QUEENSLAND resources COUNCIL

30 January 2015

Working together for a shared future

Mr Sebastian Roberts
General Manager, Network Regulation
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001
Via email (QLDelectricity2015@aer.gov.au)

Dear Mr Roberts

Ergon Energy Determination 2015-2020

Thank you for the opportunity to comment on Ergon Energy's regulatory proposal.
QRC welcomes the establishment of the Consumer Challenge Panel, as part of the Better Regulation reforms, and looks forward to their submission informing the regulatory process.

The Queensland Resources Council (QRC) is the peak representative body of the Queensland minerals and energy sector. The QRC's membership encompasses minerals and energy exploration, production, and processing companies, and associated service companies. The QRC works on behalf of members to ensure Queensland's resources are developed profitably and competitively, in a socially and environmentally sustainable way.

The operating environment for the resources sector in 2015 is quite different to the context in which the previous AER regulatory determination for Ergon Energy (Ergon) was set. Faced with a sustained price slump and persistent oversupply in many global commodity markets, Queensland's resource industry is focused on significantly reducing production costs to remain competitive and to stay in business. As you would know, electricity is a key input for the resource sector and efficient pricing is essential to maximizing economic benefit to Australia's economy. As part of this focus on cost abatement, QRC has participated extensively in the 2015-2020 determination process. Through our members we can provide a unique and valuable insight to the QRC as being representative of the customer segment that has the most in-depth interaction with Ergon. We can make a practical judgment of the efficiency with which Ergon's operates.

The QRC supports and endorses the AER statement in the '*State of the energy market 2014'* that energy customers "should pay no more than necessary for the safe and reliable delivery of electricity network services". QRC understands "no more than necessary" to mean an economically efficient cost based on economic fundamentals, rather than as Ergon appear to have done, relying on demonstrating relative savings against unvetted historical spending. Further, QRC supports the AER's approach to place greater emphasis on benchmarking network proposals. When establishing the efficient costs for Ergon's network services that will determine prices, the AER should not be distracted by what Ergon believes it can achieve. Customers should not pay for historical choices and performance that make today's performance sub-optimal.

ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T 07 3295 9560 F 07 3295 9570 E info@qrc.org.au
www.qrc.org.au

QRC members anticipate significant price reductions for electricity in the coming regulatory period based on the AER's approach in recent determinations in other states. For QRC members, electricity accounts for as much as 15 per cent of their input costs. Based on data provided by members, during the period 2006-2014 electricity costs rose 12 per cent annually, which contributed to the declining competitiveness of Queensland exporters competing globally.

Our submission seeks to address four key areas of Ergon's proposal for your consideration;

1. Consider Ergon's actual level of risk and operating environment;
2. Scrutinise Ergon's operational expenditure
3. Revisit Ergon's demand forecasting
4. Reliability is important, but must be delivered efficiently.

Unlike QRC member companies, Ergon Energy enjoys the security of a regulated return within a monopolistic operating environment delivering consistently high profits throughout the recent economic downturn. The 2013/14 Stakeholder Report cited a $403 million profit after tax, allowing for an above budget dividend of $392 million paid to the Queensland Government. This equates to 11.2% return on average equity for the Government. Given this insulated operating environment, the QRC is skeptical that Ergon's proposed rate of return is realistic and would encourage the AER to take the local views of the Queensland Competition Authority into consideration when determining the rate.

A key concern for the QRC in responding to Ergon's proposal is the concept of prudency and efficiency. We note the ability of many Network Service Providers (including Ergon) to defer previously approved expenditure (including replacement CAPEX) when pressured by shareholders. Expenditure should be approved when essential, not simply when it can be justified. And the expectations of efficiency, the per-unit costs, particularly in the present economic circumstances should be high. Using the 2010-15 period as a baseline to estimate the prudent level of expenditure for the next period is not necessarily a reflection of efficient expenditure. Our submission includes a number of examples given by QRC members to demonstrate the inefficiencies of the Ergon businesses.

As a significant portion of Queensland's total electricity demand and a small user of the total distribution network, the demand forecast for the resources sector is important in considering the implications for Ergon's network in the period 2015-2020. While the previous period was characterised by an urgency for new connections to new operations, QRC foresees a limited demand increase from new entrants over the next five years. The forecast demand increase from the LNG projects and proposed Galilee coal projects are expected to connect to Powerlink and have minimal impact on the Ergon network. Until global commodity markets begin to recover we would expect to see a continuation of high volumes from existing operations with the aim of minimising the marginal cost per unit. The use of contingent projects to minimise Ergon's expenditure to until absolutely necessary is important.

The sector wide focus on increasing production volumes places great importance on the reliability of the network. It is important for the AER to distinguish between the tolerances for residential customers to an increase in network disruptions in comparison to the consequences for businesses. QRC members will always give serious consideration to any proposal to invest in better services – improved reliability and quality of power – but any such proposal needs be considered in the context of efficient and appropriate investment against a background of a history of overinvestment and the resulting capacity overhang. .

QRC welcomes ongoing engagement with the AER on any of the issues raised in this submission and would be happy to host detailed discussions with QRC members. For any further information please feel free to contact QRC's Andrew Barger, (07) 3316 2502 or andrewb@qrc.org.au

Yours sincerely

Michael Roche
Chief Executive

ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T 07 3295 9560 F 07 3295 9570 E info@qrc.org.au

www.qrc.org.au

QRC
submission

Working together for a shared future

Ergon Energy determination 2015-2020

January 2015

ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T 07 3295 9560 F 07 3295 9570 E info@qrc.org.au

www.qrc.org.au

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EXECUTIVE SUMMARY

The operating environment for the resources sector in 2015 is significantly different to the context in which the previous AER regulatory determination for Ergon Energy (Ergon) was set. Faced with a sustained price slump and persistent oversupply in many global commodity markets, Queensland's resource industry is focused on significantly reducing production costs to remain globally competitive and to stay in business. In contrast with Ergon's escalating cost structures, Queensland's resource companies who are QRC members have reduced their costs by between a fifth and a third over the past few years.

Our submission seeks to address four key areas of Ergon's proposal for the AER's consideration: the level of risk and operating environment (including rate of return and regulatory asset base); the efficiency and prudent approach to operational expenditure; demand growth attributed to the resources sector and other large users; and why reliability is critical, but must be delivered efficiently.

QRC estimates that the Queensland resources sector consumes approximately 22% of the state's energy with aluminum and zinc smelters consuming approximately 15%. Electricity is a significant input cost, accounting for up to 4-5% of a typical mining operation's total costs and up to 50% for a smelter[1]. As part of that electricity price, network costs in Queensland have risen much more quickly than has been the case in other jurisdictions. The rapid growth in the regulated asset base of network service providers has driven much of this cost increase. QRC members are not confident that these investments reflect appropriate and efficient use of capital.

Ergon enjoys the security of a regulated return within a monopolistic operating environment delivering consistently high profits throughout the recent economic downturn. Given this insulated operating environment, the QRC is skeptical that Ergon's proposed rate of return is realistic and would encourage the AER to take the local views of the Queensland Competition Authority into consideration when determining the final allowable rate of return.

The QRC endorses the AER's statement in the '*State of the energy market 2014'* that energy customers "should pay no more than necessary for the safe and reliable delivery of electricity network services[2]". QRC understands "no more than necessary" to mean an economically efficient cost, based on economic fundamentals, rather than as Ergon appear to have done, relying on demonstrating relative savings against un-vetted historical spending.

Further, QRC supports the AER's approach to place greater emphasis on benchmarking network proposals. When establishing the efficient costs for Ergon's network services that will determine network prices, the AER should not be distracted by what Ergon believes it can achieve; efficiency is not easy to attain. Customers should not pay for historical choices and performance that may make today's performance sub-optimal.

QRC members anticipate significant network price reductions in the coming regulatory period based on the AER's approach in recent determinations in other states. For QRC members, electricity accounts for a significant portion of their costs, and network charges are a substantial and growing share of that delivered cost of electricity. Based on data provided by members, during the period 2006-2014

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1 QRC's submission to the Queensland Government's 30 year electricity strategy, page 3 https://www.dews.qld.gov.au/__data/assets/pdf_file/0013/135202/queensland-resources-council.pdf

2 https://www.aer.gov.au/sites/default/files/State%20of%20the%20energy%20market%202014%20-%20Complete%20report%20%28A4%29_0.pdf (page 68)

average electricity costs rose 12 per cent annually (including distribution use of system (DUOS) and transmission use of system (TUOS)), which contributed to the declining global competitiveness of Queensland exporters.

Electricity is a key input for the resource sector and efficient pricing is essential to maximising the benefit to Australia's economy from the nation's largest export sector. As part of this drive for cost abatement, QRC has participated extensively in the 2015-2020 determination process. Through our members we can provide a unique and valuable insight to a large portion of the customer segment that has the most in-depth interaction with Ergon. We can make a practical judgment of the efficiency with which Ergon operates.

The practical experience of QRC members is that Ergon, on balance, is not an efficient operation and has not undertaken the sort of highly effective cost reduction and efficiency measures that many firms in competitive markets have been forced to implement. In the absence of a competitive market for Ergon's services, we look to the AER's regulatory decisions to apply this pressure.

In summary, in assessing Ergon's proposal, the QRC recommends that the AER considers:

1. the rigorous use of benchmarking to compare Ergon's *actual* costs with the costs of an *efficient* optimised network and not simply the historical performance of Ergon;

2. the views of the local regulator (the Queensland Competition Authority) when determining Ergon's weighted average cost of capital (WACC);

3. requesting that Ergon justify each departure from the AER's rate of return guideline;

4. revising Ergon's demand forecasts given the actual decline in demand, a history of over estimating demand and the network's low asset utilisation;

5. not permitting Ergon to increased their regulated asset base (RAB) and requiring that Ergon only invest in augmentation when it is absolutely necessary using a contingent project approach; and

6. the much higher opportunity costs of poor quality energy supply for Ergon's resource customers. While network reliability is important to the resources sector, Ergon must be able to demonstrate that it is delivered efficiently.

QRC welcomes ongoing engagement with the AER on any of the issues raised in this submission and would be happy to host detailed discussions with QRC members.

INTRODUCTION

About QRC

The Queensland Resources Council (QRC) is the peak representative body for the commercial developers of Queensland's minerals and energy resources.

With voluntary membership of more than 320 businesses with interests in the sustainable development of minerals and energy resources in Queensland, the QRC enjoys 100 percent support of the state's coal producers, over 90 percent of metals production, the four major developers of Queensland's export CSG/LNG industry and a large group of minerals and energy explorers.

The QRC has a membership base now responsible for more than 442,000 direct and indirect jobs through $37.5 billion in wages and salaries and local purchases of goods and services from 17,000 Queensland businesses. The resources sector is calculated as responsible directly and indirectly for one in every four dollars of the Queensland economy and one in every five jobs.[3]

The minerals and energy sector continues to play a fundamental role in shaping Queensland's regional future by contributing to economic growth, creating high-paying jobs, and supporting research and development, regional infrastructure, new services and investment. The Queensland resources sector will play a crucial role in the sustainability and growth of Ergon's businesses.

Network costs in context

QRC notes that the Queensland Government established an independent review panel (IRP) in 2012 to review network costs[4]. This panel, chaired by Mr Tony Bellas, followed on the heels of an earlier independent panel commissioned in 2011. The 2011 independent review, chaired by Mr Darryl Somerville, essentially revisited the progress against the findings of the 2004 Electricity Distribution and Service Delivery (EDSD) Review, which was also chaired by Mr Somerville.

The 2011 Somerville review concluded that significant capital savings could be achieved by Energex and Ergon, and achieved without affecting the reliability and robustness of Queensland's electricity distribution network[5]. In confirming these findings of the earlier review, the 2013 Bellas review sought to quantify these savings in concluding, inter alia, that:

- → network costs account for more than 50 per cent of residential bills (network costs are a similarly significant component of the resource sector's industrial-scale use of electricity);
- → network costs have grown by more than 100 per cent from 2007–08 to 2012–13; and
- → the underlying regulatory framework has not provided the right incentives for efficient capital expenditure.

The Bellas (IRP) Review estimated that there were up to $5 billion in savings available by 2020 in nominal terms, including:

- → reductions in total expenditure across the network businesses of approximately $3.6 billion when compared with the current five-year regulatory expenditure programs approved by the Australian Energy Regulator (AER);

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3 QRC/Lawrence Consulting analysis at www.qrc.org.au/economiccontribution
4 http://statements.qld.gov.au/Statement/Id/79388
5 https://www.business.qld.gov.au/industry/energy/electricity-industry/electricity-queensland/review-electricity-distributors

- → savings of $1.4 billion in indirect costs alone in the distribution network businesses over the five years from the end of the current regulatory period (i.e. 2005–2015); and
- → that the network operations were inefficient in comparison with interstate peers and that every 1% gain in labour productivity would translate into $4 million pa in savings.

Despite all this public scrutiny of network costs, Ergon appears to have benchmarked its next regulatory proposals against their past performance rather than the recommendations of the 2013 Bellas (IRP) Report or the 2011 Somerville review. QRC suggests that the AER needs to test Ergon's blithe assumption that past investments were inherently efficient, appropriate and necessary.

The 2013 Bellas report found that Ergon's 2014-15 capital expenditure (capex) could be pruned back by around 35% while operating expenditure (opex) could be reduced by around a fifth. By contrast, Ergon have proposed a $52 m reduction in capex for 2015-16 as compared with this financial year (a saving of 6.3%) and an increase of $200,000 in opex (an increase of 0.0057%) over the same period[6].

QRC acknowledges that Ergon have sought to deliver reduced total network charges during the regulatory period. Ergon's "quick guide" cites expenditure savings of 22% on the 2010-2015 regulatory period with a goal of a further 11% in the 2015-2020 period[7]. These cost savings are acknowledged as important achievements; however QRC remains concerned that Ergon continues to encourage comparison of their costs with inflation. The comparison with the consumer price index is misleading - the real benchmark should be to compare Ergon's *actual* costs with the costs of an *efficient* optimised network.

The practical experience of QRC members is that Ergon, on balance, is not an efficient operation and has not undertaken the sort of highly effective cost reduction and efficiency measures that many firms in competitive markets have been forced to implement. In the absence of a competitive market for Ergon's services, we look to the AER's regulatory decisions to apply this pressure.

While QRC acknowledges that Ergon is an atypical network in the context of the national electricity market – a large dispersed network with a much lower density of energy use and exposed to a much greater degree of climatic extremes than other network service providers – QRC echoes the concern of the consumer competition panel (CCP) that Ergon's regulatory proposal has strayed from the AER's guidelines and that these departures have not been justified. The AER's preliminary benchmarking suggests that Ergon's performance is significantly less efficient that its network peers.

It is difficult not to discern a degree of ambit in how Ergon's claims exceed the AER's guidelines without a cogent argument to explain this departure. QRC would encourage Ergon to embrace the AER's new (and entirely laudable) focus on benchmarking performance. Ergon's arguments for higher returns should be dismissed until they can be justified by detailed benchmarking that demonstrates to the satisfaction of their consumers that Ergon's performance is both appropriate and efficient.

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6 Based on slide 20 of Ergon's presentation on 9 December 2014 to the public forum.

7 "*A quick guide to our plans: Regional Queensland's future electricity service*", Ergon Energy, page 4

1. Consider Ergon's actual level of risk and cosseted operating environment

1.1 Return on capital

Unlike resource companies, Ergon enjoys the security of a regulated return within a monopolistic operating environment which has delivered consistent profits on a growing asset base throughout the recent economic downturn. Ergon's 2013-14 Stakeholder Report[8] cited a $403 million profit after tax, allowing for a dividend of $392 million (more than was budgeted) to be paid to the Queensland Government. This equates to 11.2% return on equity for the Government. In addition, Ergon absorbed a further $99 million in network costs from Cyclones Yasi and Oswald. While Ergon are to be commended for their community spirit, these funds would otherwise have been realised as an even higher profit.

Given this cosseted operating environment, the QRC is skeptical that Ergon's proposed rate of return of 8.02% is realistic and encourages the AER to take the local views of the Queensland Competition Authority into consideration when determining the rate[9]. Further, the QRC is interested in the explanation for why Ergon have departed from the published AER rate of return guideline (December 2013). From a customer's perspective even a marginal reduction in Ergon's rate of return will have profound effects on delivering real price decreases for electricity users over the five year regulatory period.

As was seen in the New South Wales draft determinations, QRC hopes for a substantial decrease in the rate of return to more accurately reflect Ergon's current operating environment, including historically low interest rates. In our view the rate of return set by the AER should be the minimum required to enable Ergon to procure sufficient capital. Our members believe a business like Ergon can procure capital very cheaply in today's economic environment where secure regulated investments are scarce.

1.2 Capital expenditure

Gross capital expenditure by Ergon in 2015-16 is forecast to exceed the 2014-15 capital expenditure. QRC questions the increase in non-system capital expenditure from approximately $123 million in 2014-15 to $178 million in 2015-16 as shown in Table 1 and 2 below. The reasoning for this increase is not clearly explained in the Ergon submission.

Further, the increase in customer connection initiated capital works throughout the forecast period (particularly high from 2016-17 onwards, Table 2) is also a concern for QRC given the potentially limited new connections anticipated for large users given the current economic environment. The AER should be concerned that Ergon's demand forecasts appear far too bullish to those industrial customers who Ergon expects to be the source of demand growth in the regulatory period.

QRC suggests that consideration should be given to forecast declining industrial demand and residential demand (with the take up of solar PV), and revisions of forecast LNG demand would be prudent, as historical forecasts have not been realised.

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8 https://www.ergon.com.au/__data/assets/pdf_file/0007/218806/2014-Ergon-Energy-Annual-Stakeholder-Report.pdf

9 See for example http://www.qca.org.au/getattachment/a61eda28-464f-4bdc-b99a-df55a0593e9a/WACC-Paper.aspx or http://www.qca.org.au/Rail/Aurizon/Intro-to-Aurizon/2013-Draft-Access-Undertaking/Ti/In-Progress/Cost-of-Capital or https://www.treasury.qld.gov.au/publications-resources/services/government-owned-businesses/documents/cost-of-capital-principles-paper.pdf

Table 1: Ergon Energy capital expenditure 2010-15

$'000 (real 2014-15)	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Asset Renewal	228,371	266,667	289,671	229,834	240,719	1,255,262
Corporation Initiated Augmentation	148,225	175,096	152,173	165,888	167,497	808,880
Customer Connection Initiated Capital Works	204,234	197,787	209,593	207,267	227,004	1,045,886
Reliability and Quality of Supply	22,327	28,275	24,577	32,868	51,487	159,534
Other System	84,657	56,464	37,934	35,932	44,054	259,042
Non-System	156,394	149,502	135,604	95,124	123,107	659,731
Gross capital expenditure	**844,208**	**873,792**	**849,552**	**766,914**	**853,868**	**4,188,335**
less Alternative Control Services customer contributions	*0*	*(2,248)*	*(8,914)*	*(27,729)*	*(31,950)*	*(70,841)*
Standard Control Services gross capital expenditure	**844,208**	**871,544**	**840,638**	**739,186**	**821,918**	**4,117,494**
less Standard Control Services customer contributions	*(75,854)*	*(59,023)*	*(71,117)*	*(61,340)*	*(86,220)*	*(353,553)*
Standard Control Services net capital expenditure	**768,354**	**812,521**	**769,521**	**677,845**	**735,698**	**3,763,940**

Table 2: Ergon Energy proposed capex, 2015-2020

$'000 (real 2014-15)	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Asset Renewal	255,606	286,325	255,677	282,134	278,322	1,358,064
Corporation Initiated Augmentation	171,365	173,956	177,551	132,239	135,381	790,490
Customer Connection Initiated Capital Works	219,082	225,999	239,416	249,149	255,290	1,188,935
Reliability and Quality of Supply	3,361	3,400	3,527	3,603	3,638	17,528
Other System	42,070	31,050	20,613	29,432	25,708	148,872
Non-System	177,552	136,598	105,625	97,698	85,869	603,341
Gross capital expenditure	**869,035**	**857,326**	**802,408**	**794,254**	**784,208**	**4,107,231**
less Alternative Control Services customer contributions	*(99,420)*	*(103,750)*	*(111,130)*	*(116,850)*	*(120,790)*	*(551,940)*
Standard Control Services gross capital expenditure	**769,615**	**753,576**	**691,278**	**677,404**	**663,418**	**3,555,291**
less Standard Control Services customer contributions	*(29,750)*	*(30,390)*	*(31,860)*	*(32,860)*	*(33,400)*	*(158,260)*
Standard Control Services net capital expenditure	**739,865**	**723,186**	**659,418**	**644,544**	**630,018**	**3,397,031**

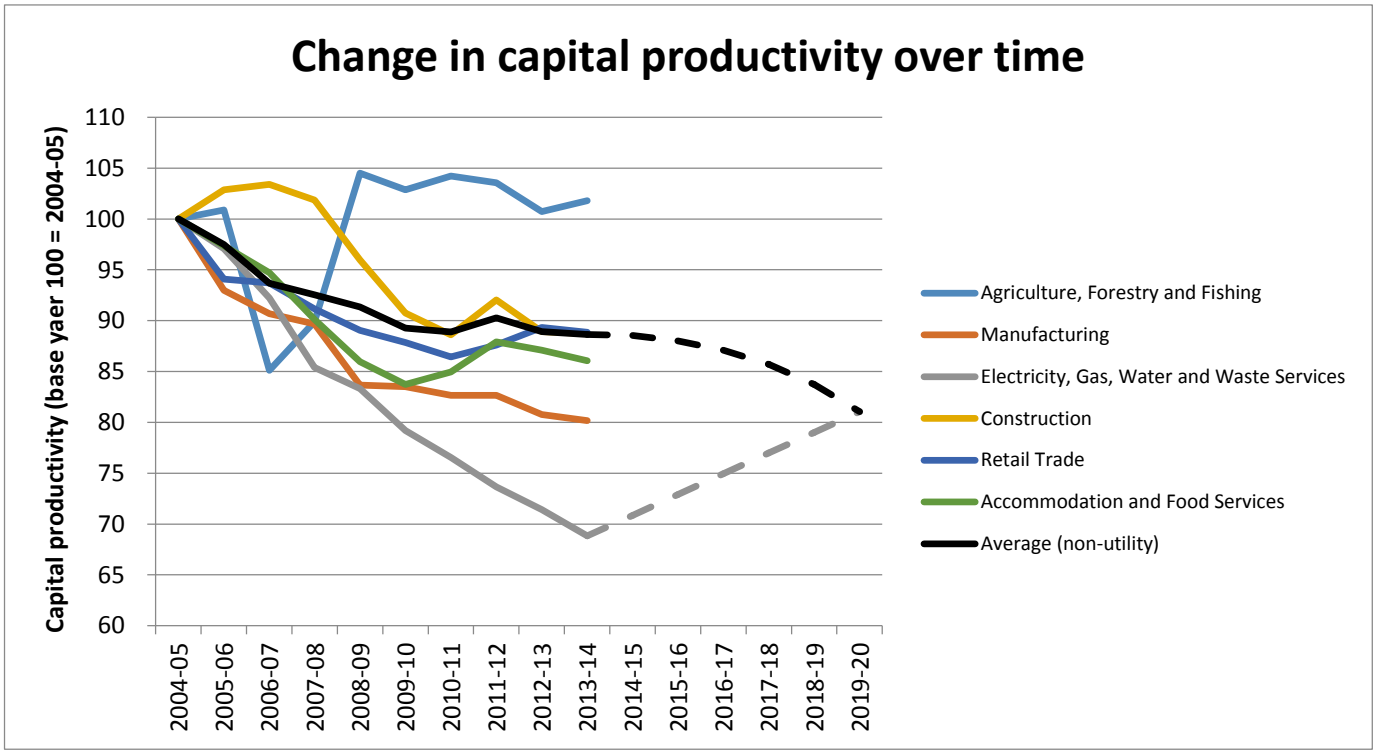
Source: Ergon Energy Regulatory Proposal

In addition, QRC suggests that Ergon's increasing ability to progress Customer Initiated Capital Works under Alternative Control Services (ACS) as opposed to Standard Control Services (SCS) is significant in determining their efficient capital expenditure[10].

Ergon's capex less Alternative Control Services (ACS) forecast and less Standard Control Services (SCS) customer contributions are still significant, and should be revised down. $3.76 billion from 2010-2015 compared to $3.4 billion for 2016-2020 is not a notable reduction (Table 1 and 2 above). Nor does it match the experience of QRC members who see an increasing ability for Ergon to apply ACS or customer contributed SCS and the offers to connect received from Ergon by QRC members during the current regulatory period clearly showed that the majority of connection related costs were ACS.

QRC has benefitted from participating in an Alliance of Electricity Consumers, which was organised by SAS Consulting. The 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, suggests that the electricity sector has not invested efficiently.

Chart 1: Sectoral change in capital productivity since 2004/05



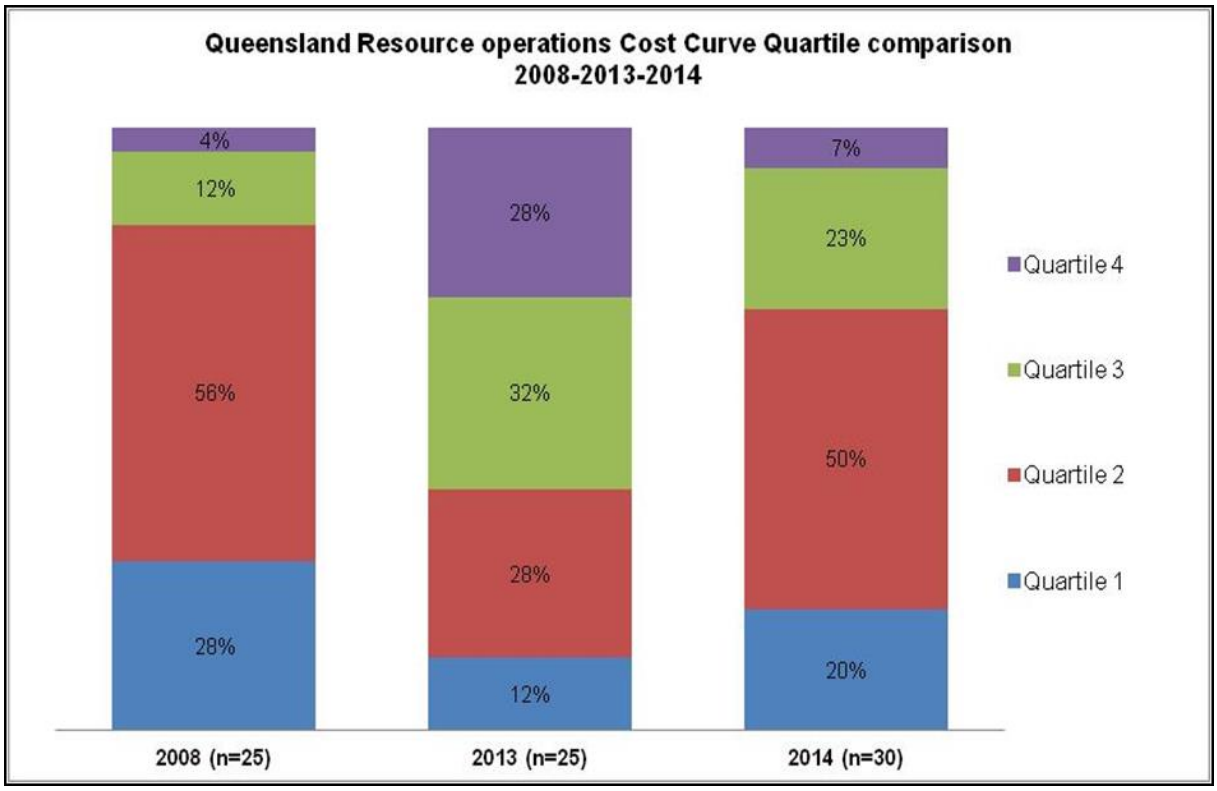
Source: Alliance of Electricity Consumers submission on Ergon Energy's regulatory proposal 2015-2020

[10] See Ergon Energy Regulatory Proposal Supporting Documentation Chapter 2 – Classification of Services and Control Mechanisms

The Alliance submission emphasises that all electricity consumers have paid for lower capital productivity through higher electricity prices.

As evidence of the resource sector's ability to invest more efficiently and rein in costs to regain global competitiveness, twelve months ago the QRC surveyed the CEO's of full members (across all sectors) to divulge cash operating cost curve information to ascertain where the same operations sat in the years 2008 and 2013 (see chart below). Of those surveyed in 2013, 19 companies responded with 25 operations in total. The exercise was repeated in March 2014, this time with 21 companies and 30 operations in total. These operations were a mix of mining, minerals processing, oil and gas production and 'other' activities.

Chart 2: Cost quartiles, Queensland resource operations since 2008



Source: QRC, 2014

In 2008, over 80 per cent of operations sat in the 1st and 2nd quartiles meaning only 20 per cent were exposed to higher risks in the upper 3rd and 4th quartiles. In 2013, following a sustained period of high prices and considerable competition for business inputs, the balance shifted and only 40 per cent of operations remained in the lower 1st and 2nd quartiles meaning the majority of producers were under serious competitive threat if they could not reduce their cost profiles. In 2014 30 per cent of those high risk operations had successfully reduced costs to fall back into quartiles 1 or 2 (total 70 per cent) reflecting comparable cost profiles to the 2008 results (refer Chart 1). These cost reductions have come in the main from considerable reductions in operating costs and productivity gains. It is understandable that the resource companies would expect key suppliers like Ergon to demonstrate a similar capacity for reform and cost reduction.

1.3 Regulatory asset base

QRC members also disagree with the incentive given to regulated entities to over-invest in assets that drives up their asset base and therefore delivers an even greater, risk-free return for Ergon and shareholders. Ergon's proposed asset base is forecast to continue to grow over the next regulatory period despite falling demand and low asset utilisation. Table 3 below shows a 28% increase from $10.1 billion asset base in 2014-15 to $12.9 billion asset base by 2019-20. This translates to an ongoing financial burden for the life of the asset to be paid for by energy users.

While the regulatory arrangements that govern the RAB for NSPs (including valuation) are outside the scope of the AER's revenue determination for Ergon, we believe the constant upward pressure on RAB and therefore prices is relevant to consideration of the reasonable revenue required by Ergon to operate its business. QRC members are conscious that most investments to increase the RAB are likely to stem from major industrial users and involve ACS. In this context, QRC suggests it is appropriate to reject Ergon's forecast to further augment their RAB. Rather QRC would urge Ergon to maintain their RAB and only to invest in augmentation as absolutely necessary. Ergon has avenues under the regulatory regime to make these investments, if and when, they are required (for example due to unforeseen circumstances).

Table 3: Ergon Energy's Regulatory Asset Base, 2010-15

$m (nominal)	2010-11 Actual	2011-12 Actual	2012-13 Actual	2013-14 Actual	2014-15 Estimate
Opening RAB	7,160.95	7,858.05	8,360.76	9,006.79	9,606.34
plus capital expenditure (net of disposals and capital contributions)	801.49	758.16	827.95	748.54	885.91
less regulatory depreciation	(104.39)	(255.46)	(181.92)	(148.99)	(186.67)
less difference between actual and forecast net capital expenditure in 2009-10, and the return on difference for the net capital expenditure in 2009-10	-	-	-	-	(209.75)
Closing RAB	**7,858.05**	**8,360.76**	**9,006.79**	**9,606.34**	**10,095.83**
less adjustments to recognise changes in service classifications that occur on 1 July 2015	-	-	-	-	(54.29)
Opening RAB 1 July 2015					**10,041.54**

Table 4: Ergon Energy's Forecast Regulatory Asset Base, 2015-2020

$m (nominal)	2015-16	2016-17	2017-18	2018-19	2019-20
Opening RAB	10,041.54	10,651.75	11,233.28	11,748.10	12,311.45
plus capital expenditure (net of disposals and capital contributions)	783.74	773.23	722.49	724.13	725.82
less regulatory depreciation	(173.53)	(191.70)	(207.66)	(160.77)	(170.28)
Closing RAB	**10,651.75**	**11,233.28**	**11,748.10**	**12,311.45**	**12,867.00**
Inflation rate	2.57%	2.57%	2.57%	2.57%	2.57%

Source: Ergon Energy Regulatory Proposal

2. Scrutinise Ergon's operational expenditure

2.1 Prudency and efficiency

A key concern for the QRC in responding to Ergon's proposal is the concept of prudency and efficiency. We note the ability of many Network Service Providers (including Ergon) to defer previously approved expenditure (including replacement CAPEX) when pressured by shareholders. Expenditure should be approved when essential, not simply when it can be justified. Further, the expectations of efficiency, the per-unit costs, particularly in the present economic circumstances should be high. Using the 2010-15 period as a baseline to estimate the prudent level of expenditure for the next period is not necessarily a reflection of efficient expenditure.

QRC members consistently report frustration with the operational efficiencies of Ergon. The following examples are provided by QRC members to demonstrate the inefficiencies of the Ergon businesses.

As an example of Ergon's complex levels of accountability, one company reported a network failure and the request was passed through multiple operational teams until after a week of duck-shoving it was clear who within Ergon was the appropriate contact point. A lean globally efficient network services provide requires a much sharper customer focus that clearly defines key contacts and responsibilities.

Another industrial site reported operational inefficiencies associated with a planned shutdown of power. The shutdown was not delivered at the right time, which created consequent delays and costs on site. Compounding the QRC member's frustration with Ergon's inefficiency was the fact that the remote operations coordinator appeared unaware of the issue and lacked the organisational mandate to liaise with the site operations team to rectify the issue.

New resource projects report great frustration in securing connections in a timely manner. Many QRC members report that their experience of network service providers requiring a three-year lead time is simply un-commercial and doesn't reflect the critical path of their project development[11]. A number of

[11] QRC's submission to the Queensland Government's 30 year electricity strategy, page 5 see https://www.dews.qld.gov.au/__data/assets/pdf_file/0013/135202/queensland-resources-council.pdf

QRC members would prefer to be able to provide their own network assets in preference to an upfront payment to retain control of project timing and to be confident that the investment is being made efficiently and only when required as existing capacity is exhausted.

The practical experience of QRC members is that Ergon, on balance, is not an efficient operation and has not undertaken the sort of highly effective cost reduction and efficiency measures that many firms in competitive markets have been forced to implement. In the absence of a competitive market for Ergon's services, we look to the AER's regulatory decisions to apply this pressure.

2.2 Other operating costs (including demand management)

Another issue for QRC is the ambiguity in cost allocation, particularly concerning other operating costs. This category is defined by Ergon to include customer service activity such as education and customer contact in respect of electrical safety issues and other general advisory services[12]. In the current proposal, Ergon have requested a 68% increase in 'other operating costs' from $35.9 million in 2014-15 (Table 5) to $60.4 million in 2015-16 (Table 6). This substantial increase is in contrast to the Ergon submission that they have 'delivered substantial savings across our operating program, particularly in the areas of overhead cost reduction and workforce optimisation'[13].

The following insert[14] goes further to explain Ergon's changes to 'other operating costs',

> 'In the current regulatory control period, this expenditure category also included meter reading costs associated with Ergon Energy's role as a Metering Data Provider for Types 5 and 6 metering installations. However, these costs will not be included in the operating expenditure requirement in the next regulatory control period as Default Metering Services will be classified as an Alternative Control Service.'
>
> and…
>
> 'Other operating costs also include demand management, which includes a range of non-network alternatives solutions, as a tactical response to network problems – primarily where growing customer peak demand requirements create the need to expand network capacity.'

Therefore, given the above information we would expect a significant decrease in other operating costs from 2014-15 to 2015-16 period. Like all efficient businesses, we would expect Ergon to deliver genuine cost reductions under challenging economic conditions.

In the context of demand management, Ergon propose to invest $60.5 m[15], 'to achieve targeted reductions of 80MVA in demand. This is considered a key strategic capability for supporting the proposed reducing capital works forecast for the 2015-20 period. Our reduced capital works program is not possible without the forecast risk mitigation support from demand management activities.'

QRC would encourage the AER to challenge this $60.5 million investment in demand management as industry sees demand management as an initiative more driven by customers themselves, especially in light of kVA based network charges and the newly proposed Excess Reactive Charge. In addition, QRC notes a report released by the AEMC[16] which outlines the $/kVA long run marginal cost of a

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12 Ergon Energy Regulatory Proposal 2015-2020, pg 66
13 Ergon Energy Regulatory Proposal 2015-2020, pg 71
14 Ergon Energy Regulatory Proposal 2015-2020, pg 66
15 Ergon Energy Regulatory Proposal 2015-2020, pg 21
16 AEMC, NERA: Economic Concepts for Pricing Electricity Network Services, pg 19

number of NSPs. These figures (ranging from approximately $150/kVA to $350/kVA) are significantly less than Ergon intends to invest in trying to manage kVA.

Table 5: Ergon Energy's current operating expenditure by category, 2010-15

$'000 (real 2014-15)	2010-11	2011-12	2012-13	2013-14	2014-15	Total
Network Operating Costs						
Network Operating Costs	36,168	35,075	34,775	35,241	34,462	175,722
Network Maintenance Costs						
Preventive Maintenance	83,105	103,534	92,096	73,440	78,602	430,777
Corrective Maintenance	117,323	147,271	113,905	107,694	106,502	592,694
Forced Maintenance	105,368	67,059	73,115	69,413	63,850	378,805
Subtotal	*305,795*	*317,864*	*279,116*	*250,547*	*248,954*	*1,402,276*
Other Costs						
Meter Reading	12,985	14,282	13,330	13,195	14,070	67,862
Customer Services	20,980	27,338	32,389	26,125	16,089	122,922
Other Operating Costs	40,654	47,193	5,073	35,056	35,862	163,838
Subtotal	*74,619*	*88,813*	*50,793*	*74,377*	*66,021*	*354,622*
Total actual operating expenditure	**416,582**	**441,752**	**364,683**	**360,165**	**349,437**	**1,932,620**

Table 6: Ergon Energy's forecast operating expenditure by category, 2015-2020

$'000 (real 2014-15)	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Network Operating Costs						
Network Operating Costs	34,260	34,990	36,590	37,650	38,330	181,820
Network Maintenance Costs						
Preventive Maintenance	77,520	79,240	82,950	85,460	87,090	412,260
Corrective Maintenance	108,280	110,660	115,810	119,280	121,520	575,550
Forced Maintenance	64,750	65,990	68,860	70,720	71,850	342,170
Subtotal	*250,550*	*255,890*	*267,620*	*275,460*	*280,460*	*1,329,980*
Other Costs						
Customer Services	4,370	4,490	4,720	4,880	4,980	23,440
Other Operating Costs	60,420	60,700	54,680	54,900	55,190	285,890
Subtotal	*64,790*	*65,190*	*59,400*	*59,780*	*60,170*	*309,330*
Total forecast operating expenditure	**349,600**	**356,070**	**363,610**	**372,890**	**378,960**	**1,821,130**

Source: Ergon Energy Regulatory Proposal

3. Demand forecasting

3.1 Resources sector outlook and new projects

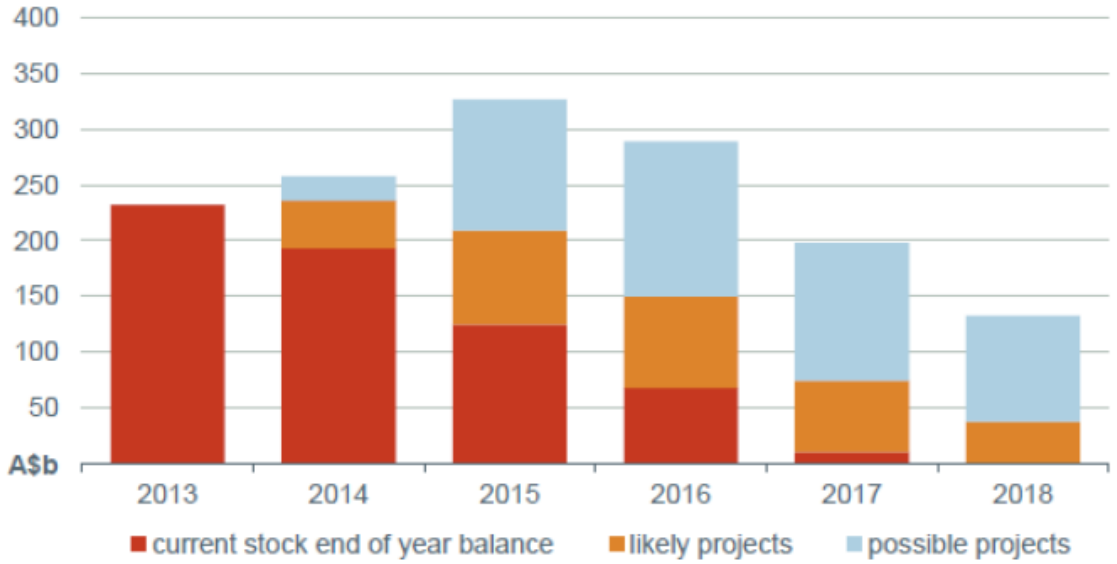
As a significant portion of Queensland's total electricity demand and a small user of the total distribution network, the demand forecast for the resources sector is important in considering the implications for Ergon's network in the period 2015-2020.

While the previous period was characterised by urgency for new connections to enable new and expanding resource operations to commence, QRC foresee a limited demand increase from new resource projects over the next five years. The exception to this would be the continued demand increases from LNG projects and the proposed Galilee coal projects, although it is important to distinguish the vast majority of this new demand will be placed on Powerlink's transmission and very limited demand increase for the Ergon network.

While commodity prices may recover within the 2015-2020 period, the investment decision-making timing of our members and other organisations makes it unlikely that significant new network capacity will be required. It is also likely that increased consideration of new technology (including solar and storage) may reduce the grid-supplied demand resulting from any increase in resources industry production. The use of contingent projects to minimise Ergon's expenditure to until absolutely necessary is important and can provide a safety net to avoid unnecessary expenditure.

Chart 3 below, provided by the former Bureau of Resources and Energy Economics (BREE), demonstrates the marked end to the current Australian investment cycle highlighted by the dramatic decline in current and likely projects. This chart is consistent with the view of the QRC for Queensland as the resources sector transitions from a capital intensive investment period to an operational phase. Until global commodity markets begin to recover we would expect to see a continuation of high production volumes from existing operations with the aim of minimising the marginal cost per unit.

Chart 3: Australian major projects forecast

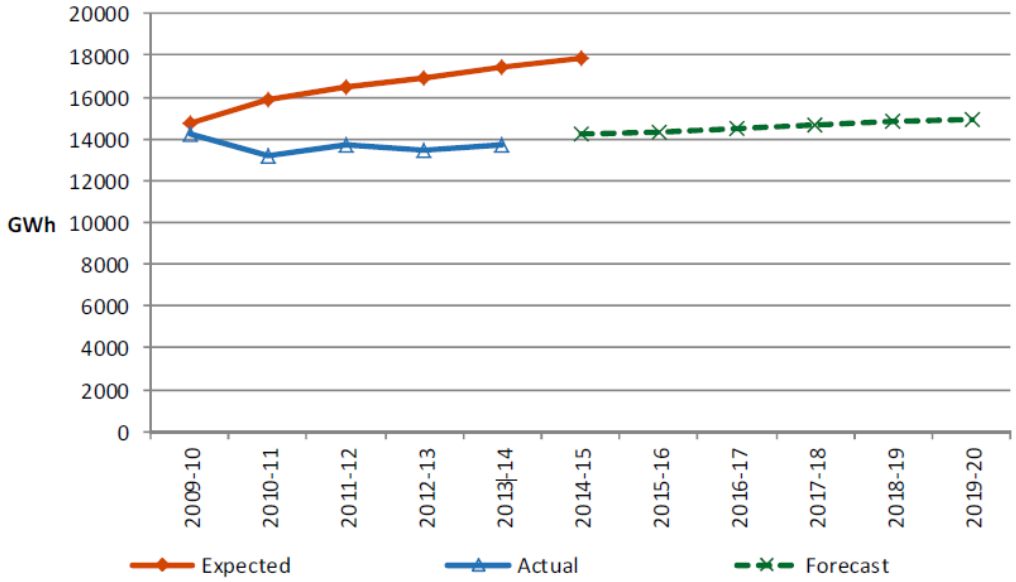


Source Bureau of Resources and Energy Economics (BREE)

3.2 Forecast consumption volumes

The forecast consumption volume shown below (Chart 4), marks the expected consumption for the Ergon Energy network to 2020. The QRC would be surprised if a net increase eventuated, particularly in the first 18-24 months of the determination period particularly given the increase in demand from new or expanding projects on Powerlink's network rather than Ergon.

Chart 4: Ergon Energy electricity volumes (consumption)



Source: AER Issues Paper, December 2014

4. Reliability is critical, but must be delivered efficiently.

The resource sectors' focus on volumes to reduce marginal costs places great importance on the reliability of the network. It is important for the AER to distinguish between the tolerances for residential customers to an increase in network disruptions in comparison to the consequences and costs for businesses. The AER State of the Energy Market 2014 report[17] noted that 'Queensland experiences significant variations in performance, partly because its large and widely dispersed rural networks make it more vulnerable to outages than are other jurisdictions'.

The opportunity cost for industrial users of poor quality network services, in terms of energy quality and reliability, is high. In many cases production halts when electricity supply fails. Longwalls, compression stations, refineries, locomotives, smelters, LNG trains, crushing and grinding plant, draglines, pumps, and wash-plants simply don't operate without electricity and there are very real costs, both direct and knock-on costs associated with any unscheduled outages. For this reason, QRC members emphasise to the AER the importance of maintaining the reliability of Ergon's network services; however, this economic importance should not be misconstrued by Ergon as a blank cheque for exuberant over-investment.

[17] https://www.aer.gov.au/sites/default/files/AER%20-%20Issues%20paper%20Qld%20electricity%20distribution%20regulatory%20proposals%20-%20December%202014_0.pdf Page 83

Ergon have embarked on a major campaign of capital expenditure since 2006 to ensure that they satisfied jurisdictional security and reliability standards. These standards have now been relaxed and Ergon now easily exceeds them. The legacy for customers is an asset base of underutilised and stranded assets with a capacity utilisation as low as forty per cent. QRC members will always give serious consideration to any proposal to invest in better services – improved reliability and quality of power – but any such proposal needs be considered in the context of efficient and appropriate investment against a background of a history of overinvestment and the resulting capacity overhang.

Conclusion

The operating environment for Queensland's resources sector in 2015 is quite different to the context in which Ergon's previous regulatory determination was set. Faced with a sustained price slump and persistent oversupply in many global commodity markets, Queensland's resource industry is focused on minimising production costs to stay in business.

QRC members anticipate significant price reductions for network services in the coming regulatory period based on the AER's approach in recent determinations in other states. For QRC members, electricity accounts for a significant portion of their costs. Based on data provided by members, during the period 2006-2014 electricity costs rose 12 per cent annually, which contributed to the declining competitiveness of Queensland exporters competing globally.

The practical experience of QRC members is that Ergon, on balance, is not an efficient operation and has not undertaken the sort of highly effective cost reduction and efficiency measures that many firms in competitive markets have been forced to implement. In the absence of a competitive market for Ergon's services, we look to the AER's regulatory decisions to apply this pressure.