    - The AER's preferred control mechanism (the revenue cap) allows full and highly timely recovery of all operating and capital costs.
    - Ergon Energy is able to recoup any under-recovery of revenue in any given year, in future years.
    - Ergon Energy's cost of capital is updated every five years, to ensure on-going debt and equity financing costs can be met.
    - The AEMC's recent rule change on network tariff pricing will ensure network tariffs are efficient and focused on recovery of forward-looking costs.
- Sufficiency of rates of return
    - Ergon Energy's rates of return are strong relative to its global peers
    - The AER sets rates of return that permit full cost recovery, with a substantial return on investments
    - Previous AER decisions have traditionally not heavily questioned Ergon Energy's cost assumptions
    - Ergon Energy is able to receive a return on all assets in its Regulated Asset base, not just those that are used and useful

AA cost of debt

The Alliance calls on the AER to use a AA trailing average cost of debt when calculating Ergon Energy's WACC. The Alliance has sought information from the Reserve Bank of Australia (RBA) about corporate bond rates, but this information had not been provided to The Alliance at the time of lodging this submission with the AER.

The Alliance has used a 3.65% AA debt rate as a placeholder, pending further information from the RBA. The information from the RBA will be provided to the AER as soon as possible.

Key parameter	Ergon Calculations	Alliance Calculations
Return on Debt	**6.36%**	**3.65%**
Credit rating	BBB	AA

Equity in future regulatory period

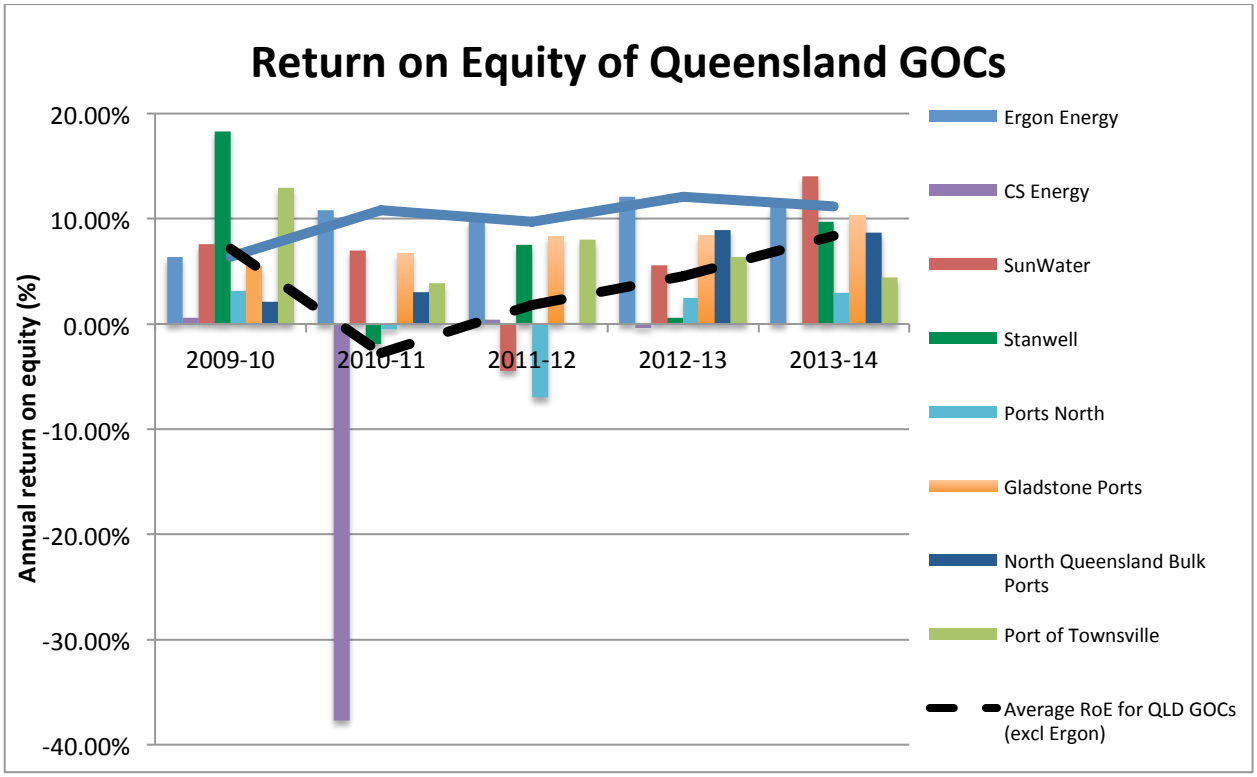
SFG findings

The Alliance disagrees with SFG's deliberations on Ergon Energy's equity beta.

The results of SFG's findings are overly generous to Ergon Energy and will provide returns in excess of what would be deemed necessary, which is not in the short- or long-run interests of consumers. Further, the regulatory regime in Australia is unique and provides significant protection against systemic risk faced by other distribution networks in other jurisdictions due to the AER's preferred Control Mechanism.

Required return on the market

The Alliance does not support Ergon Energy's proposed Market Risk Premium. The Alliance believes that Ergon Energy's proposals are out of step with equity expectations of other QLD GOCs and inflate Ergon Energy's expected returns at the direct expense of Ergon Energy's consumers. Ergon Energy's proposed Market Risk Premium is not in the short- or long-run interest of consumers.



The Alliance calls on the AER to adopt a value of 3.83% (as the average of QLD GOCs over the past five years) as the required return on the market in its calculations for the future Regulatory Period. Using Ergon Energy's proposed Risk Free Rate of 3.63%, Ergon Energy's Market Risk Premium should be no higher than 0.2% (subtract risk free rate from expected returns).

Equity beta

The Alliance does not support Ergon Energy's proposal for an equity beta higher than the AER's Rate of Return Guideline. The Alliance urges the AER to approve the only the lowest possible equity beta within the Rate of Return guidelines, to reflect Ergon's comprehensive lack of systemic risk under the current Control Mechanism (the revenue cap).

Any value of the equity beta above 0.3 is not in the short- or long-run interests of consumers.

Alliance proposed Cost of Equity

By applying The Alliance's preferred equity parameters to the Sharpe-Lintner CAPM model, Ergon Energy's required Return on Equity is significantly reduced over the next regulatory control period.

The Alliance calls on the AER to apply a cost of equity of no more than 3.7% when setting Ergon's WACC.

Key parameter	Ergon Calculations	Alliance Calculations
Return on Equity	**10.53%**	**3.69%**
Risk-free Rate	3.63%	3.63%
Equity Beta	0.82	0.3
Market Risk Premium	7.57%	0.20%

Alliance proposed WACC

The Alliance's preferred parameters for debt and equity result in substantially reduced WACC for Ergon Energy in the next Regulatory Control Period. The Alliance calls on the AER to adopt these parameters.

Key parameter	Ergon Calculations	Alliance Calculations
Return on Equity	**10.53%**	**3.69%**
Return on Debt	**6.36%**	**3.65%**
Rate of Return	**8.03%**	**3.67%**
Gearing	60%	60%

Incentive schemes

Capital Efficiency Sharing Scheme & Efficiency Benefit Sharing Scheme

The Alliance believes that the EBSS and CESS protect networks' inefficient expenditure. Therefore, the Alliance calls on the AER to NOT APPLY the CESS and EBSS incentive schemes. In their current format, the CESS and EBSS do not provide the appropriate incentives for Ergon Energy to invest in and operate its network efficiently.

For example, if the EBSS and CESS are to be applied, electricity consumers will still be required to pay for 30% of any inefficient expenditure incurred by Ergon Energy. This is not in the short- or long-run interest of consumers. In a competitive environment, any business would not be able to pass on 30% of their inefficient costs to consumers – the inefficient cost is borne by the business.

The Alliance firmly believes that the AER should be setting only the efficient levels of expenditure through the Regulatory Reset. This means that Ergon Energy would have no scope to further reduce its capital or operational expenditure to gain from the EBSS or CESS.

Further, The Alliance calls on the AER to revoke the $153.87 million of EBSS payments Ergon Energy is seeking to recover in the next Regulatory Control Period.

Service Target Performance Incentive Scheme

The Alliance does not support the application of the Service Target Performance Incentive Scheme (STPIS). Electricity consumers in regional Queensland are paying significantly higher electricity prices due to mandated N-1 network planning criteria. Due to the N-1 criteria, Ergon Energy is meeting its STPIS targets through its legal obligations, not through innovative network management. Rewarding Ergon Energy for meeting legislative levels of service through additional incentive payments (paid through higher electricity prices) is not in the short- or long-run interests of consumers.

Further, The Alliance calls on the AER to revoke the $30.22 million in STPIS payments Ergon Energy is seeking to recover in the next Regulatory Control Period.