Suite 2, 89-97 Jones Street, Ultimo, NSW 2007
Ph: 02 9211 5022 | Fax: 02 9211 5033
www.tec.org.au

Total Environment Centre

Submission to the AER on

Queensland distribution networks' 2015-20 revenue proposals

February 2015

Linda Parmenter
Energy Market Consultant

Mark Byrne
Energy Market Advocate
markb@tec.org.au

Total Environment Centre's National Electricity Market advocacy

Established in 1972 by pioneers of the Australian environmental movement, Total Environment Centre (TEC) is a veteran of more than 100 successful campaigns. For nearly 40 years, we have been working to protect this country's natural and urban environment, flagging the issues, driving debate, supporting community activism and pushing for better environmental policy and practice.

TEC has been involved in National Electricity Market (NEM) advocacy for ten years, arguing above all for greater utilisation of demand side participation — energy conservation and efficiency, demand management and decentralised generation — to meet Australia's electricity needs. By reforming the NEM we are working to contribute to climate change mitigation and improve other environmental outcomes of Australia's energy sector, while also constraining retail prices and improving the economic efficiency of the NEM — all in the long term interest of consumers, pursuant to the National Electricity Objective (NEO).

Summary

TEC has reviewed the regulatory proposals submitted by Energex and Ergon in for the 2015-20 regulatory period, and in particular the demand management (DM) strategies and expenditure outlined in attachments to their proposals. TEC supports the DM specific spending by the businesses, however has concerns about the overall level of capex, opex and the rate of return being proposed by the businesses. In particular we question the levels of proposed expenditure on augmentation capital (augex), replacement capital (repex), and operational expenditure (opex).

A number of our comments in this submission are directed to the AER and concern our views on ways to strengthen the framework for DM in the context of the current round of revenue determinations. In particular we suggest that the AER could provide better commentary and guidance to the DBs on:

- The requirement to consider of non-network alternatives in developing capex proposals.
- The expectations of DM plans, including how the AER will assess business as usual (BAU) DM as well as the Demand Management Incentive Allowance (DMIA).
- The expectation to report targets, outcomes and benefits in a consistent way.

Ideally, this direction to the businesses could be provided by the development of a Demand Management Guideline, similar to the Consumer Engagement Guideline.[1]

Introduction

TEC welcomes the opportunity to comment on the Queensland Electricity Distribution Businesses' (DBs) Regulatory Proposals. These proposals, and the AER's response to them, are of great significance to Queensland consumers. In addition to determining the prices paid by consumers, the DBs' periodic revenue proposals set out and effectively lock in the strategic approach to network management and network services that will be taken by the business, including investments in innovation and alternatives to network augmentation over the longer term. This is especially important in the context of the radical shift that is now occurring from a centralised and fossil-fuelled electricity system to a decentralised one based around

[1] TEC acknowledge that guidance is currently provided for the DMIA funds under the Demand Management Incentive Scheme 2008. We suggest the future revised scheme would be refered to and integrated with a broader DM guideline.

renewable energy and storage, complemented by a greater emphasis on energy efficiency and demand management. Consumers require, and have a right to expect, a high level of consultation, transparency, and accountability in the development of these proposals. It is also critical that there is robust examination and scrutiny of these proposals guided by principles that support the National Electricity Objective (NEO), before they are accepted and implemented.

As with other current network revenue determinations, TEC's interest is primarily in demand management and in how the DBs' regulatory proposals reflect their use of DM to meet the long-term interests of consumers. This focus is driven by a concern for both the need to reduce network capital expenditure and increase the affordability of energy for consumers, and to improve the environmental performance of the electricity system.

In spite of declining volumes, over the 2010-15 regulatory period the total revenue earned by Queensland DBs approximately doubled. [2] The Queensland Networks expended approximately $9 billion on network assets (i.e. capex) in this 5-year regulatory period justified by the need to cater for growth, and in particular growth in peak demand. Network prices drove a 70% increase in electricity prices paid by households between 2008 and 2013[3], while shareholder profits steadily increased each year from 2007-08 and by 2013-14 had more than doubled.[4] These outcomes represent a gross failure of the regulatory regime that must not be allowed to be repeated for the 2015-2020 determination period.

The Productivity Commission estimates that although peak demand events occur for less than forty hours per year (or less than 1% of the time) they account for approximately 25% of the average residential bill.[5] It is estimated that $2.2 billion per year of avoidable network costs are being passed on to consumers Australia wide[6], while the future potential savings through peak demand reduction in the NEM range from $4.3 billion to $11.8 billion over the next ten years[7]. These savings are largely cost reductions associated with avoided network capital expenditure.

Not only is DM is critical to halting the unprecedented growth of network infrastructure that occurred in the previous regulatory period, there are also strong technological and environmental imperatives to invest in DM. Australia has one of the most carbon intensive economies in the world and the electricity sector currently accounts for 35% of Australia's greenhouse gas emissions. [8] The continued supply side focus in this sector has exacerbated this. Peak demand is mostly met by fossil fuelled generation. Improving energy efficiency and reducing energy consumption, particularly at peak times, is one of the most cost effective ways of achieving carbon abatement.[9] Technological change is also presenting challenges for electricity networks and their continued supply side focus. The widespread adoption of photovoltaics, improved energy efficiency of appliances and buildings, and the future possibilities of energy storage and electric vehicles is generating rapid changes that have led to a decline in overall demand while widening the gap

[2] Hugh Grant, Preliminary perspectives- Energex and Ergon Revenue Proposals. AER Public Forum 9 December 2014

[3] ABS, Consumer Price Index, analysised by QCOSS in their Cost of Living Report, Issue No 5. 2014.

[4] Bruce Mountain, CCP member, Ergon and Energex's proposals 2015-2020 – initial comments. AER Public Forum 9 December 2014.

[5] Productivity Comission, 2013, Electricity Network Regulatory Frameworks, Report No.62, Canberra

[6] Futura Consulting, 2011, Power of Choice – Giving consumers options in the way they use electricity . Cited in Dunstan c, et.al, 2013, op cit.

[7] Australian Energy Market Commision, 2012, Power of Choice Review – Giving Consumers options in the way they use electricity (Final Report).

[8] Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education, 2013. Quarterly Update of Australia's National Greenhouse Gas Inventory, December Quarter 2012

[9] It is acknowledged that the increase in generation output to meet peak demand is mostly gas and hydro, though coal use does increase as well, however reducing peak demand helps mostly where it leads to load shaving rather than load shifting, which can lead to higher emissions where peaking gas and hydro are replaced by offpeak coal.

between overall and peak demand. Demand Management is critical to this transformation and DBs need to embrace and facilitate, not resist and obstruct this future.

TEC notes that the AER has recently confirmed the relevance of DM in the current flat growth environment in its draft determinations on the NSW distribution businesses regulatory proposals. The AER states, " In this demand growth environment there is a stronger economic case for the use of demand management as investment in long-life network assets can be deferred until there is a more certain need, reducing the risk of stranded network assets. Further, the option value of demand management also increases."[10]

DM performance in Australia

Despite the overwhelming case for DM, DM utilisation in Australia has been historically limited when compared to international best practice. The current value of network and non-network DM in Australia currently equates to less than 2% of total peak demand.[11] As noted by the Australian Energy Market Commission (AEMC) and the Productivity Commission in the context of recent reviews, there is significantly more opportunity for DM in the Australian system than is currently being pursued.[12] The funds available under the DMIA are relatively small and, perhaps because of this, utilisation of the scheme has been low with just 13% of the scheme expended in 2012.[13] By comparison, in the US DM meets 4.3% of total peak, with many states currently setting targets for peak demand reduction between 5 and 15%.[14] In California the equivalent peak load reduction is 6 per cent.[15] International utility companies are also moving more quickly and decisively to invest in future technologies and related capacity. In Texas utility Oncor has recently sought regulatory approval for up to $5.2 billion in distribution-grid-connected batteries, with deployment set to start in 2018.[16] In another example in Southern California, Edison is planning to spend about $9.2 billion through 2017 to allow the two-way flow of electricity on its system.[17] The contrasting low level of investment in similar projects domestically points to regime that is encouraging complacency and lack of innovation.

DM in the regulatory process

The barriers and disincentives to undertake DM as an efficient alternative to capex spending have been closely examined in recent years and a reform program has been mapped out. Some of these reforms have been progressed, and TEC acknowledge that there have been significant improvements across a range of areas since the 2012. We refer particularly to the changes to the Regulatory Investment Test for Distribution, the requirement for businesses to implement a Demand Side Engagement Strategy, and more

[10] AER, Draft determination NSW
[11] Productivity Comission, 2013, Electricity Network Regulatory Frameworks, Report No.62, Canberra.
[12] Productivity Comission, 2013, op cit., and Australian Energy Market Commision, 2012, Power of Choice Review – Giving Consumers options in the way they use electricity (Final Report).
[13] Dunstan, C., Downes, J. & Sharpe, S. (2013) Restoring Power, p 27.
[14] Dunstan C, Downes, J & Sharpe, S. (2013). Restoring Power: Cutting bills & carbon esmissions with Demand Management. Institute for Sustainable Futures, University of Technology Sydney. Prepared for the Total Environment Centre, p 57
[15] Productivity Commission, 2013, op cit. citing Faruquiand Fox-Penner (2011), p46
[16] http://reneweconomy.com.au/2014/texas-utility-wants-to-invest-5-2b-in-battery-storage-46548, accessed 29 January.
[17] http://www.bloomberg.com/news/articles/2014-12-05/musk-battery-works-fill-utilities-with-fear-and-promise, accessed 29 January.

broadly to the AER's Better Regulation program which included a new Consumer Engagement Guideline and revised Rate of Return as well as Capital Expenditure Incentive Guidelines.

However at this stage it is still not clear whether these reforms have created the incentives required to drive significantly stronger DM plans and results into the next regulatory period. One key reform - of the Demand Management and Embedded Generation Connection Incentive Scheme (DMEGCIS) - has not even begun, despite it being earlier identified by the AER as a high priority area under the Better Regulation program, and despite TEC submitting a DMEGCIS rule change request in November 2013. TEC is disappointed that an opportunity to properly incentivise DM has been missed for the current regulatory period; however, we accept the reasons outlined by the AER for not revising the current DMEGCIS at this time as we requested in our submission on the NSW regulatory proposals. We understand that the AER does not wish to pre-empt consultation on the AEMC's review of DM arrangements by commencing consultation on a new DMEGCIS, or to pre-empt the outcomes of that review. We look forward to the consultation on the revised DMEGCIS and ask that the AER proactively engage in the rule change process and amend the DMEGCIS immediately following the rule change, applying the scheme to the remainder of the next regulatory period in order to maximize the incentives to undertake DM. A new DMEGCIS should include annual reporting, voluntary performance targets and incentives for exceeding targets.

The DMEGCIS is only one of three key ways that DM features and is an appropriate consideration by the AER in the regulatory determination process. For the current Queensland regulatory determination the AER has determined that only Part A, the Demand Management Innovation Allowance (DMIA) component, will by applied. DMIA funds is provided on a "use it or lose it basis" with businesses applying to the AER annually for ex ante costs for applicable projects. The businesses may also put forward expenditure proposals for DM activities that are part of their business as usual (BAU) approach. These proposals are usually for opex, but may include capex components. Finally, the use of DM by the businesses is relevant in the AER's assessment of both the capex and opex components of the revenue block approach, where at Clause 6.5.7(e)(10) (and the equivalent clause in relation to opex) the AER may consider evidence of "the extent the Distribution Network Service Provider has considered, and made provision for, efficient and prudent non-network alternatives…"[18]. This consideration is relevant in determining whether or not the businesses have met the capex or opex expenditure criteria.

Including reform of the DMEGCIS, TEC supports the development of a range of regulatory mechanisms to support and drive greater DM outcomes in the NEM. An ideal framework would include:

1. *Overarching objective*: the National Electricity Rules ensure that DM and other non-network options (energy conservation and efficiency and local generation and storage) are given an opportunity to contribute to the National Electricity Objective (NEO) on an equal footing to capex spending.
2. *Incentives*: an effective DM incentive scheme (DMIS) for both transmission and distribution businesses drives DM wherever it will reduce net costs to consumers.
3. *Innovation*: network businesses use the demand management innovation allowance (DMIA) to drive real innovation to reduce peak demand.
4. *Targets*: network businesses set DM targets in collaboration with regulators.
5. *Expectations*: the AER clearly and consistently signals its determination to scrutinise network revenue proposals for evidence that DM and other non-network options are being considered seriously by network businesses.

[18] National Electricity Rules Version 64, 2014 , Chapter 6, Cl. 6.5.7 (e) (10)

6. *Benchmarking*: the AER compares the DM performance of all networks according to metrics such as the benefit:cost ratio and/or $/kVA of energy saved, and applies these benchmarks to its revenue determinations.
7. *Timing*: DM and other non-network options are seriously considered prior to being included in networks' revenue proposals, rather than through the regulatory investment tests (RITs) administered once revenues have already been guaranteed.
8. *Reporting*: network businesses report annually to the AER on their DM activities and outcomes, with inadequate performance penalised by reduced revenue allocations.

While this outlined framework is hypothetical, TEC urges the AER to take all possible steps to maximise its focus on DM in the current round of regulatory determinations, using the process to both affirm the value of DM and provide guidance to the businesses about what is required. To date TEC has been generally underwhelmed by the AER's focus on, consideration of and guidance for businesses on DM, as reflected in framework and approach papers and also the recent draft decisions in relation to the NSW businesses. The AER's 2012 and 2013 framework and approach papers address DM only in terms of the DMEGCIS, and even here give relatively little direction to the NSW or Queensland DBs in designing effective DM strategies, especially in relation to targets or project details.

The AERs draft decisions relating to the NSW DBs have provided an opportunity for commentary on DM, however the position adopted by the AER here was to rely heavily on the broader incentive mechanisms to drive investment by the businesses. We are concerned by this approach, particularly as no effective DMEGCIS is in place or is likely to be in place for the current regulatory period. Most of the incentives on which the AER are relying are relatively new and at this stage the AER has no way of knowing whether or not the DBs will see and respond to these incentives in the way the AER anticipates. Other commentary on DM in these decisions is somewhat unclear and requires further discussion and debate. TEC feel such discussion would have been of more value leading into the regulatory process, rather than at the end of the process.

TEC believes that if the DBs are to demonstrate adequate DM plans, the AER needs to display a much greater interest in the benefits to consumers of DM. In the context of the Queensland draft decisions, TEC urges the AER to address in some detail its approach to demand management, and to set out for the businesses the expectations and requirements that it has about the efficient and prudent use of DM. This would cover what the AER views as 'efficient' expenditure in the context of the businesses' BAU DM plans, as well as how the businesses should demonstrate, in the context of capex proposals, that they have first considered non network alternatives.

TEC would also like the AER to require distribution network businesses to set DM targets, in collaboration with the AER, and to report clearly and consistently on their DM activities and outcomes against established performance indicators.[19] Assessment would include the quantity and quality of:

- DM outcomes over previous period
- DMIA outcomes specifically, and
- DM plans for the next regulatory period including new DMIA projects.

Quantitative performance indicators might include:

- The capex/opex trade off (or cost benefits analysis).
- Peak demand reductions proposed/achieved.

[19] Dunstan, C., Downes, J. & Sharpe, S. (2013) op cit.

- Capital deferral achieved/estimated.

Other possible (qualitative) indicators include:

- Whether the strategies (broad based or targeted) are appropriate to the opportunities and risks.
- The extent to which DM plans outline processes to integrate DM considerations into the whole of business planning (so that DM options are considered before or alongside asset augmentation or replacement options).
- The extent to which there is continuity and development of DM programs over successive years.
- The extent to which DM plans demonstrate that businesses understand future technology challenges and opportunities (i.e. are developing new business models to respond or take advantage of opportunities).

We are aware that the AER generally takes a fairly high level, light handed regulatory approach – approving overall revenue, rather than detailing how it should be spent – and that it does not want to be seen to be telling the networks how to run their businesses. However, TEC believes there would be merit in developing a guideline, similar to the Consumer Engagement Guideline, which would set out the framework through which the businesses performance will be assessed. This guideline would not be a regulatory requirement, but would assist the businesses in understanding what the AER will consider when having regard to DM both as part of expenditure proposals and as an expenditure factor relevant to capex plans.

Providing this guidance, supported by a requirement for annual reporting against consistent and common performance indicators, will send a message to the businesses and to other stakeholders that the AER is serious about the benefits of DM for consumers. It would also provide a framework for the assessment of the regulatory proposals – both the capex component and the specific requests for DM operational expenditure, as well as the DMIA plans. Finally, it will provide the information required for the AER to determine whether or not the approach, including any incentives are in fact working as the AER expected. Without asking the businesses to report on what they have done, what they didn't do and why, as well as what has been achieved and at what cost, it is impossible to really understand how DM spending is tracking and the comparative performance of the businesses.

Assessment of Ergon and Energex DM plans

The DM plans presented by the Queensland DBs are stronger than those we viewed from the NSW DBs. Not only do the plans propose a level of investment and outline targets that are more ambitious than we observed in NSW, the plans present coherent strategies, provide more detail, and are more cognisant of the future network challenges the businesses are likely to encounter. Energex in particular provided good information on the outcomes achieved to date and those anticipated, and while Ergon did not do this as clearly within their DM attachment, they referred to their annual outcome report to the Queensland Government which was easily accessible on its website. Nonetheless, there were a number of areas where we would have liked to have seen more information and a more consistent approach to the format of the plans, for example in relation to reporting of the proposed benefits of the various programs. Some of these areas will be identified in the discussion below.

It is arguable that the stronger outcomes achieved in DM in Queensland to date, and the quality of the current Queensland DBs' DM plans, have been driven by the framework for DM set out by Queensland regulations as well as early investment in pilots and trials supported by both the AER and the former Queensland Government. Annual DM planning, target setting and annual outcomes reports are a requirement in Queensland under the *Queensland Electricity Regulation 2006*.[20] While the businesses are not required to make these documents public, Ergon currently does publish its plans and outcome reports, resulting in a much greater level of transparency and information than we were able to glean in the NSW process. Energex advised us that it intends to publish their outcomes report in the future, and TEC would strongly support it doing so. While it is unclear whether the level of support for DM provided early on has been maintained in recent rounds of government initiated efficiency drives, TEC believes that the outcomes that have been achieved in the Queensland context to date are nonetheless evidence of the value of the type of target setting and reporting we are asking the AER to drive more broadly.

We note that Energex's and Ergon's plans outline thoroughly different approaches to DM, with Energex strongly focussed on 'broad based' DM strategies, while Ergon's aproach is focused on a targeted approach. This in part reflects the nature of the different networks and the associated opportunities that are available, and to the extent that we believe there is merit in both approaches TEC is supportive of the proposed investment for the next 5 year period. We have reached this conclusion through an assessment of the plans presented by the businesses, which we undertook using some of the same indicators we identified as useful for the AER, and on the basis that there is at least a 1:1 benefit to cost ratio. That is, so long as an equivalent amount of capex is being deferred, we prefer the DM investment knowing it will not add to the regulated asset base (RAB) and it is likely to build the bank of DM strategies generally. Of course this ratio becomes problematic if the deferral is only short-term in nature, and we agree it would not be acceptable in such circumstances.

Proposed investment, targets and approach

Energex

Energex proposes an investment in BAU DM of $95 million for the 2015-20 regulatory period. This investment is some $5 million higher than its actual spend during the previous regulatory period, representing about 5.5% of its total opex revenue proposal and just over 1% of total revenue. This is a higher proportion of opex than proposed by any of the NSW DBs. At the same time, however, almost half of this expenditure is for direct customer incentives rather than on delivery of the DM program. We would be concerned if this represented a reduction in effort in DM delivery, however we accept the evidence provided by Energex that it has generated efficiencies in program delivery over time while building its programs up from trials to BAU programs.

Energex reports that it is on track to achieve the peak demand reduction target of 144MVA that it had set for the previous 5 year regulatory period, and we are pleased to see that it has set a target of 170MVA for the next period. Energex estimates the Net Present Value of the benefits at $75 million. This outcome looks lower than the achievement in previous years, and while Energex has explained that its method of calculation has changed since the previous period, TEC questions whether the business is understating the benefit of these programs in order to maintain higher than required capex revenue. It would have been helpful if Energex had provided an assessment of the benefits using its previous method as well as the new approach, in order to allow a comparison of results with the previous period.

The DM approach that Energex is proposing for the regulatory period is made up of four strategy areas: Residential DM, Business DM, Tariff Reform and the DMIA. Energex's residential DM strategy primarily involves broad based programs to further develop load control capacity. While there is a continuation of programs associated with existing controlled load tariffs, these are supplemented with incentives to customers to connect to these tariffs. Another key program in the residential suite is the further

[20] Queensland Electricity Regulation 2006. Cl. 127(C)

development of the Peak Smart air conditioning program that has shown very good outcomes through a trial and pilot period including over 20.1MVA of (diversified) peak load under control through 13000 activated units. Here Energex plans to use direct financial payments for customers in the absence of tariff incentives to adopt load control devices. We understand that Energex is planning to transition from direct incentives to a tariff based approach once suitable tariffs are in place, and tariff reform is a separate strategy area in the DM plans. We believe that this is a good approach for a range of reasons:

- It provides an opportunity for consumer benefit.
- It communicates a price signal (of an indirect sort) and educates customers about peak demand.
- It allows the program, load under control, partnerships and associated technology to develop, while not rushing the development of cost reflective tariffs that need to be developed through engagement with consumers and with appropriate consumer protections.

The Energex DM plan reveals considerable work in developing partnerships with market and industry stakeholders and that this is not only enabling higher program take up but it has enabled them to generate cost efficiencies for their program. This is their primary justification for using a broad based rather than a targeted DM approach for this sector. We note also that even though these programs are not targeted specifically to areas of network constraint, with sufficient load under control they do provide Energex with the capacity to manage that load at a local level.

Should broad based DM be supported?

Given that the bulk of Energex's DM strategy is in broad based initiatives, it is necessary to comment on the AER's recent draft decision on the NSW distribution businesses regulatory proposals. In relation to DM, the AER rejected a $22.5 million step change proposal by Ausgrid for DM initiatives, stating that it did not believe the expenditure would be efficient, and more specifically, that the benefits of DM will not be available till towards the end of the regulatory period, by which time new tariffs with cost reflective pricing structures are likely to produce similar outcomes in terms of demand reductions. TEC does not agree with this aspect of the decision, and considers that the AER has provided insufficient detail of the factors that led to its conclusion that the proposals were not efficient, or alternatively what the AER would expect to see from businesses to meet the efficiency criteria. It appears to us that the AER is relying heavily on the outcomes of tariff reform, and that it prefers DM outcomes that can be achieved in the short term and therefore prefers specifically targeted DM activities to broad based programs.

TEC believes it is extremely optimistic to rely on tariff reform as the benefits, not to mention the timing of tariff reform, are uncertain. Tariff reform, when it arrives, may be part of the solution, but it is unlikely to provide the only answer. It is arguable that if the main issue is critical peaks on a few very hot days each summer, then a rebate and/or automation of response from appliances may be more useful than a year round time of use tariff. This approach may also produce better outcomes for vulnerable households than time of use tariffs, plus provide more certainty of response and thus fewer risks for retailers and networks.

TEC also believes that there is merit in broad based DM activities that may achieve outcomes over the longer term. We understand that there will be cost impacts in the current period and that because these programs take time to embed the gains are only likely to be realised in the longer term. However, we believe long term benefits are of value and are worth investing in, and we ask the AER to consider these, not just returns within the regulatory period, when making its final decision.

Does Energex have greater scope for targeted DM than is being utilised?

Notwithstanding our support for Energex's broad based programs, it would be reasonable for the AER to question whether there is more scope for targeted DM in its network than is being utilised. One of the four strategy areas in the Energex plan is in Business DM, where it is shifting focus towards more targeted approaches and working with the commercial and industrial sector. Energex's outcomes reporting reveals that this sector provided it with more than half of its demand reduction target in the last 5-year period, and we note that Energex suggests it will assist with more than a third of its target in the current period. The slowdown in growth and relaxation in network security standards may have reduced some of the imperative for targeted DM the short term. However, to the extent that the business is proposing 'growth and security'related augmentation projects totalling some $510 million, we think it is fair to ask whether there are more opportunities for targeted DM then are currently being pursued.

Ergon

Ergon is proposing to invest approximately 3.8% of its proposed opex allowance, or $70 million in DM for the 2015-20 regulatory period. Its approach is focused largely on very targeted DM projects rather than broad based programs and direct customer incentives. Almost half of the allocation is in its planned 'network constraint targeted programs' and 'safety net risk mitigation' program. Approximately 20% of its DM budget is in the continuation of already committed works, including contracts for managing demand, so this is also very targeted.

Having achieved its 122 MVA target for the last period 12 months early, Ergon has lowered its demand reduction target for the upcoming period to 80MVA, noting an additional 20MVA would be achieved if demand growth were to return to a medium to high growth scenario. Ergon explain in its proposal that the lower target is due to the fact that a very large amount of the capital deferral achieved last time was for two projects that achieved a large (59MVA) but one-off demand reduction in North Queensland and Townsville. This is evidenced by their most recent outcomes report on DM, which outlines further detail of the projects and the results. Ergon argues that similar opportunities of this scale are not available this time around. It is difficult for TEC to know how accurate this assessment is without a level of investigation that we do not have the resources to undertake, though we do note that work Ergon has done on mapping network constraints should provide the AER with a good basis for considering whether the targets are high enough.

The value of the capital deferral benefits to be achieved by Ergon's DM program is estimated by the business to be between $70 million and $200 million. Again, this is considerably lower than that actually achieved in the last period, and we would ask that the AER consider this carefully when assessing the businesses capex proposals. Over $600 million in capital deferrals was achieved in the previous period; however TEC acknowledge there is a different context in this period. Ergon argues that the change in reliability criteria and move to the 'safety net' approach means much of what was counted as a deferral last time would not be in the capex plan this time. However, they estimate a further $600 million in capital reductions in this period are available through to 2030 due to the safety net planning criteria. This planning approach requires Ergon to use risk mitigation activities such as DM in locations that may have previously been scheduled for augmentation projects, and is consistent with the AER's concept of the higher 'option value' of DM in the current low demand growth environment.

<u>Is the benefit to cost ratio enough?</u>

Based on our understanding of the AERs draft decision in NSW, we assume that the AER will look positively upon Ergon's very targeted approach to DM. However, we are unclear whether AER will be satisfied with an achievement of capital deferral at the lower end of the scale that Ergon has identified. In the draft NSW decisions the AER did not directly identify a benefit to cost ratio that it would find acceptable; however, in the case of Ausgrid the AER noted that a 2.5:1 ratio was achievable and reasonable to expect based on past performance. Even at the higher end of the scale, the capital deferrals proposed by Ergon do not achieve this ratio. Inclusion of the additional optional $600 million out to 2030 changes the cost benefit outcome considerably. We think it would be useful if the AER was to more clearly outline its views on the cost benefit ratio or the capex /opex trade off it believes is necessary, in order that stakeholders can respond and engage in a dialogue on this issue.

Linkages with network planning

TEC strongly believes that if DM plans are designed to reduce capex expenditure there should be evidence of integrated planning processes taking place within the businesses and evidence of linkages between DM and capex plans. Without this evidence the businesses cannot demonstrate that they have considered non-network alternatives; and the AER should consider this in determining whether the businesses have met the capex criteria.

Our experience of the regulatory determination process is that there is simply not enough detail describing the links between the capex and DM planning process. We acknowledge that we have not been able to read all of the detail contained in the regulatory proposals in looking for such links. However, in our view the businesses should be demonstrating upfront an integrated approach to planning – one that incorporates consideration of non-network approaches within the standard asset planning process. This should be evident in their overview documents, and not require reconstruction from information buried within the attachments.

The AER could provide significant direction to the businesses by outlining the evidence that would be sufficient to satisfy the AER that they are considering non-network alternatives as part of their capex proposals. For example, the AER could ask for evidence and examples of how the businesses integrate capex and DM plans. The AER could ask the businesses to describe the level of scrutiny at a project level that is undertaken prior to including a project in their capex plans, or what type of assessment of both supply and demand side options occurs before a decision that a capital solution is required is made. Businesses could be asked to describe both their process and their criteria for this assessment. While not expecting that businesses will be scrutinising projects at the level of a RIT-D process, we do believe there should be some level of scrutiny required before capex plans are submitted, and businesses should be asked to explain their processes for doing so. This would also be of assistance in ensuring non network alternatives are considered at some level in projects that are not subject to the RIT-D, such as asset replacement projects augmentation projects under $5 million.

Energex

In Energex's chapter outlining its capex proposal the business states that the first step in its asset planning approach is to consider DM or non-network alternatives to network augmentation. However, TEC could find only limited practical demonstration of this within either the DM plans or in the overview of their capex proposals that we examined.

Ergon

There is greater evidence of the linkages between DM and capital planning in Ergon's plans. This is the result of their targeted approach to DM which ensures they are addressing specific network constraints through strategies such contracting demand and 'market enablement' to assist build future DM solutions under the Effective Market Reform (EMR) program. One of the key features of this program is the development of the demand response inceptive map (DRIN). This is a market communication tool that engages the market to identify the value, location and other metrics related to a DM program of works, and in doing so should assist to build the market for DM. TEC is supportive of this work, though its precise benefits are as yet untested, and believes that the existence of such transparent public information can be of benefit to consumers and the AER in assessing the reasonableness of capex and DM claims in future regulatory processes.

Planning for new technologies/market reforms

TEC is interested in the extent to which the businesses are preparing for and adapting to longer-term changes to the energy market: the frequent unpredictable changes to government climate and energy policy, and the radical changes to generation and demand technology that are driving a more decentralised energy system likely to accelerate the decline of the traditional energy supply model. As AER Chairman Andrew Reeves said recently,

> …we need to re-consider network services so that we make the best use of existing assets. This 'new world' means we will utilise the network in different ways. The network is no longer only about transporting energy from 'A to B'. The vision of the network that I have outlined … is a platform for the two-way trade of electricity.[21]

Compared to the proposals submitted in NSW and SA, TEC believes the Queensland businesses' DM plans demonstate a greater recognition of these issues and clearer plans to adapt to them. At the same time, we note that the responses to these challenges are quite inwardly focused – that is, to position themselves effectively to manage the emergence of new residential demand drivers, such as solar PV, battery storage and electric vehicles, and to protect their load control capacity in an environment where they may not own the meter. This is not unreasonable at one level. There is significant investment to date in the Load Control System (LCS) and the current load under control is of great benefit to the networks. A number of future technology developments have the potential to add costs to the network and provide undesirable incentives from a network point of view. However, rather than being threatened by this future and attempting to obstruct and control it, we would prefer to see the networks embracing and facilitating the rapidly growing shift to a decentralised energy system.

Of the two businesses, Ergon seems to be more likely to do so, and their plan to position themselves as a 'market enabler' suggests a more proactive approach. The possibility of significant load being taken off grid may be a more immediate threat within Ergon's network, particularly as there are some large customers who do not have the protection of the Queensland government's universal tariff and have sufficient resources to invest in their own distributed generation.

DMIA plans

Energex

Energex provided a 12-page DMIA attachment to its regulatory proposal outlining a suite of possible projects that are complementary to its current DM strategy. From our reading of Energex's DMIA plans and our conversations with the businesses, we see that Energex is strongly geared to converting trials to BAU, and that they are unlikely to embark on any DMIA project if they don't have a reasonable expectation that the project will grow and transition into their larger DM program. This is evident in the linkages drawn between possible projects utilising batteries and electric vehicles and the existing load control programs within their suite of DM programs. We support this focus on transitioning trials to business as usual, but we would also like to see a commitment to the innovation that the DMIA funds are designed to achieve.

21

Ergon

It is disappointing that no details of Ergon's proposed 2015-20 DMIA activities have been provided in the DM plan attached to the revenue proposal, despite the fact that Ergon referred to DMIA as a 'valuable tool' and comments throughout plan suggest it will respond to opportunities and risks around battery storage and PV. However, its plan does refer to the suite of DMIA projects undertaken in the previous period, and to the DMIA outcomes report which is available on their website rather than as an attachment to the regulatory proposal.

The DMIA projects that have been outlined or suggested by the Queensland DBs are fairly predictable, and very similar to the types of projects being contemplated by those other distribution businesses that have indicated their future DMIA plans. We do not have great confidence that the DMIA funds will be wholly spent, or indeed that the businesses are overly interested in utilising these funds to explore innovative projects and technologies. This is likely because DMIA funds are seen as minuscule in the context of overall revenue and therefore not particularly interesting. The businesses attitude to the DMIA provides further evidence of the need to urgently reform this aspect of the DMEGCIS and to provide real incentives for innovation.

Capital expenditure

Both Energex and Ergon have submitted capex proposals that are lower than the approved and actual expenditures of the previous regulatory period. TEC welcomes this reduction, but observes that it has come too late to offer price relief to consumers. The unprecedented levels of investment in network augmentation of the previous period resulted in a massive increase in the combined RABs of the Queensland businesses from $15 billion in 2010/11 to $21.9 billion in 2014/15.[22] This has in turn driven higher revenues for the businesses and significantly increased prices for consumers. It will also lock in high prices for the foreseeable future, given that the return on the RAB accounts for more than 60% of network revenue.

In this context we believe that it is critical that the AER scrutinise the businesses capex proposals with the utmost rigor. TEC is of the view that the current capex proposals are too high, and ask that the AER substitute lower capex amounts in its draft and final determinations. TEC finds it particularly concerning that while Ergon provides information on specific augmentation projects, Energex provides only very limited project specific information. Consistent with the NSW draft decisions on capex, we expect the AER to apply a 'top down' approach using metrics such as capex per customer and capex per maximum demand in order to test the efficiency of the 'bottom up' capex proposals from the businesses. While TEC supports the approach of establishing efficiency benchmarks to assess the reasonableness of the base costs claimed by distributors, we also believe the AER should 'ground-truth' its capex benchmarking by doing a ''bottom up' analysis of some planned augex and repex projects, to determine whether networks have adequately considered non-network options.

The current process places considerable reliance on the RIT-D process to test the businesses proposals at a subsequent date. In the context of a regulatory process where project level detail to support capex is not provided (and even if it were the AER would not be able to scrutinise everything), to provide the correct level of consumer protection the AER needs to scrutinise the RIT-D process carefully rather than simply relying on benchmarks. One approach for assessing the proposals of the DBs might be to review their RIT-

[22] 2014/15 figures are estimates, based on information provided in the businesses' regulatory proposals.

Ds over the previous determination period to identify what their performance in those processes suggests about how carefully and creatively they are considering non-network alternatives.

Augmentation capex

While the proposals show a large drop in augmentation capex compared to the previous period, we would nonetheless ask the AER to closely examine whether these proposed costs have fallen sufficiently given revised reliability standards, falling demand, the opportunities for demand management, and questions raised about both businesses' efficiency.

Demand Forecasts

The businesses have a poor record in forecasting demand and an incentive to overstate it. Demand forecasts in the previous period were significantly overestimated, and capex was underspent as a result. Overall demand has been falling for some time, driven by a range of factors including rising prices and, to the extent that price is a factor, this trend is likely to continue in the medium term. While lower demand growth expectations have been reflected in lower capex proposals for the 2015-20 period, we would nonetheless expect to see a greater drop in the levels of capital expenditure proposed.

Both Energex and Ergon make the point that overall system demand is not relevant and that are pockets of strong growth and localised constraint that are driving their augmentation capex plans. Data compiled by QCOSS on Energex's network provides evidence that questions this assertion. For example, while the assets in Energex's network used to deliver peak demand grew from to $4 billion to $7.9 billion between 2006 and 2013, the energy delivered per dollar of assets rapidly declined. It is also noted that demand on Energex's network is slowly migrating from peak to off peak times. Further, peak demand has been declining since 2010 with 5 year growth rates in peak demand of -0.5% in the Energex area and -0.1 in the Ergon area. Despite this, both businesses are forecasting peak demand growth rates of 1.1% and 2.2% per annum respectively. This deviation from the trend requires robust explanation by the businesses, particularly by Ergon which has not reduced its augmentation category capex as significantly as has Energex. Without such explanation we would expect claims for peak demand related augmentation to be rejected by the AER.

TEC is also not persuaded that the businesses are providing a full picture when they argue that spatial peak demand is driving capex at a substation level. For example, the businesses provide maps of substation constraints, but they do not show us a connection between these particular areas, the particular capex projects they are contemplating, and their non-network considerations. Moreover, they do not overlay mapping of network constraints with network capacity, although we are aware that Ergon is working on just that with their demand response inception mapping project with the Institute for Sustainable Futures. What would be useful would be information at the zone substation level on installed capacity, current peak demand (at either or both 50 and 10POE) and the current growth rate of peak demand. To avoid provision of unnecessary information ,criteria could be set so that such information is only required in particular hot spots. This could provide an early warning system for the consideration of area focussed non-network efforts.

Reliability

We ask the AER to consider that not only have reliability standards reduced due to the Electricity Network Capital Program (ENCAP) Review in Queensland,[23] but also that the DBs' performance in meeting reliability

[23] Electricity Network Capital Program Review 2011, Detailed report of the Independent Panel, at https://www.business.qld.gov.au/__data/assets/pdf_file/0018/9117/ENCAP_Review_Final_Report_3_new.pdf, accessed 25 January.

standards has improved over the last period. Indeed, in general both businesses are meeting reliability standards comfortably,[24] a point which also contradicts a need for higher augmentation expenditure.

Efficiency Benchmarks

The AER's 2014 benchmarking report shows that Energex and Ergon do not perform well on various metrics related to capex performance, with Energex somewhere in the middle of the pack in terms of operators in the NEM and Ergon near or at the bottom. These findings are consistent with two reports initiated by the Queensland Government over the recent period. The 2013 report of the Independent Review Panel (IRP) made a number of recommendations for reform of the businesses, and estimated that $3.6 billion in opex and capex could be saved in the 2010-15 regulatory period, as well as a further $1.4 billion in indirect opex and capex costs in the subsequent period.[25] This is significantly more than the $150 million in benefits Ergon says it has generated since 2005 under its 'get fit' efficiency drive.[26] The ENCAP Review in 2011 also found significant scope for savings in implementing new reliability standards, citing efficiencies in the order of $5 billion (for both opex and capex across the 2010-15 and 2015-20 period.[27]

Replacement capex

We also ask the AER to carefully scrutinise the businesses claims for replacement capital. While Ergon's repex level remains similar to the previous period at approximately 45% of their capital proposal, Energex has proposed a significant increase (approximately 66%) in repex in this regulatory period. The businesses have not provided a compelling case for this expenditure, and some of the justifications they point to can be contradicted. For example, both refer to the need to replace ageing assets, yet there is evidence that the average age of assets has been reducing. Representatives of the Consumer Challenge Panel (CCP) have also pointed out that system utilisation has been reducing over time for both Energex and Ergon and that the justification for high levels of replacement expenditure is weak given both these trends.[28]

Energex argues that some strain was taken off in the previous period due to the large augmentation program, and it also notes that some replacements occurred in the previous period under augmentation program. In our view this does not support the large increases in repex being proposed. We would expect to see the benefits of improved asset performance flowing from the large augex and repex expenditure of the previous period being translated to savings in the current period. We would also expect to see corresponding reduced levels of expenditure for maintenance in their opex proposals, but this is also not the case.

TEC would also question whether all ageing assets need to be replaced, and whether the businesses are considering non-network options that may now be available. We ask that the AER looks for evidence of this in the proposals, and note that replacement assets are not subject to the scrutiny of the RIT-D as augmentation assets are. Given that repex is likely to be the best way for DBs to continue to grow their

[24] Queensland Department of Energy and Water Supply, Performance against minimum service standards (MSS) by Energex and Ergon Energy for the 2013-14 financial year, at https://www.dews.qld.gov.au/__data/assets/pdf_file/0004/222565/performance-mss-energex-ergon-energy-2013-2014.pdf, accessed 25 January.

[25] Independent Revew Panel on Network Costs (IRP), Electricity Network Costs Review – Final Report, at https://www.dews.qld.gov.au/__data/assets/pdf_file/0010/78544/irp-final-report.pdf, accessed 25 January.

[26] Ergon energy, Operational expenditure workshop slides, 18 Sept 2014

[27] Electricity Network Capital Program Review 2011, Detailed report of the Independent Panel, at https://www.business.qld.gov.au/__data/assets/pdf_file/0018/9117/ENCAP_Review_Final_Report_3_new.pdf, accessed 25 January.

[28] Bev Hughson, Getting Ready! Potential issues for consumers, Slide Presentation, Slide 10, AER forum, 8 August 2014.

RABs, particular attention should be given to adding a RIT-D or some other type of test to ensure that the repex level is efficient including the use of non-network approaches to reduce total costs.

PV related capex

TEC acknowledges Ergon's initiative in seeking to respond to the high uptake of household and business PV systems in rural Queensland, as reflected in the document 'Distribution Network Impacts of Photovoltaic Connections to 2020.' We accept that high PV penetrations will lead to technical issues for Ergon, which it says will require a range of solutions likely to cost in the range of "$39.2 million to $90.1 million of capital expenditure, exclusive of operational expenditure of $13.0 million for implementing… voltage management" .[29]

TEC does not have the technical expertise to analyse Ergon's assessment of the network impacts and the best ways to respond to them. However, we have some doubts about other aspects of this document, as follows:

1. It is not clear why Ergon is anticipating cumulative impacts from greater PV penetration of its network to 2020 when it has effectively prevented PV systems up to 30 kW from exporting to the grid. Where will the additional impacts come from in this case? If they are the result of ongoing export to the grid of energy from past PV connections, why will they escalate out to 2020?
2. While noting in passing its potential, Ergon does not appear to have modelled and developed a strategic response for the likely equivalently disruptive impact of affordable distributed storage in 2015-20. As well as affecting Ergon's overall ability to recover a fixed amount of revenue from lower energy volumes, this could nullify the technical impacts of higher PV penetration, since there will be less PV available for export to the grid during the middle of the day, and less import from the grid during the evening and early morning peaks.
3. TEC sees little evidence to support the assertion that 'the size of the new systems is expected to decrease significantly, and with increased penetration of non-exporting installations it is expected that they will be sized closer to actual consumption. Based on commercial modelling by Energeia, the expectation is that this size will reduce to between 2.0-2.5kW per household. Ergon Energy has adopted a long-term model for new connections of 2.0kW.'[30] This ignores both the general increase in system size in recent years across Australia (currently ~4 kW) as a reflection of falling system costs, and the opportunities offered by affordable distributed storage to generate, store and consume energy behind the meter using large systems to supply most household load. For instance, *RenewEconomy* reported on 11 November that new data from Energex revealed that

   > …an increasing number of homes – 74,000, or 6 per cent of all residences, are not getting [the 44c feed-in] tariff, so have an incentive to "self consume" to offset the cost of grid power. A total of 24GWh was "self consumed" during the month. Interestingly, according to the Energex data, these homes tend to have larger systems, averaging around 4kW. That will probably give homes an incentive to install battery storage to maximize their self consumption.[31]

   In other words, the absence of generous FiTs may lead to larger systems, not smaller ones, as households seek to cover most of their load by self-generating.

4. Ergon treats PV solely as a cost burden and does not appear to have considered the positive impacts of PV on the network. While estimates vary considerably, the most conservative estimates (eg Nera's 2014 modelling for the AEMC) suggest that at least 10% of PV output is available during evening peak

[29] Ergon Energy, *Distribution Network Impacts of Photovoltaic Connections to 2020*, p7

[30] ibid, p 13.

[31] http://reneweconomy.com.au/2014/rooftop-solar-now-13-residential-demand-s-e-qld-83078.

periods. Higher PV penetration therefore has the potential to reduce the main driver of new network investment, especially in locations where the network is constrained.

TEC therefore considers that Ergon's request for $41 million of capex to manage further uptake of PV would be justified if certain conditions are met. Primarily, Ergon should guarantee to remove the current ban on automatic connections without equipment to prevent export to the grid for PV systems up to 30 kW. In addition, this cost should be shown to be justified in view of the positive impacts of PV on the network.

Due to time constraints and difficulty in extracting similar relevant expenditure, we have not been able to critique Energex's claims for PV related capex in a similar way. However the same issues are likely to be relevant to the Energex network and its treatment of PV.

Operating expenditure

Ergon and Energex have submitted opex proposals that involve a reduction in expenditure on the actual spend in the previous 5-year period. However, these reductions are relatively small, particularly when adjusted for metering costs. Ergon's reduction is the smaller of the two. Ergon proposes to spend $1.9 billion over the 5-year period in contrast to $1.7 billion for Energex. If approved this would be the first time Ergon's opex exceeded Energex's.

TEC would expect to see a more significant reduction in opex being proposed by the businesses for the 2015-20 regulatory period, and we question whether the operational costs proposed by the businesses reflect the costs of a prudent and efficient operator. While we note that operational costs did not peak in quite the same way as capex in the last regulatory period, expenditure in that period was nonetheless higher than in any preceding regulatory period, and therefore could be taken as an exception rather than a base for a step change in costs. As already noted, during this regulatory period the Queensland government initiated two separate reviews of the distribution businesses and their costs, and both found inefficiencies and the capacity for operational and capital expenditure savings.

The AER's benchmarking report has also established that Energex and Ergon do not benchmark well when compared to more efficient Victorian and South Australian DBs. Ergon in particular performs very poorly with the highest average operating cost per customer compared to customer density over 2009-13, and only some improvements towards the end of the period moving it from last place in the NEM in terms of partial factor productivity.[32]

Both Ergon and Energex propose to use 2012-13 as the base year for establishing their operational costs in the current period. We note that while costs across the period were relatively flat, the businesses have picked a base year that reflects the highest level of expenditure of the period. Ergon's expenditure in particular spiked during 2011 and 2012, most likely due to the impacts of Cyclone Yasi which Ergon notes as having had a significant impact on their opex.[33] Although not spiking in the base year, Energex also overspent its opex allowance by $130.5 million in the previous period, claiming this is due to underestimating the feed in tariff, and responding to one-off events such as the 2011 floods, Cyclone Oswald, and restructuring costs.[34]

All of the evidence above suggests that opex in the previous period was above efficient levels, and therefore TEC would ask the AER to reduce the base amount on which the businesses are forecasting their opex, to reflect efficient costs. We also note that there may be one-off costs relating to some of the

[32] Australian Energy Regulator, Annual distribution benchmarking report, November 2014.
[33] Ergon, RP, p 69.
[34] Energex RP Overview, p32.

network efficiency measures that were introduced during the 2010-15 regulatory period, such as those associated with large reductions in workforce for both businesses, and that these should be removed from the base year. Not only were these costs one-off, they will result in savings in the future period that would not have been observed over the full previous regulatory period.

TEC would also ask the AER to scrutinise some of the specific opex costs that appear to have significantly increased in this period, or for which no compelling case has been made. In particular, the high levels of planned maintenance that is being proposed by both businesses concern us. Planned maintenance accounts for 47% of Energex's and 73% of Ergon's operational expenditure. Energex is forecasting a rise in costs for maintenance from $329.5 million in the previous period to $397.2 million in the upcoming period. This increase in maintenance was also a feature of the recent NSW proposals, where the AER's assessment was that the proposed expenditure levels would result in over servicing. TEC notes the relatively young age of Energex and Ergon's network assets, the extended pole life being achieved as well as recent improvements in meeting service standards, as evidence that existing levels of maintenance are more than adequate.

Revenue, prices and rate of return

TEC notes that while the overall allowances for capex and opex proposed by the businesses have been reduced from the previous period, if approved both the total revenues and the RABs of the DBs will continue to grow over the next regulatory period. While much is made of the fact that the resulting increased costs to consumers will be no greater than the Consumer Price Index (CPI), TEC does not consider that this fact in itself justifies the proposed revenues. As with the capex and opex levels, the approved revenues in the previous regulatory period were severely out of kilter with earlier periods, and should not be regarded as the base for future expenditure. We support the arguments put forward by the CCP in its submission on the proposals in NSW, that network tariffs should in fact be lower in the future. We are very pleased that the AER's draft decisions relating to NSW DBs, if affirmed, will result in price reductions for consumers. We seek the same level of scrutiny of the various building block components to ensure a similar outcome for Queensland consumers.

TEC is not in a position to specifically examine the proposals relating the rate of return, however we are aware that Energex and Ergon have sought a rate of return of 7.75% and 8.02% respectively and, in coming to these positions deviate from the approach outlined in the AER rate of return guideline. These guidelines have been developed as part of the Better Regulation Program that involved considerable consultation with industry and consumers. Given the transparent, consultative and detailed approach which has been taken toward the development of these guidelines, we believe the threshold to justify a departure must be placed very high. We observe that the AER was not willing to accept the businesses' departure from the existing guideline in making the NSW draft determinations, and we would expect a similar approach in relation to the Queensland DBs.

However, we are also persuaded by the arguments presented by the CCP and others that the existing guideline may in fact be too generous, and believe that AER should not be bound by the existing guideline if it does not serve the long-term interests of consumers. TEC believes that the AER would be justified in departing from the guideline in view of the significant number of submissions from consumer representatives providing evidence in support of amendment. In particular, we agree with the advice provided by the CCP that real world data about profitability and actual costs of borrowing should and could be considered.[35] Given the impact that a single percentage point can have on the overall revenues

[35] Consumer Challenge Panel, *Smelling the roses and escaping the rabbit holes: the value of looking at the actual outcomes in deciding WACC*. July 2014.

recovered by the businesses, it is critical that the rate reflect the real costs of debt and equity experienced by the businesses, and not a hypothetical model.

We also find it concerning that the AER's rate of return seems to be higher than the rates allowed in similar circumstance by State regulators, and considerably higher again than the rates applied in international jurisdictions including New Zealand and the UK.[36] We believe the AER should explain in detail why something comparable is not an appropriate rate of return for businesses in the Australian context. TEC asks the AER to revise and reapply the guidelines or at least adopt the lower end rather than the higher end of the ranges provided for the various parameters within the existing guideline.

Consumer engagement

TEC acknowledges that the consumer engagement by the Queensland DBs represents a marked improvement on practices of the past. The businesses' engagment approach involved two key strategies:

- Market research and surveys of customers views and priorities around issues of price and reliability.
- Engagement with consumer representatives on aspects of the regulatory proposals.

TEC has not assessed the first of these strategies at a level where we could make meaningful comment. However, TEC did participate in a number of workshops and information sessions held by both businesses through August – October 2014. We felt the businesses did a very good job of this engagement on a number of levels. While the the information presented sometimes fell short of stakeholder expectations, both businesses made strong efforts to follow up with reponses and details that were requested. The representatives of the businesses that attended the workshops were generally the most appropriate people to answer the questions asked and to engage in what was often robust discussion and critique of the material presented. They did so with a considerable degree of openness rather than defensiveness, and for the most part negotiated the technical complexities and varying levels of stakeholder expertise well. Energex in particular was willing to adapt the length of the sessions and add additional sessions or hold follow up meetings where requested by stakeholders.

However, in the process of engagement with stakeholders both businesses openly acknowledged that the purpose was to provide information in advance of the submission of regulatory proposals to the AER in order to assist stakeholders with their own submissions, rather than to give stakeholders an opportunity for input into the process. In order to have sought input both businesses would have needed to commence their engagement at a much earlier stage in the process. It is disappointing that it took the businesses so long to respond to the AER's Consumer Engagement Guideline[37] (which was finalised almost a year earlier), and that when they did respond they were not able to follow the guideline. Looking forward, we note that both businesses have commenced engagement on the tariff reform process, and that we would expect to see consumer input reflected in the tariff statements due to be submitted to the AER in November 2015. We also look forward to the businesses continuing to improve their engagement processes and providing a far greater opportunity for input into their 2020-25 revenue proposals.

[36] ibid.

[37] AER, Consumer Engagement Guideline, November 2013.

Recommendations

1. The AER should proactively engage in the DMEGCIS rule change process, and immediately following its finalisation should amend the Ergon and Energex determinations to apply the scheme to the remainder of the next regulatory period in order to maximize the incentives to undertake DM. A new DMEGCIS should include:
   - Annual Reporting
   - Voluntary Performance targets
   - Incentives for exceeding targets
2. The AER should develop a guideline, along the lines of the Consumer Engagement Guideline and separate to the DMEGIS, on how expenditure factor 10 (consideration of non network options) in Clause 6.5.7(e)(10) of the NER will be considered by the AER in regulatory determinations. The guideline would provide guidance on both DM and capex plans in the regulatory determination process.
3. In the interim, the AER should give network businesses a greater indication of how they could design and present effective DM strategies. This advice should go well beyond the narrow interpretation of the DMEGCIS to cover targets, outcomes and performance metrics, and project details. This could be achieved through appropriate commentary in issues papers and draft determinations.
4. The AER should 'ground-truth' its capex benchmarking by doing a 'bottom up' analysis of some planned augex and repex projects, to determine whether networks have adequately considered non-network options.
5. The AER should subsitute lower allowances than proposed for the Queensland DB's augmentation and replacement capex in view of evidence regarding demand trends, asset age, network utilisation, effiency benchmarks, and reliability standards.
6. The AER should subsitute a lower amount for the base year on which the businesses opex proposals are established, in view of evidence that these do not reflect efficient costs.
7. The AER should consider the views and evidence put to it by the Consumer Challenge Panel that the current rates of return guidelines are too generous, and revise the guidelines accordingly. Failing this, we ask the AER to adopt the lower end rather than the higher end of the ranges provided for the various parameters within the existing guideline.

Yours sincerely,

Jeff Angel
Executive Director