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Mr Sebastian Roberts
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Dear Mr Roberts

SUBMISSION ON THE QUEENSLAND ELECTRICITY DISTRIBUTION REGULATORY PROPOSALS 2015–16 TO 2019–20 ISSUES PAPER

Ergon Energy has reviewed the Issues Paper released by the Australian Energy Regulator (AER) on the regulatory proposals submitted by Energex and Ergon Energy for the regulatory control period 2015–20.

We would like to take this opportunity to respond to some of the issues raised by the AER, as well as comments made by the AER and the Consumer Challenge Panel (CCP) at the public forum held on 9 December 2014.

We are concerned that, in some areas, the substance of our Regulatory Proposal may be misinterpreted by customers who rely on the Issues Paper to consider and engage on key issues. For example, data underpinning some of the graphs has been drawn from a number of sources which means the basis of preparation may be different. This makes it difficult to directly compare and compromises the reader's ability to effectively engage. Further, the key points raised in the Issues Paper may not fully represent the substance of our Regulatory Proposal.

Our submission therefore largely focuses on clarifying these points so customers can make a more fulsome judgement on the key preliminary issues that should be the subject of further engagement.

At the public forum, we also noted the AER's focus on issues of benchmarking. We have been monitoring with interest the distribution determination process in New South Wales (NSW) and the Australian Capital Territory (ACT) and the role benchmarking has played. From statements made by the AER at the public forum, Ergon Energy understands that the

AER will apply similar techniques to Queensland distributors. As such, the latter part of our submission provides our initial response to the AER's approach in this area.

We also wish to raise some other concerns we have identified regarding the AER's views on transition paths to efficiency and the potential safety and other impacts that could flow from the level of expenditure cuts implied in the AER's Draft Decisions for NSW and ACT DNSPs.

A more detailed response to the above-mentioned issues will be provided in a separate submission to the AER's Draft Decision for NSW and the ACT, however, we felt it important to raise these matters now as part of the consideration of our 2015-2020 regulatory proposal.

Actual vs allowed revenue

Ergon Energy is concerned that customers may misinterpret Figure 2 in the Issues Paper and conclude that we are recovering more revenue than we are allowed to in the current regulatory control period 2010–15. This is not the case.

In the current regulatory control period, Ergon Energy's Standard Control Services are regulated under a revenue cap form of price control. Generally, the revenue cap for any given year reflects Ergon Energy's Maximum Allowed Revenue (MAR) plus any under/over adjustment required to clear the Distribution Use of System (DUOS) unders and overs account for the most recently completed regulatory year.

As per the AER's 2010–15 Distribution Determination, the MAR is comprised of:

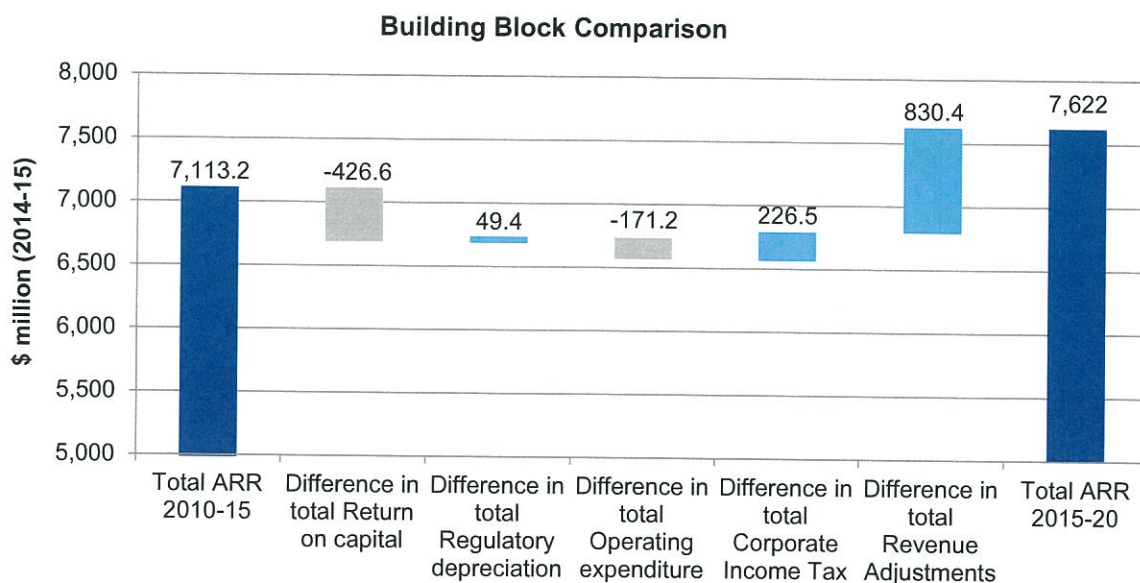
- the allowed revenue set out in the AER's Distribution Determination. This is derived from the AER's Post Tax Revenue Model (PTRM) and updated for inflation
- any rewards or penalties associated with the Service Target Performance Incentive Scheme
- any adjustments for the difference between actual and forecast capital contributions
- any adjustments for transitional factors, such as unders and overs adjustments for shared assets
- approved pass through amounts (which includes the Solar Bonus Scheme feed-in tariff payments).

The 'allowed revenue' in Figure 2 represents the first point above only (albeit, based on forecast inflation). That is, it does not take into account the annual revenue adjustments that are applied in the revenue cap calculations. Consistent with the NER and our last determination, Ergon Energy is permitted to recover these amounts, and is therefore not recovering more revenue than it is allowed to.

Comparison of revenues between periods

Both the CCP and the AER mentioned the revenue recovery between periods. In particular, the CCP made reference to revenues being much higher in the next regulatory control period compared to actual and allowed revenues in the current period. The CCP attributes this additional revenue recovery to increasing inputs such as a higher Regulatory Asset Base (RAB) and operating expenditure.

Section 8 of our *Building Block Components* document provides a detailed comparison of the forecast Annual Revenue Requirements between periods. The following diagram depicts these differences, by building block component.



In summary:

- There has been a reduction in the return on capital component, largely due to the lower proposed nominal vanilla Weighted Average Cost of Capital.
- There has been an increase in the regulatory depreciation component, largely due to the larger RAB in the next regulatory control period.
- Our forecast operating expenditure in the next regulatory control period is lower than that forecast for the current period.
- There has been an increase in the corporate income tax, largely due to:
 - the lower operating expenditure and interest expense in 2015–20
 - higher capital contributions in 2015–20 due to change in regulatory treatment
 - no tax loss carried forward in 2015–20.
- There are other revenue adjustments required (e.g. higher carryover amounts from 2010–15).

Replacement expenditure

The AER commented on page 15 of the Issues Paper that the distributors have submitted “that the average age of network assets continues to increase” and the “proposed repex is required to maintain the average age of the network within an acceptable range, consistent with their reliability and safety obligations.” The AER has also questioned why replacement expenditure is increasing. No specific reference to Ergon Energy’s proposal was provided in support of this commentary.

Customers may now be confused by the commentary in the AER’s Issues Paper with reference to other information provided by the CCP at the public forum.

However, we believe most of the confusion can be attributed to an inaccurate portrayal of the drivers of Ergon Energy’s replacement expenditure. We wish to make it clear that Ergon

Energy's submission and supporting material do not contain statements that our proposed repex is required to maintain the average age of the network within an acceptable range

As noted on page 43 of our *Asset Renewal Expenditure Forecast Summary* document, Ergon Energy's replacement expenditure is focused on mitigating safety risks (30 per cent of expenditure) and renewing assets that are at the end of their serviceable lives (70 per cent). In Ergon Energy's context, serviceable life refers to the expected remaining functional life of the asset in service based on its condition or potential to fail in service, not the standard, average or technical age of that asset.

For the avoidance of doubt, renewal decisions are based on a number of factors and are not driven by decisions to reduce or maintain the average age of assets within a particular range as is suggested by the AER in its Issues Paper.

For example, Ergon Energy has adopted a Condition Based Risk Modelling approach for a number of our high value zone substation assets. The methodology combines asset information, engineering knowledge and practical experience to define the current and future condition, performance and risk for network assets.

Likewise, the most significant component of this asset renewal expenditure involves basic lines based component replacement of high-volume, low-cost components identified from mandated periodic asset inspection and condition-based processes as required under the *Queensland Electrical Safety Act (2002)* and the *Queensland Electrical Safety Code of Practice (Works) 2010* (Line and Substation Defect Remediation program).

Further information on our expenditure forecasting approach is contained in Section 5 of our *Asset Renewal Expenditure Forecast Summary* document.

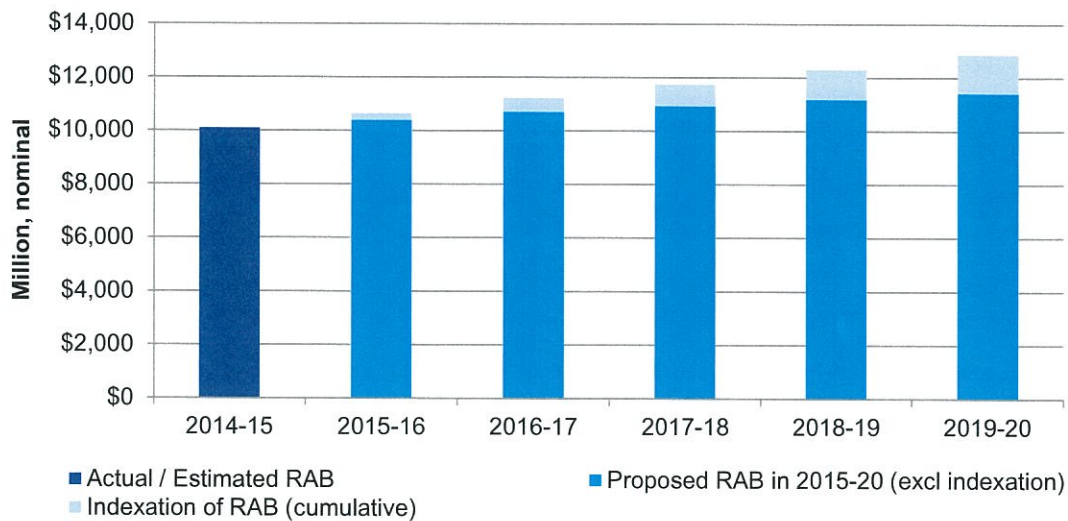
Growth of the Regulatory Asset Base

In its Issues Paper, the AER stated that our RAB is continuing to grow, despite lower capital expenditure being proposed and weak demand forecasts. The AER indicated that it will investigate this issue. The CCP also raised similar concerns at the public forum.

Our forecast RAB is expected to grow by 27 per cent over the next regulatory control period. However, over half of the increase in the RAB over the period relates to the revenue calculation approach adopted in the AER's PTRM.

Rather than Ergon Energy receiving the full rate of return recovery in our revenue building block, the inflation component of the rate of return is included the asset base roll forward. The PTRM therefore allows the residual value of the RAB at the end of each regulatory year to be adjusted upwards for the amount of expected inflation in that regulatory year.

If the indexation component of the rate of return was applied to revenues, the RAB would effectively grow at a much lower rate (13 per cent). This is illustrated in the figure below. Applied over time, it is clear that these regulatory arrangements have a material effect on the opening and closing RAB values. Such analysis is often neglected when considering the value of the RAB.



Operating expenditure

The AER has stated that our operating expenditure in the current regulatory control period is higher than the AER-approved allowance. This statement is supported by Figure 12 in the Issues Paper, which draws on historical operating expenditure amounts from the submitted reset RIN.

The AER appears to have used historical expenditure amounts which include cost pass through amounts associated with the Queensland Government Solar Bonus Scheme. These amounts were approved by the AER and formed part of our Annual Revenue Requirements which were recovered from customers through network tariffs (consistent with the control mechanism and pricing arrangements). Including actual/estimate costs for the Solar Bonus Scheme without also including them in the allowance may be misleading to customers.

The cost pass through mechanism was adopted in the current regulatory control period to allow Ergon Energy to recover the difference between the forecast feed-in tariff payments (included in forecast operating expenditure) and actual feed-in tariff payments. This was due to uncertainty surrounding the scheme and forecast volumes. If feed-in tariff payments had been accurately forecast at the time of the 2010–15 Distribution Determination, the equivalent of the cost pass through amounts would have been included in the AER-approved allowance. This means the AER-approved allowance would have been higher.

If expenditure associated with feed-in tariff payments is excluded, we expect to deliver an operation program *less* than the AER-approved allowance.

Further, it is important to note that Ergon Energy absorbed the full financial cost (within the AER allowances) of two major events that impacted our distribution area in the first half of the current regulatory control period. In 2011, Severe Tropical Cyclone Yasi took out power supplies to nearly a third of our customer base, interrupting over 220,000 homes and businesses and at least 50 major substations. Then, in January 2013, serious weather events relating to Cyclone Oswald impacted 40 per cent of our distribution area. Our total costs for these two events (capital and operating expenditure) totalled around \$120 million.

Ergon Energy had the option to apply for a cost pass through for these events, but, in the interests of customer affordability, elected not to do so. This does not appear in the AER's Issues Paper.

Feed-in tariff recovery

Ergon Energy would like to re-iterate that our approach to feed-in tariff recovery aims to avoid a price spike in 2015–16 and 2016–17. The AER's Issues Paper does not acknowledge this. Nor does it recognise that our proposed two year lag approach is effectively another form of smoothing (i.e. if we did not apply the lag, there would be significant price spikes in 2015–16 and 2016–17).

Ergon Energy consulted with our customers on various options to moderate the price impacts of the Solar Bonus Scheme. There was general support at our Customer Council meeting in May 2014 for the lagged approach.

Customer Transfer fee

The classification of services set out in the Framework and Approach Paper for Queensland included a meter exit fee. This fee was classified as an Alternative Control Service and allowed for the "recovery of stranded asset costs associated with the removal of a meter(s) from customer's premises before the end of its useful life at the request of the customer (or customer's retailer) due to a change in Responsible Person / Meter Coordinator".¹ In turn, Ergon Energy proposed a Customer Transfer fee in our Regulatory Proposal.

The AER's initial view is that the Customer Transfer fee proposed by Ergon Energy is likely to inhibit the development of effective competition in the provision of metering services. The AER is therefore seeking to develop an alternative approach to allow these costs to be recovered.

We note the AER had a similar view in its Draft Decisions for NSW. Its response was to classify the residual capital costs component of the metering exit fee as a Standard Control Service. This means the costs will be recovered from the general customer base through network tariffs.

In making this decision, the AER relied on clause 6.12.3(b) of the NER, which allows them to depart from the classification of services set out in the relevant Framework and Approach Paper if there is an 'unforeseen circumstance'. The unforeseen circumstance the AER used to justify the departure was that there was no stranding risk previously as customers were unable to switch to an alternative provider for Type 5 and 6 metering services. This is because the metering rule change request was released after the NSW Framework and Approach Paper.

Ergon Energy believes it would be difficult for the AER to adopt a similar position in Queensland. This is because the AER would not be able to rely on the same unforeseen circumstance used in NSW as the metering rule change request was released before our Framework and Approach. We are also unaware of any other unforeseen circumstance which would justify a departure.

¹ p116.

We also note the AER's position in the Framework and Approach Paper regarding the cost elements of a service and how they should be classified. This was raised in the context of wasted attendances. On page 49, the AER stated the following:

"we consider wasted attendance to be an element of a service provided by the distributors. That is, it is not a service in itself. We further consider the cost of a wasted attendance should be recovered consistently with the classification of the related service."

We are therefore concerned with the legitimacy of classifying metering exit fees as a Standard Control Service when the service to which it relates is an Alternative Control Service (i.e. Type 5 and 6 metering services).

Ergon Energy also questions whether transferring the portion of the metering RAB attributable to a stranded meter to the Standard Control Services RAB is permissible under the NER. Clause 6.5.1(a) of the NER requires the RAB to only include the value of those assets used to provide Standard Control Services. We consider that a stranded meter is not providing a service at all, and even if it was, it would be used to provide an Alternative Control Service.

Concerns regarding barriers to competition can be overcome by other mechanisms. Firstly, the AER can ensure the exit fee is appropriate, clearly defined and transparent. Ergon Energy considers that our proposed Customer Transfer fee has these attributes. Secondly, the AER may wish to consider other options to recover the forecast residual capital costs through the annual depreciation charge for the existing meter service. It is not clear the extent to which the AER has properly considered all options on this issue and how it has explained these to customers.

If the AER decides to reclassify the residual capital costs as a Standard Control Service, Ergon Energy would appreciate the opportunity to liaise with the AER on how these costs will be recovered, prior to the release of the Preliminary Determination.

No matter which approach is adopted, it is important for Ergon Energy to be able to recover our efficient costs associated with customer churn.

Benchmarking

The AER has suggested in its Issues Paper that an important tool in assessing the efficiency of expenditure forecasts is benchmarking. It further proposes that there is a performance gap between Ergon Energy and other distributors, both in terms of operating expenditure and overall.

Ergon Energy is concerned with statements made by the AER in its Issues Paper, Annual Benchmarking Report and the Draft Decisions for NSW and the ACT about the efficiency of Ergon Energy. For example, in its operating expenditure attachment to Ausgrid's Draft Decision, the AER indicated that Ergon Energy's operating expenditure is materially

inefficient but the AER does not appear to have considered any of the benchmarking material previously supplied to it by Ergon Energy in forming this view.

It seems the AER has already reached a conclusion about our efficiency before assessing our Regulatory Proposal or properly considering the operating environment Ergon Energy faces. The AER's assessment to date has failed to take into account, among other things, the unique challenges facing our network which were outlined in our supporting document, *How Ergon Energy Compares*. These factors affect our costs. Cost differentials cannot be meaningfully compared and explained by using information from the RINs (which form the basis of the AER's Benchmarking Report).

Ergon Energy notes that in response to the AER's Draft Decisions in November 2014 the NSW and ACT DNSPs have now released a number of reports and conducted analysis which casts significant doubt on the reliability of the benchmarking data and the robustness of the conclusions reached by the AER based on this benchmarking material. These concerns are similar to the matters that Ergon Energy raised with the AER's Board on 16 January 2015 (see **Attachment 1** which contains a copy of Ergon Energy's presentation to the AER Board).

Our research, and analysis by external experts and the NSW and ACT DNSPs, indicates that there are very large differences between DNSPs in the Australian sample in terms of:

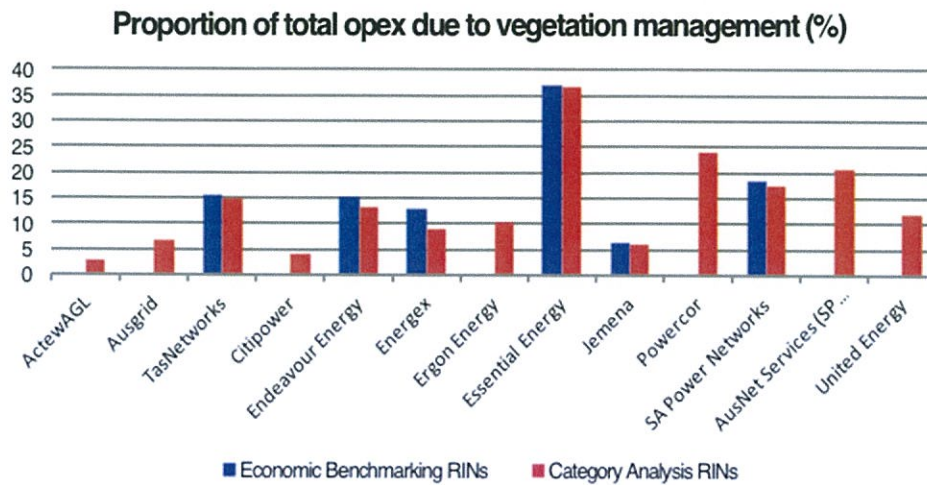
- scale
- service area
- impact of extreme weather events, bushfires, cyclones etc.
- impacts of the significant levels of embedded/distributed generation on our network
- investment in high voltage assets.

Analysis shows that the AER's models fail to account for most of these large differences. As a result, these models appear to favour the smallest and densest networks (with a few exceptions). It also seems that these models and the AER's assessment of operating environment factors do not adequately consider a number of key factors, including:

- scope of activity (e.g. vegetation management – the role of local councils in Victoria and differing legal accountabilities Queensland DNSPs have when compared with Victorian DNSPs; differing inspection/patrol activities; and differing Occupational Health and Safety requirements and other regulatory regimes applying in each state and territory etc.)
- differences in the operating and capital expenditure trade-offs made by DNSPs.

It is also concerning that the data sourced by the AER and/or its external consultants from the international and Australian DNSPs in the benchmarking sample appears to contain numerous inconsistencies and errors that have not been properly accounted for by the AER and/or its external consultants.

For example, the graph below, drawn from analysis released by Frontier Economics, shows only six Australian DNSPs reported vegetation management costs in their Economic Benchmarking RIN data.



Of those DNSPs that reported vegetation management costs in **both** the Economic Benchmarking and Category Analysis RINs, the analysis by Frontier Economics shows that:

- none reported these costs consistently
- in all cases the difference was 2.8 per cent or more
- in Energex’s case the difference was nearly 47 per cent.

For a number of DNSPs, there were also large differences between the total operating expenditure (Standard Control Services) reported in the Economic Benchmarking and Category Analysis RINs (in one case greater than 20 per cent). No apparent effort appears to have been made by the AER to resolve these evident discrepancies even though vegetation management seems to be a significant cost for most networks.

Additionally, it seems from the analysis undertaken by Frontier Economics and Huegin for the NSW DNSPs that the relative ‘efficiency’ rankings of the Australian DNSPs can alter markedly, depending on which statistical model and techniques are used. It also seems that the efficiency rankings selected by the AER have not incorporated the potential uplift in operational costs being flagged by some DNSPs in the next regulatory control period, particularly for DNSPs currently assessed by the AER as being at the efficient frontier, e.g. SA PowerNetworks.

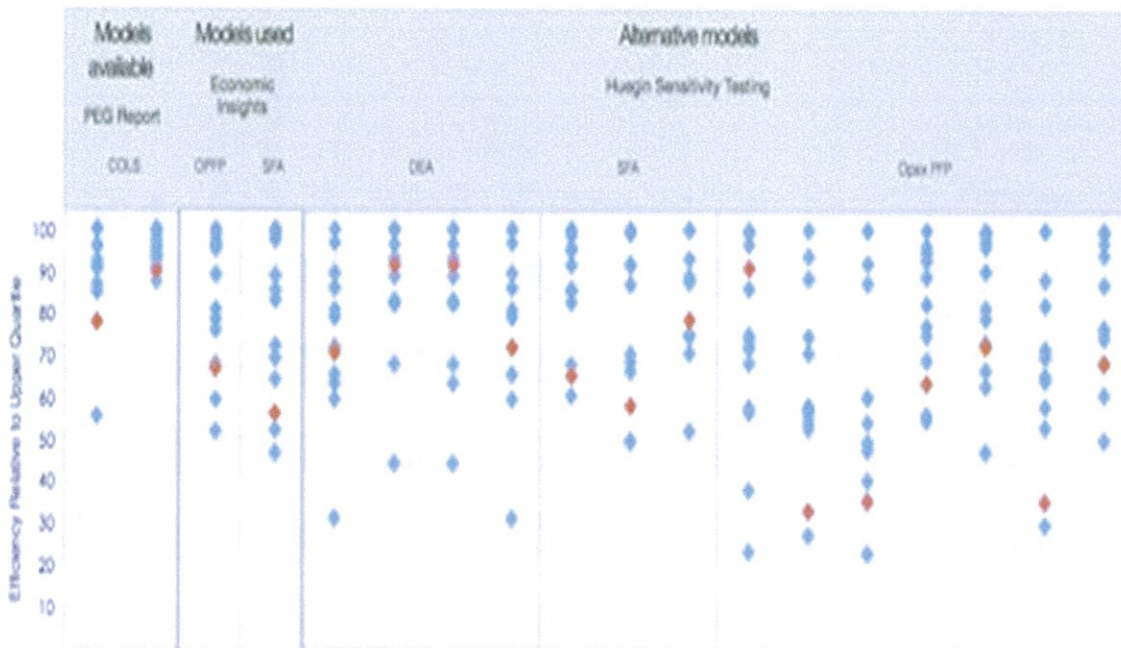
Of even greater concern is the fact that the Canadian DNSP apparently ranked by the Stochastic Frontier Analysis model used by the AER’s consultants as the most ‘efficient’ DNSP of all Australian, New Zealand and Canadian DNSPs sampled is actually ranked as being substantially less efficient by the relevant Canadian regulator when compared to its local peers.

Ergon Energy has not yet fully reviewed the material relied upon to date by the AER in undertaking its various benchmarking comparisons. However, in light of the above concerns, we commissioned Huegin to review the relevance of this material for our proposed operational expenditure and its relative efficiency when compared with other DNSPs.

A copy of Huegin’s preliminary report is attached (see **Attachment 2**). Throughout this report, Huegin illustrates many of the issues with the AER’s model and approach. Huegin also provides examples of important differences in Ergon Energy’s network and cost

structures that simultaneously cast doubt on the AER's approach and demonstrate the lack of veracity in the estimates of efficient operational expenditure implied in the analysis the AER has released with the Draft Decisions for the NSW and ACT DNSPs.

The graph below, drawn from the aforementioned Huegin analysis, demonstrates the wide range of results produced for Ergon Energy (marked in an orange dot) by the various statistical models potentially available to the AER. The graph illustrates the significant risks associated with placing heavy (or any) reliance on these statistical models to assess the relative efficiency of the Australian DNSPs. Depending on which of the 18 models was used, Ergon Energy's ranking varied from fourth to 12th.



The need for a transition path

In light of the comments made by the AER at the December 2014 public forum regarding its intention to apply a similar benchmarking approach to that applied to the NSW and ACT DNSPs, it would seem from the Huegin analysis mentioned above and other internal analysis of our capital expenditure, that the magnitude of cuts to our forecast operating and capital expenditure that could be applied are likely to be substantial and in the range of 20 to 40 per cent. Such an outcome would likely result in a distribution determination for the next regulatory control period that does not conform to the requirements imposed on the AER under the National Electricity Law (NEL) and the NER.

If, however, the AER is determined to make such a determination, we believe it is critical that the AER employ a transition path to ensure that the Ergon Energy's employees and customers are protected from the immediate and irreversible impacts on the business that would follow from cuts in expenditure of the magnitude that is implied by the AER's Draft Decisions for NSW and the ACT.

An immediate cut in forecast operating and capital expenditure in the order of 20 to 40 per cent in 2015–16 would likely require Ergon Energy to immediately review, and substantially reduce, expenditure in areas such as workforce levels, the size and number of depots and

other facilities, and inspection and maintenance of the network and prevent us from meeting our customer commitments around delivering peace of mind. The disruption to Ergon Energy's business that would result from such immediate cuts, together with the potential loss of corporate knowledge and expertise of how we would manage the network, would threaten to undermine the long term interests of electricity consumers. We believe it would jeopardise the safety of our network and would also be inconsistent with the strong customer feedback and customer research data we have received in developing our 2015-2020 investment plans about the need to deliver peace of mind – including to maintain an adequate local presence across our vast network and to deliver a safe, reliable and resilient network – particularly in light of the harsh operating environment and severe storms, cyclones and floods we face.

We note that Synergies has also reached this conclusion in some recent analysis we requested they undertake of this aspect (see **Attachment 3**).

While the AER has suggested, in its NSW and ACT Draft Decisions, that any expenditure reductions are simply a decision for the relevant network service provider,² it also states:

“If our determined prudent and efficient allowance to achieve the opex is lower than actual past expenditure, our view is that a prudent operator would take the necessary action to improve its efficiency”.³

Consistent with the AER's views on this matter, we believe it is necessary under the NER for the AER to have regard to the consequences of expenditure reductions made by a DNSP, when the production of those reductions is the rationale that underpins the AER's decision. We consider that it is inconsistent with the requirements imposed by section 16 of the NEL for the AER to fail to consider whether an immediate reduction in future expenditure, rather than the use of a transition path:

- (a) contributes to the achievement of the NEM objective, and
- (b) takes into account the revenue and pricing principles prescribed in section 7A of the NEL.

Ergon Energy notes the AER's observation that the NER appears not to permit a transition path where the AER's expenditure forecast is lower than a service provider's forecast.⁴ However, in rejecting a transition path, Ergon Energy believes that the AER has not fully considered how it could apply the expenditure criteria in clauses 6.5.6(c) and 6.5.7(c) of the NER.

While the AER places, in its Draft Decisions for NSW and the ACT, an overwhelming emphasis on 'efficiency', it is important to recognise that efficiency is only one of the criteria that direct the AER in approving an expenditure forecast. Efficiency is not to be considered

² For example, see the Ausgrid Draft Decision, Attachment 7 (Operating expenditure), pp7-27.

³ Id, pp7-54.

⁴ Id, pp7-16.

to the exclusion of the other criteria, and does not constitute a rigid cap on the expenditure that can be approved.

It also seems to us that the AER view on 'efficiency' is largely based on what the lowest cost option is, without necessarily appreciating the specific operating risks a DNSP faces or understanding the impact on the commitments that each DNSP has to their customers, as well as the expectations the customers have of their respective DNSPs following the customer engagement processes undertaken under the NER.

Ergon Energy believes that the NER permits (indeed it requires) the AER to be satisfied not only that its total expenditure forecasts are efficient, but that they reasonably reflect the cost inputs required by Ergon Energy to achieve the expenditure objectives. The cost inputs in question are those facing Ergon Energy, not a hypothetical service provider operating in another part of the world. The 2012 rule amendments referred to by the AER in its Draft Decisions for NSW and the ACT (*removing the words 'in the circumstances of the service provider'*)⁵ related to the prudence criterion only. Clauses 6.5.6(c)(3) and 6.5.7(c)(3) of the NER remained untouched.

The proper application of the expenditure criteria was illustrated by the Australian Competition Tribunal (the Tribunal) in *Re Ergon Energy Corporation Limited (Labour Cost Escalators) (No 3)* [2010] ACompT 11, where the Tribunal found that the labour cost escalators to be applied in making Ergon Energy's current distribution determination were to be based on:

- (a) Ergon Energy's actual enterprise agreement for the first year of the current period (in which that agreement was in force), and
- (b) the AER's assessment of efficient labour costs in the remaining years (in which the agreement will have expired).

At paragraphs [56]-[57] of this decision, the Tribunal stated:

[56] ...The Rules also require that the AER must accept a forecast if it is satisfied that the forecast reasonably reflects the opex criteria. However, that requirement does not rule out the need for the AER to consider the forecasts that may be presented as alternatives reasonably reflecting the opex criteria as well as the methods by which those alternatives are arrived at. Indeed, if the requirement were to rule out this consideration on the part of the AER it would deny the AER's argument that the 'transitional' risk issue it identified allowed it to weigh the importance of a DNSP's efficient costs against a realistic expectation of its cost inputs.

[57] There is substance to the concerns underpinning the AER's submission that to automatically allow a labour cost increment negotiated under an agreement that transits

⁵ Id, pp7-54.

two regulatory periods creates an unacceptable risk of undermining the incentives to promote economic efficiency in future negotiations for such an agreement. The concerns are not, however, sufficient to conversely and automatically reject a labour cost increment so derived. Indeed, the gravamen of Ergon Energy's complaint, namely, that the AER had failed to satisfy itself in terms of cl 6.5.6(c) by investigating whether the circumstances in which the UCA [Union Collective Agreement] had been negotiated resulted in efficient costs, costs that a prudent operator in Ergon Energy's circumstance would require and costs which founded a realistic expectation of the cost inputs required to achieve the opex objectives, is well founded. The AER's reliance on the forecasts of its consultant, Access Economics, to arrive at its real escalator for the first year of the regulatory period, is no substitute for such an investigation."

Ergon Energy notes that, as in 2010, the approach implied by the AER's Draft Decisions for NSW and the ACT appears to involve no consideration of whether Ergon Energy's labour costs under our current enterprise agreements were negotiated in circumstances that indicate these costs are efficient. Rather, the AER, once again, appears to take an approach which rejects the efficiency of such costs by reference only to its own benchmarking.

Of equal importance, these are cost inputs that are, in the short term at least, fixed. Whatever the AER may consider to be an 'efficient' level of expenditure, however determined the AER may be to impose incentives to further improve efficiency, the fact is that the cost inputs required by Ergon Energy to achieve the expenditure objectives in clauses 6.5.6(b) and 6.5.7(b) of the NER will not change overnight.

While the AER can, under the NER, have regard to the need for incentives to promote efficiency, in deciding whether it is satisfied of the criterion in clause 6.5.6(c)(3) and 6.5.7(c)(3) it must assess *what is realistic*.

While the AER may consider that its assessment of efficient labour costs, and its desire to create incentives to promote efficiency, justify its decision to drive Ergon Energy towards lower costs over the regulatory control period, a realistic assessment of Ergon Energy's labour costs (being one of our major cost inputs) must start from the recognition that, in the transition from one regulatory control period to the next, these costs will not change in the immediate short term. The same is true for most of Ergon Energy's cost inputs.

In deciding whether it is satisfied the Ergon Energy's expenditure allowances satisfy *each* of the expenditure criteria, the AER must consider the use of a transition path in order to ensure that Ergon Energy's forecast expenditure reasonably reflects both prudent and efficient costs, *as well as* a realistic expectation of our cost inputs, over the regulatory control period.

If the AER refuses to incorporate a transition path into its approved expenditure allowances it can, and Ergon Energy submits it must, consider whether to create a transition path through the X factors approved under clause 6.5.9 of the NER.

Even if it is accepted (for the sake of argument) that the capital or operating expenditure building block cannot exceed a sum which, in the AER's view, satisfies the relevant expenditure criteria, the NER do not require that this expenditure be recovered in the year in which it is forecast to occur. As the AER itself has noted, it must approve an estimate of the *total* capital or operating expenditure required for the regulatory control period. The recovery of these costs in each year of the regulatory control period can be adjusted through the X factor. For example, a smaller reduction in operating expenditure in year one of the regulatory control period can be offset by a correspondingly greater reduction in operating expenditure in another year.

It is noteworthy in this context that clause 6.5.9(b)(2) of the NER (which would normally require the AER to minimise the variance between expected revenue and the Annual Revenue Requirement for the last year of the regulatory control period) does not apply to the AER in making this determination for Ergon Energy.⁶

Ergon Energy also submits that a transition path of this type, if it is to contribute to the achievement of the National Electricity Objective, must be incorporated into the first of the two determinations to be made for Ergon Energy in 2015 (i.e. the Preliminary Determination). If the AER simply takes this issue on board for consideration in making its second determination later in the year, a full P₀ adjustment will be required in 2015–16, resulting in the immediate and irreversible outcomes referred to above.

A transition path of this type would not, by itself, overcome the serious consequences that would follow from reductions in the total expenditure forecasts implied by the NSW and ACT Draft Decisions. It would, however, provide a more realistic timeframe in which Ergon Energy could introduce the changes needed to achieve the efficiency improvements and likely cuts in programmes and services triggered by the AER, without providing for the recovery of capital and operating expenditure costs in excess of the total forecasts which, in the AER's opinion, satisfy the relevant expenditure criteria.

Concerns regarding safety impacts and use of risk assessments and cost-benefit analysis

Ergon Energy notes that in light of the very substantial cuts to expenditure proposed by the AER the NSW and ACT DNSPs have raised many concerns over the approach the AER has taken to examining expenditure driven by the need to meet safety requirements and the approach taken by the NSW and ACT DNSPs to assess their various operational and other risks in developing their forecasts.

For example, in relation to Ausgrid, the AER stated:

⁶ NER, clause 11.60.3(b)(1).

“In the course of our review of Ausgrid's proposal we have determined that Ausgrid's risk management practices are overly risk averse and result in higher capex forecasts than necessary. This view is supported by the independent review conducted by our consultants, EMCa. We consider that Ausgrid undertakes expenditure to avoid risks even when the cost benefit is not justified. This impacts all aspects of its proposal and as a consequence its revenue requirement and prices.”⁷

The AER relied on statements by its consultants which were critical of Ausgrid, in part, because the consultants believed that Ausgrid's forecasts were not supported by robust cost-benefit analysis.⁸

Ergon Energy also has concerns about the AER's reliance on such views, and the potential impacts on safety for our network and the community, especially in so far as they relate to forecast expenditure that is driven by the need to comply with a firm's duties to maintain the safety of its network.

Ergon Energy is committed to delivering efficient service that balances safety, value and productivity and meeting the high standard placed upon it under safety legislation in Queensland.

Ergon Energy's expenditure on safety represents prudent steps to ensure it meets its obligations under the various statutory regimes to employees, customers and members of the public, which is particularly challenging given the size of its network.

Ergon Energy is subject to duties under Queensland legislation (chiefly the *Electrical Safety Act* and *Work Health and Safety Act*) to ensure that our network is electrically safe and to eliminate or minimise risks to health and safety where it is reasonably practicable to do so. We have discussed these obligations in detail in our Regulatory Proposal (refer to 06.01.05 – *Meeting the Rules Requirements*).

While compliance with these obligations necessarily requires Ergon Energy to undertake risk assessments to identify and prioritise threats to health and safety, and to address such risks as efficiently as possible, works that are undertaken to address risks to health and safety are, as a general rule, not capable of being fully justified by reference to a cost-benefit analysis. This is because the chief 'benefits' of such expenditure are, typically, the avoidance of death and serious injury. Attempts to quantify such benefits and weigh them against the costs of corrective action:

- (a) are viewed as having questionable value in decision making, and
- (b) expose a firm to extremely serious consequences under relevant laws if it decides against preventative action on the basis that the cost of addressing such a risk would exceed the 'benefit' of avoiding death or serious injury.

⁷ Ausgrid Draft Decision, Overview, pp26-27.

⁸ Ausgrid Draft Decision, Attachment 6 (Capital expenditure), pp 6-35 to 6-36, 6-42, 6-61 to 6-63.

In relation to the first of these points, the European Agency for Safety and Health at Work (an agency of the European Union) published a report in 2014 entitled *The business case for safety and health at work: Cost-benefit analyses of interventions in small and medium-sized enterprises*. At pages 17 and 18 of this report, the agency questioned the model for making decisions on health and safety expenditure that is based on the minimisation of the total cost of preventative activities and of safety incidents, stating:

“...calculations of this kind rely on oversimplified assumptions (ROWER, 2010). Risks involve too much variability and complexity to allow enterprises to be ranged on a one-dimensional safety scale. Moreover, even if a safety level can be defined, it cannot be seen as a function of preventive expenditure alone. Moreover, different OSH measures have different degrees of efficiency, which does not allow for a univocal relationship between a (hypothetical) ‘level of prevention’ and expenditure on prevention; the correspondence of an OSH level (S) to every level of OSH expenditure is simply impossible.

In general, it has been widely discussed (Owen, 1996; Miller, Whynes and Reid 2000; Miller, Rossiter and Nuttall, 2002; Mossink and Nelson 2002) that it is not easy to show a causal and quantifiable relationship between interventions and actual improvement in OSH, and in fact this might not even be necessary for an SME.”

While this report was focused on small and medium sized enterprises in particular, these propositions apply equally to a larger enterprise such as Ergon Energy.

More importantly, an approach to decision making which proceeds by reference to cost-benefit analysis would leave a firm exposed to a serious risk of prosecution in the event of a safety incident.

It is inconceivable that a prudent firm, operating under the workplace health and safety laws applying in Queensland in 2014, would decide against taking action to eliminate a safety risk on the basis that its cost would exceed the value placed by the firm on the life that would be saved by that action. It is highly unlikely that a company or its directors and officers could successfully defend itself against a prosecution for a contravention of the *Electrical Safety Act* and *Work Health and Safety Act* on the basis of such an assessment, or avoid the potential fines and potential criminal sanctions (including imprisonment) arising from such a contravention.

The appropriateness of using cost-benefit analysis in making decisions relating to safety was considered in the review of Victoria's workplace health and safety laws undertaken by

Chris Maxwell QC (as he then was) in 2004.⁹ The Maxwell Report described the 'orthodox' approach to cost and risk prevention in the following terms: "*Cost must be considered in relation to the level of risk, as determined by likelihood, exposure and severity*". Put another way, "*is the expenditure justified by reference to the degree of risk to be prevented?*". The report described the unstated premise as being that the required expenditure should be (no more than) that which is proportionate to the risk.¹⁰

However, the Report goes on to state:

"[532] It is often argued that to balance risk and cost in this way is simply inappropriate, because it does not involve a comparison of like with like. In essence, the argument is that:

"the risk is borne by the worker, while the cost is borne through the employer and through the cost structure by the employer's clientele (and ultimately the community at large). In other words, the scales are false."

[533] There is, in my view, considerable force in this argument. The so-called cost/risk balance is simply a form of cost-benefit analysis. It inevitably involves quantifying in dollar terms the benefit of preventing an injury or a death. The very notion that the value of a person's life can be weighed in the scales at a particular dollar value is a disquieting one."

The Maxwell Report recommended that Victoria's legislation be amended to include a test of "gross disproportion". That is, once the severity and likelihood of the risk have been assessed, the relevant safety measure should be implemented unless the cost of doing so would be grossly disproportionate to the risk as assessed.¹¹ The Report stated:

"[565] ... this clarification should greatly simplify the task of inspectors and dutyholders. It would henceforth be clear that cost should not be an obstacle to risk prevention unless there is such a manifest disproportionality between the cost of a preventive measure and the benefit (in risk prevention) that it would be clearly unreasonable to expect the measure to be implemented.

⁹ Maxwell, C. (2004), *Occupational Health and Safety Act Review (the "Maxwell Report")*, March 2004, <http://www.dtf.vic.gov.au/Publications/About-publications/Occupational-health-and-safety-legislation-review-report>.

¹⁰ Maxwell Report, paragraph 524-525.

¹¹ Id, paragraph 563.

[566] By promoting a “transparent bias” in favour of safety, the “gross disproportion” test would reinforce a precautionary approach. It would establish a presumption in favour of safety. That is, the test would require the requisite preventive measure to be taken unless there was a stark imbalance between the cost and the risk.”

The 'grossly disproportionate' standard has been incorporated into the national framework for work health and safety¹² (but not, it is worth noting, into Victoria's legislation).

Safe Work Australia has published an interpretative guideline on what is 'reasonably practicable',¹³ which states (at page 5):

“Cheaper, available and suitable options may be used instead of a costlier option that may further minimise the risk or severity of harm, where the cost of the costlier option is grossly disproportionate to the risk. This will only apply where the cost is high and the likelihood or degree of harm is low (e.g. a slight chance of minor cuts or strains and the cost of replacing plant would be very high).

Choosing a low-cost option that provides less protection simply because it is cheaper is unlikely to be considered a reasonably practicable means of eliminating or minimising risk.

If the degree of harm is significant (e.g. death or serious injury is at least moderately likely) then it is unlikely that the cost of implementing available and suitable safety measures to eliminate or minimise the risk would ever be so disproportionate to the risk to justify a decision not to do so.”

Clearly, in addressing risks to safety, consideration of the costs of preventative action, as well as the nature and magnitude of the risk, is a relevant consideration. However, in complying with safety laws operating in Queensland, the role of cost-benefit analysis is not to determine whether the benefits of proposed expenditure will outweigh the costs, but rather whether that cost is *grossly disproportionate* to the risk in question.

A finding by the AER, which discounted forecast expenditure necessitated by safety considerations on the basis that it was unsupported by a cost-benefit analysis, would be a

¹² *Work Health and Safety Act 2011 (Qld)*, section 18.

¹³ Safe Work Australia (2011), *Interpretive Guideline – Model Work Health and Safety Act: The Meaning of 'Reasonably Practicable'*, September 2011.

flawed finding, based on an incorrect understanding of the obligations created by safety legislation in Queensland.

Only if there is reason to believe that forecast expenditure would be grossly disproportionate to the risk involved would the absence of a cost-benefit analysis be a material consideration in determining that the expenditure was not prudent or efficient.

Rate of Return

The issue of the rate of return was mentioned in presentations by the CCP and raised in general discussion among stakeholders. Most stakeholders, including Ergon Energy, recommend a departure from the AER's Rate of Return Guideline, but for different reasons.

CCP members advocated their own preference to determining the appropriate rate of return which represents an outcome that is lower than if the Guideline was applied. The CCP noted that the rate of return contributes to excessive "pecuniary benefits" which appear to include costs incurred by Ergon Energy and paid to the Queensland Government (taxes and financing costs). The CCP presentations also made comparisons to regulatory arrangements in the United Kingdom to support their assertion that rates of return were too high.

Analysis supporting the CCP presentations was not provided. However, as part of our consultation process, our customers asked for further information in respect of the rate of return, which included some of the issues raised by the CCP.

In response to customer requests, Ergon Energy engaged Synergies to analyse the issues and concerns raised and provide a response. The Synergies report is attached to our Regulatory Proposal and is available on our website.¹⁴

We hope the AER will take the factors mentioned above into consideration during its assessment process of all regulatory proposals currently under review by the AER.

We also trust that the AER will engage further with all DNSPs on the concerns that have been raised in its Annual Benchmarking Report given the delays in its release and the lack of opportunity provided to DNSPs to meaningfully review this material prior to its release.

If you would like to discuss this submission, please contact Graeme Finlayson, General Manager AER on (07) 4432 8669 or 0418-763-602.

Yours sincerely



Ian McLeod
CHIEF EXECUTIVE

¹⁴ https://www.ergon.com.au/data/assets/pdf_file/0004/228415/Synergies-Response-to-Issues-Raised-by-the-CCP.pdf