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Submission to AER draft determination and Energex's revised revenue proposal for the 2015 to 2020 regulatory period

Thank you for the opportunity to provide the Energy User Association of Australia's (EUAA) perspectives on the AER draft determination and Energex's revised revenue proposal.

We are of the view the AER has the opportunity to apply far greater rigour to Energex's revised revenue proposal. This being particularly the case in the application of opex benchmarking and selection of WACC parameters.

Our recommendations on these and other matters are clearly articulated in the submission.

We hope you find this of assistance for the AER final determination and we welcome further dialogue or clarification on any of the matters raised.

Please do not hesitate to contact me should you require any clarifications or further information regarding this submission.

Yours sincerely

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Chief Executive Officer
Energy Users Association of Australia (EUAA)

SUBMISSION TO THE AER

AER DRAFT DETERMINATION FOR ENERGEX & ENERGEX REVISED PROPOSAL

ENERGEX 2015 – 2020 REGULATORY CONTROL PERIOD

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The views expressed in this document do not necessarily reflect the views of Energy Consumers Australia

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1 EXECUTIVE SUMMARY

The EUAA recognises the reductions the AER has made to the revenue proposal put forward by Energex. However, the members of the EUAA are disappointed the AER draft determination did not go far enough and also that Energex's revised proposal largely seeks to defend its original proposal. In summary the dissatisfaction arises from:

- The majority of the reduction in revenue allowance being due simply to changes in the financial markets (ie the risk free rate) rather than reflecting returns commensurate with an industry with very low risk.
- Insufficient review or consideration by the AER of Energex's expenditure history prior to 2006 which the EUAA believe is very relevant to this determination as it highlights the anomalous nature opex and capex since 2005.
- No reduction in the proposed opex allowance by Energex which is a significantly worse outcome for customers than the AER benchmarking results would suggest.
- The AER's approach to defining the "efficient frontier" and use of environmental operating factors to lower the efficient frontier by 17%.
- A capex reduction of only 19% which is significantly less than what should have been applied taking into account the flat / uncertain demand forecast and the historic significant investment in network capacity.
- The EUAA are of the view the AER had the opportunity to apply far greater rigour to Energex's revised revenue proposal. This being particularly the case in the application of opex benchmarking and selection of WACC parameters.

The EUAA are of the opinion that the period 2006-2015 is an anomaly particularly in terms of capex and opex. Most of this was driven by jurisdictional standards and overestimated growth in demand. As a result Energex's business seems to have expanded rapidly for little benefit to Queensland customers. While the EUAA acknowledges Energex has attempted to introduce efficient practices, our view is that Energex has scope for further savings to be returned to customers.

1.1 Recommendations

The following summarises the key recommendations by the EUAA that are discussed further in the main body of the submission.

Recommendation 1A

That a total capex allowance not exceeding $2,162M be approved by the AER.

Recommendation 1B

An alternate to recommendation 1A is that given the uncertainty of demand forecasts, that augmentation and connection capex is released in tranches that are triggered by actual system non coincident demand and new customer number thresholds respectively. This way, the initial level of capex can be kept lower.

Recommendation 2

That the CESS is not applied to Energex if the approved capex allowance exceeds $2,162M as this would be considered an inefficient level by the EUAA.

Recommendation 3

The AER reconsider its position on its application of benchmarking opex. In particular:

- Incorrect selection of the lower quartile performer as the efficient frontier
- That the true efficient frontier is a 100% opex efficiency score.
- Recognize that the annualized opex in the 2002-05 period is significantly lower than post 2005 for no clear reason.

In reconsidering these issues, the EUAA recommend a preferred total opex allowance of $1,208M.

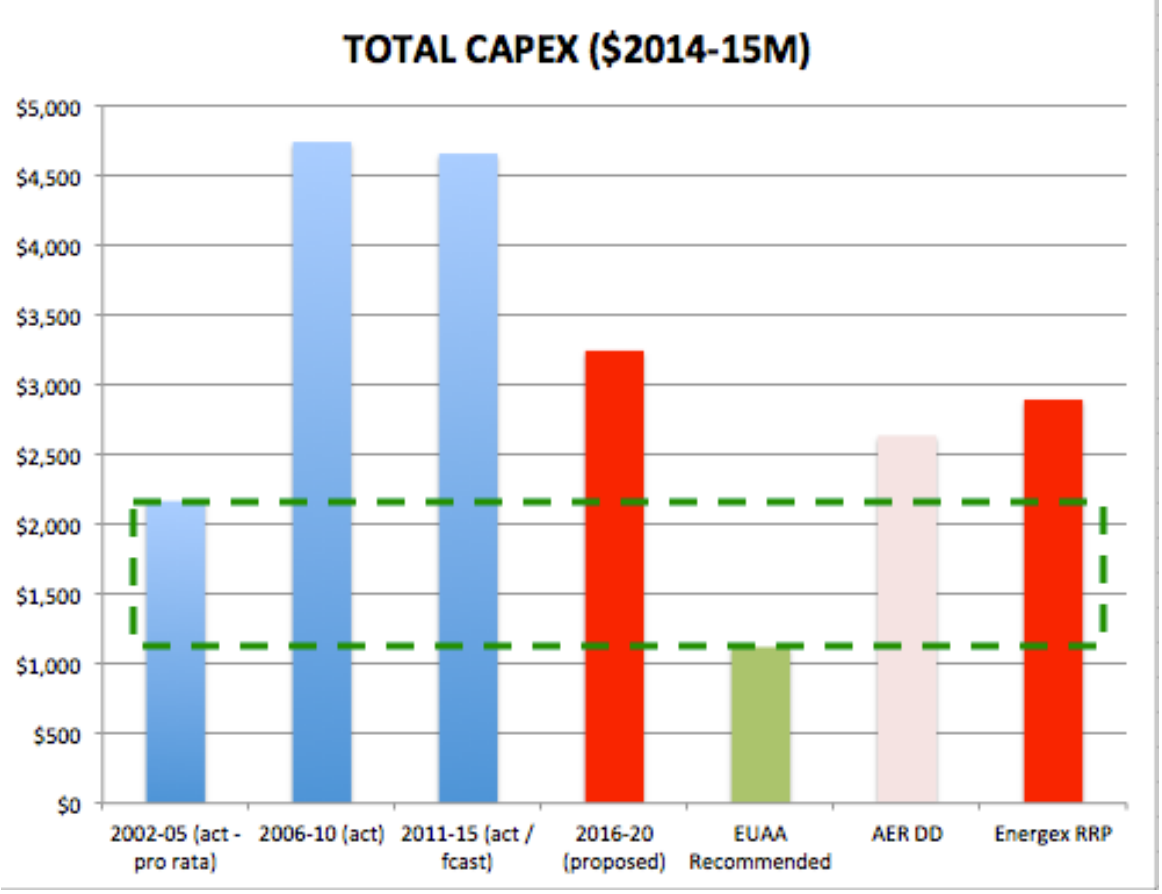
Recommendation 5

That the AER reconsider its draft determination on WACC and reduce it closer to the return on debt given the significant reduction in the risk free rate and low investment risk faced by Energex.

2 CAPEX

The following graph illustrates the past regulatory period capex against the current draft determination and Energex's original and revised proposals. The reason for going back to 2002-05 (pro rated to an equivalent 5 year period) is that it is more "like for like" with the current environment. (ie flatter demand and before the jurisdictional standards changes in 2006 that drove over investment up to 2013).

Figure 1: Energex capex trend[1]



Some observations from the above graph include:

- the EUAA recommended level of capex (in response to Energex's original proposal) and the prorated capex between 2002-05. (the boxed section on the graph) Note the EUAA value was independently derived from a top down calculation of maintaining RAB / demand constant. The EUAA does not believe a case has been made by the AER or Energex to increase capex above levels pre 2006.
- the green boxed section forms the EUAA preferred and upper capex allowances.

Another concern of the EUAA is that once the total capex allowance has been effectively approved by the AER, that Energex will internally justify the spending of the allowance to keep growing the RAB. It is noted that although the AER analyses capex by categories, it does not provide specific allowances for those categories (ie augex and repex). This means that an underspend in augex can in practice be spent in repex. The current regulatory framework has no "look back" mechanism other than for capex overspend.

[1] Energex 2010-15 Revenue Proposal, RIN, AER draft determination, Energex revised proposal

The above graph is compared to the following historical demand growth. and falling network utilisation.

Figure 2: Energex historical maximum demand[2]

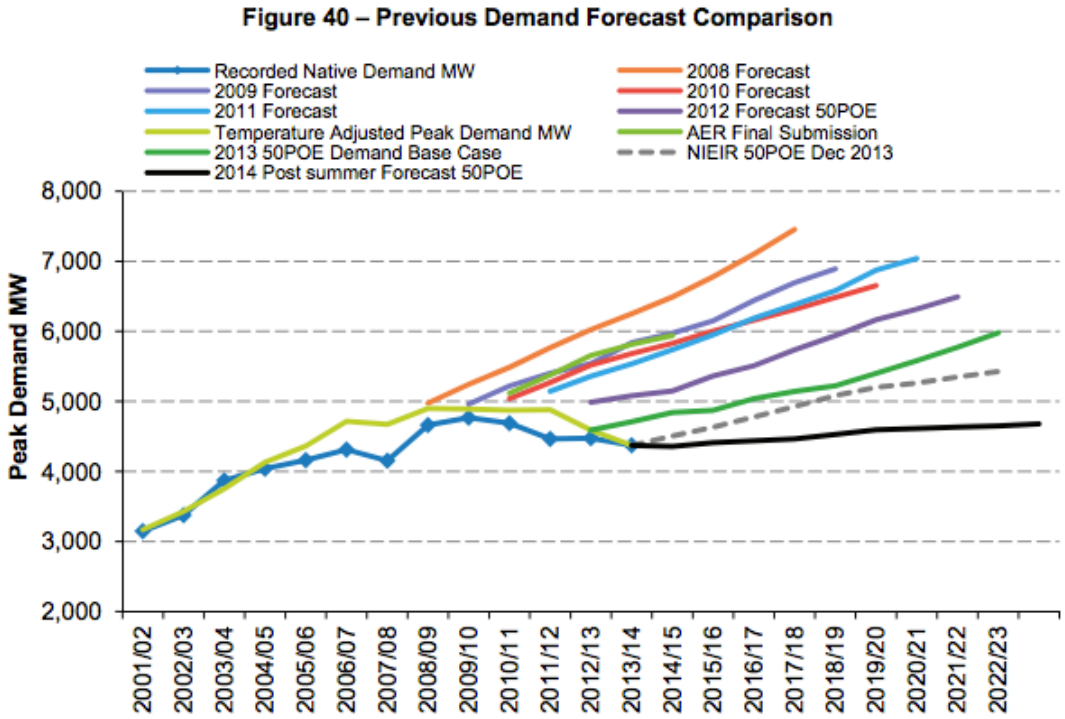
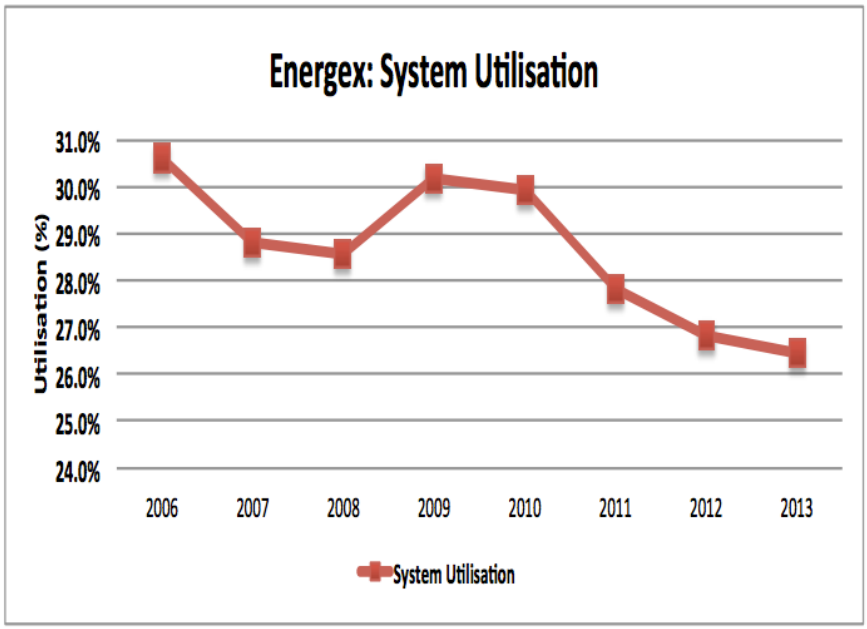


Figure 3: Energex system utilisation[3]



Source: Bev Hughson Analysis of Energex RINS Data

[2] Energex 2014/15 – 2018/19 Distribution Annual Planning Report
[3] Bev Hughson analysis

The proposed and revised capex by Energex (and the AER draft determination) is simply not credible for the following reasons:

- Demand has flattened. Comparing the demand and the capex from 2002 to today highlights the gross inconsistency in network investment in relation to demand growth.
- Jurisdictional standards have been relaxed and Energex is proposing to use a probabilistic planning approach which typically reduces capex over the historical deterministic approach.
- Network utilisation has fallen dramatically (network capacity / maximum demand) meaning that there is increased "headroom" capacity in the network to soak up demand growth.
- The partial productivity measure for replacement capex in figure 4.4 of Energex's revised proposal is likely to be quite misleading as a comparison to peers due to the significantly higher investment in capex by the Queensland DNSP's over that period compared to peers (more than doubling of the RAB). Energex is attempting to use this graph to headline a theme of under investment when the denominator (depreciation – and they also refer to RAB) is significantly higher than their peers.

2.1 Augex

History has shown a trend of over forecasting demand by industry experts (Energex, AEMO, AER) due to the uncertainties associated with PV penetration, economic growth and energy efficiency.

The 2015 NEFR recently published by AEMO indicates short term energy growth in Queensland predominantly on the back of LNG projects. The EUAA urge the AER to be very cautious with this information as augmentation from these projects are more likely to be associated with Powerlink / transmission or at the very least ACS and not part of the SCS costs. The supplementary reports to the 2015 AEMO NEFR by Monash University suggest there is uncertainty in the underlying demand in Queensland[4].

The EUAA understands the RiT-D process that applies to augex. However, there are opportunities for a significant number of cumulative projects to be undertaken that fall outside the process (eg <$5M and incidental augmentation associated with asset replacement). Even if the augmentation projects do not eventuate, the customer pays via the return on capital of the unused capex allowance within the regulatory period.

The AER has stated in public forums that it has limited capability to independently form a view of future demand and is heavily reliant on AEMO forecasts. In the interests of providing solutions rather than just being critical, the EUAA has given consideration of a way forward that is both fair to customers and Energex.

The EUAA suggest the AER consider using its discretion to apply an approach to augex similar to the approach with contingent projects. That is, set a level of augex that has a high probability of being required (this might be say 50% of that proposed for example). Subsequent release of "tranches" of augex could be triggered by reaching agreed thresholds of aggregate non coincidental demand to account for spatial demand growth.

[4] Page 3 Report for AEMO – "Forecasting long-term peak half-hourly electricity demand for Queensland" – Monash University – Hyndman, Fan – 3 June 2015

2.2 Repex

The EUAA note that the AER has considered a number of inputs in determining an appropriate level of repex. The EUAA has interpreted from the AER's draft determination that it has relied heavily on a recalibrated repex model for about 61% of the repex. The repex model was never intended to be a deterministic model. Although it is understood that the AER examined peer asset replacement lives and an engineering assessment, the EUAA believe that the AER's determination is likely to be conservative due to:

- Energex's recent high level of capex investment in both augex and repex
- The recent high levels of augex would have also resulted in some asset replacement
- The AER's consultants are unlikely to have a very accurate of asset condition

2.3 Connections

The EUAA propose that the AER apply the same approach as suggested for augex with connections. That is, allow say 50% of the connections capex in an initial tranche with the remainder released subject to the number of new connections reaching prescribed thresholds.

2.4 CESS

It is noted that the AER has determined that it is appropriate for Energex to have the CESS applied. The EUAA are of the view that the CESS is not a strong incentive and that network companies have a greater incentive to spend the capex allowance to maintain RAB growth to ensure long term returns. Further, when underspend is largely due to growth in demand being below forecast and jurisdictional standards being reviewed and relaxed, there should not be a reward for Energex.

The EUAA disagree with the arguments put forward by the AER to apply the CESS to Energex if the capex allowance exceeds the upper boxed band ($2,162M) as denoted in figure 1. If the allowance in the final determination exceeds this, the CESS should not be applied as it is very clear from the above discussion that Energex have been provided with very generous capex allowances and appears to be wanting to stay in the paradigm of over investment.

3 OPEX

The opex trend is a similar one to the capex for Energex. That is, that since 2006 there has been a dramatic increase in costs. However, for opex the reasons are less clear as they do not appear to be directly related to any jurisdictional requirements.

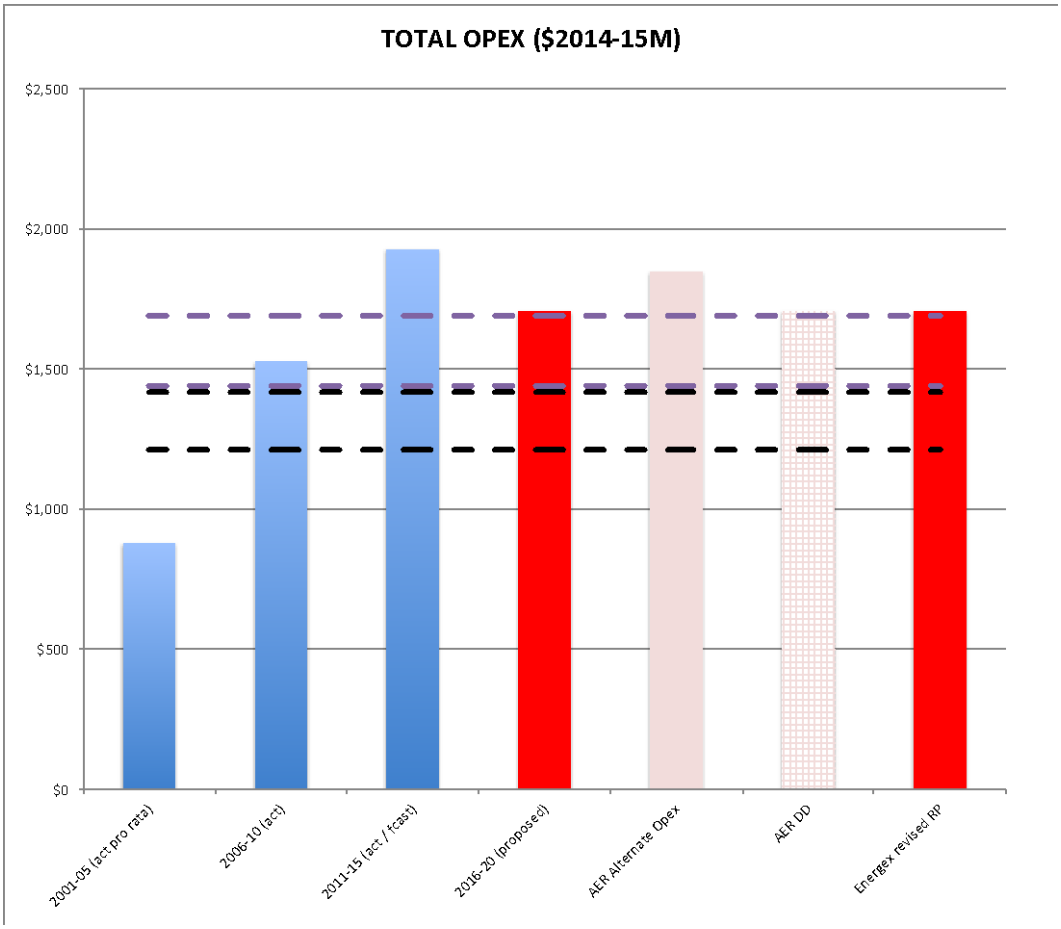
The AER draft determination for the opex allowance and Energex's revised proposal is not credible for the following reasons.

- Like capex, there is not sufficient look back to understand the unexplained significant step change in opex allowance / spend from 2005.
- The base efficient year due to the above is coming off a very high and inefficient base.
- The AER has appeared to arbitrarily re-define the "efficient frontier" as the bottom of the top quartile DNSP's.
- Notwithstanding the above, the AER appears to have selected an incorrect value for the bottom of the top quartile by reference to Ausnet Distribution instead of United Energy.
- The AER has also applied very generous and unnecessary operating environment factors (EOF's) to shift the "efficient frontier" even closer to Energex's current opex performance levels.

The following graph illustrates the trend in opex for Energex with the following points of clarification:

- The dashed purple lines are the upper and lower bounds of opex applying the AER's draft determination which includes the applied EOF's using United Energy as the upper bound and the true efficient frontier (100% opex efficiency score) as the lower bound.
- The dashed black lines are the same bounds as above without the EOF adjustments made by the AER.
- The 2002-05 was a 4 year regulatory period and has been pro rated up to a 5 year equivalent value.

Figure 4: Energex opex historical trend, AER draft determination and Energex proposals



Some observations from the above graphic :

- The AER's alternate opex was 7% higher than what Energex proposed.
- The benchmark range of efficient opex for Energex sits around 29% below the opex proposed by Energex and the AER draft determination.
- The AER's draft determination is over generous on all counts.

3.1 AER Benchmarking

The EUAA are very concerned with the approach taken by the AER in modifying the good benchmarking work undertaken by Economic Insights.

Even with the approach taken by the AER, it appears to have made a mistake with their choice of the "efficient frontier" being the bottom of the top quartile.

> *"The comparison point we used was the lowest performing service provider in the top quartile, AusNet Services. According to this model AusNet Services' opex is 76.8 per cent efficient based on its performance over the 2006 to 2013 period."*[5]

From the Economic Insights report, this value should have been 84.3% belonging to United Energy rather than 76.8% belonging to Ausnet Services as follows. The top quartile (Q3) being generated by the standard formula (3/4 x (n+1))th value = 0.8435.

Table 1: Opex efficiency scores for NEM DNSP's[6]

DNSP	SFA CD
CIT	0.95
PCR	0.946
SAP	0.844
UED	0.843
AND	0.768
TND	0.733
JEN	0.718
ENX	0.618
END	0.593
ESS	0.549
ERG	0.482
AGD	0.447
ACT	0.399

The selection of 76.8% as the efficient frontier lowers the frontier by 7% from the true bottom of the top quartile performer. Further the application by the AER of operating environmental factors (OEF's) reduced this benchmark further by a massive 17.1%. The EUAA reject the approach taken by the AER in establishing the efficient base year opex and fully support the arguments made by PIAC[7] in this regard in the context of the Energex draft determination.

3.2 Opex Conclusion

The EUAA are concerned that the regulatory process may have locked in Energex's proposed opex through the propose / respond process and Energex accepting the AER's draft determination. The EUAA believes there are grounds to review this on the basis that a material error was made in selecting the wrong bottom of top quartile performance value. The EUAA apply a true efficient frontier to Energex resulting in a total opex allowance of $1,208M.

Further, this reduction should be applied in full for the next regulatory period.

[5] AER Draft Determination page 7-27 Step 3
[6] Economic Insights report to the AER
[7] Section C1 PIAC Outline of Submissions – Document 8 – Lodged document with Australian Competition Tribunal

4 RATE OF RETURN

The EUAA's members are of the view that the NSP's were over compensated by the AER for post GFC financial market conditions that did not eventuate. The EUAA members have considered the AER's determination and selection of parameters from the ranges documented and have proposed a market risk premium of 5.00% and an equity beta of 0.4. The EUAA has come up with a resulting vanilla WACC of 5.07% being influenced by the 10 year trailing debt based on 10 year Government bond rates.

5 DEPRECIATION

It is understood that network owners only receive return of capital (depreciation) once and theoretically the timing should not matter other than short term price impacts. However, the EUAA strongly advocate that the asset lives should reflect the actual lives of the respective classes of assets that have been managed through good industry practice. Therefore the EUAA do not support Energex's proposal in section 6.3.2 of their revised proposal signaling acceleration / front ending of certain asset classes. It is also noteworthy the comments by Energex outlined on page 74 regarding not investing in non discretionary projects and the EUAA question if Energex would really be prepared to breach its distribution licence or if this is simple rhetoric. It is an ambit claim by Energex to be seeking to accelerate depreciation or change the CAM to de-risk when there is no risk of asset stranding in the current NER. It is also insulting to customers that Energex suggest in the last paragraph of 6.3 that the indexation of RAB and depreciation profiles are largely to blame for the RAB being so high when Energex have more than doubled the RAB since 2006 due to over significant investment.

Further, the EUAA raised in our submission to Energex's original proposal the question for the AER and Energex to consider a mechanism within the NER to voluntarily financially optimise the RAB (for future review) where known to be under utilized or redundant. There has not been any response to this and we therefore raise the question again via this submission.