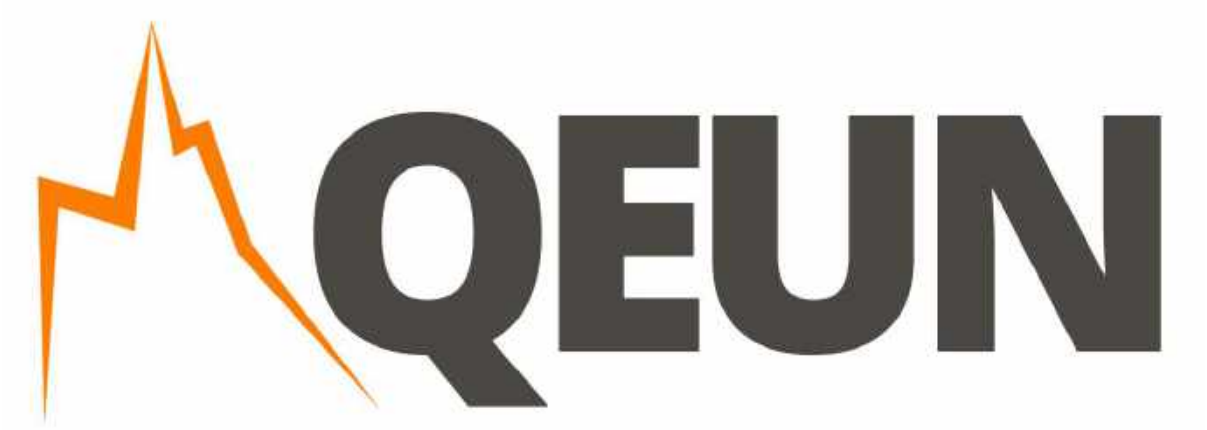

QUEENSLAND ELECTRICITY USERS NETWORK

"Advocating for affordable and reliable electricity in Queensland"

Submission
Community Consultation
The Australian Competition Tribunal
on
File Numbers 3-8 of 2016

10 November2016

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DISCLAIMER

"This project was funded by Energy Consumers Australia (www.energyconsumersaustralia.com.au) as part of its grants process for consumer advocacy projects and research projects for the benefit of consumers of electricity and natural gas.

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

Australian Competition Tribunal: File Number ACT 3-8 of 2016

The Queensland Electricity Users Network welcomes the opportunity to comment on the Australian Competition Tribunal's 3-8 of 2016.

The National Electricity Objective and the National Electricity Rules apply to all electricity consumers throughout the National Electricity Market (NEM).

The Queensland section of the national grid supplies electricity to Queensland consumers. The changing generation mix will cause Queensland consumers to be more reliant on interstate generation attached to interstate sections of the national transmission and distribution network/grid.

It is therefore critical that each section of the national transmission and distribution grid is operating prudently and efficiently and can supply affordable and reliable electricity to consumers located both intrastate and interstate.

The black system event in South Australia on 28 September 2016 highlighted the interconnectivity of electricity supply and the financial and lifestyle hardships caused to business and residential consumers when a section of the national grid is disconnected.

About the Queensland Electricity Users Network

The Queensland Electricity Users Network (QEUN) is supported by peak regional industry organisations and councils in Far North Queensland.

The QEUN was previously known as the Far North Queensland Electricity Users Network. The name change was necessary to enable consumers, particularly residential and small business consumers located in regional Queensland, to have a united voice to express their belief that electricity prices have reached unsustainable levels and must be reduced for all Queensland consumers.

The 18 organisations involved with the QEUN cover a range of industries including agriculture, tourism, construction, mining, retail and manufacturing, as well as councils and independent retirees (see Appendix 1).

The Queensland Electricity Users Network (QEUN) actively participated in the Ergon Energy 2015-2020 Determination. The QEUN did not agree with the final decision of the Australian Energy Regulator, primarily on the grounds that the decision did not act in the long term interests of consumers with respect to the price of electricity.

The end result of two years of active engagement by the QEUN with the Australian Energy Regulator and Ergon Energy was a financial saving to regional consumers' equivalent to the cost of 3 slices of bread a week.

The QEUN did not challenge the 2015-2020 Determination for Ergon Energy as the QEUN had neither the human nor financial resources to challenge the decision at the Australian Competition Tribunal. This is despite the fact that distribution charges account for 42 % of a typical residential bill in Queensland compared to 34 % in Victoria.

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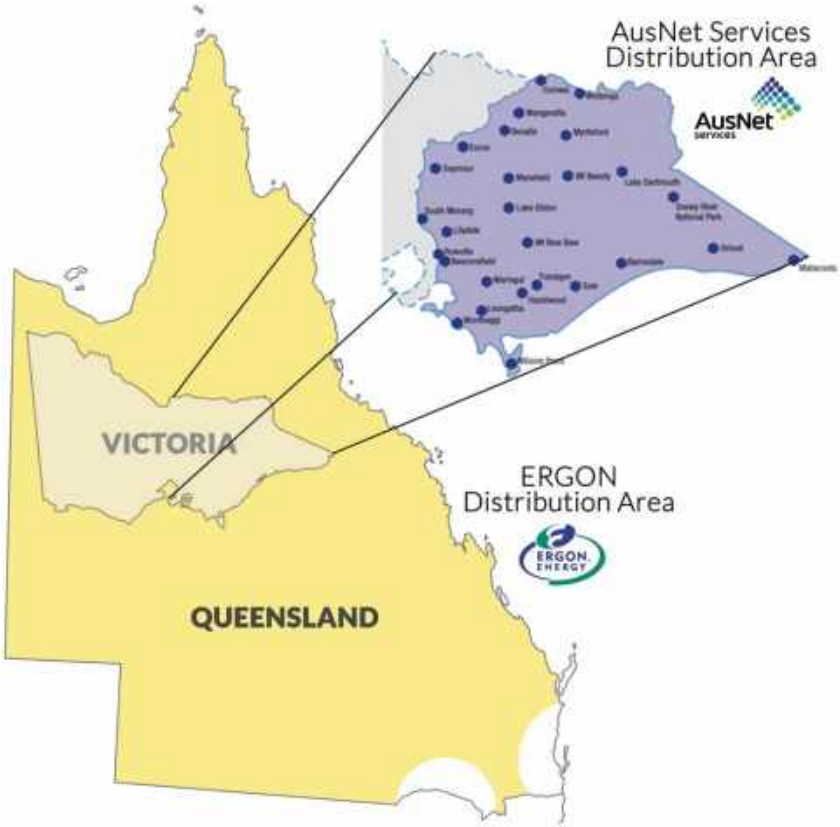
The similarities between AusNet Services and Ergon Energy

Ergon Energy and AusNet Services both provide distribution network services to customers located in rural and regional Australia. The costs and risks associated with a regional network business are not the same as those experienced by a high density urban network business.

AusNet Services has 680,000 customers in an area covering about half the geographic area of Victoria. Ergon Energy has 725,000 customers in an area covering 97 percent of the geographic area of Queensland.



	AusNet Services	Ergon Energy
Customers	680,000	725,000
Power poles	370,000	1,000,000
Power lines	50,000 km	160,000 km
Area	80,000km^2	1,000,000 km^2
Regulatory Asset Base	$3,442 m	$9,873 m
Operating Expenditure - 2015/16 to 2020 - 5 years	$1,169 m	$1,758 m
Allowed revenue - 2015/16 to 2020 – 5 years	$3,130 m	$6,295 m
Proposed Parametric Insurance		$66 m
Proposed Poles & Wires plus Fire Insurance	$16.6 m	
Distribution charges as % of typical residential bill	34%	42%

Self-insurance versus an insurance policy premium

AusNet Services and Ergon Energy both take steps to mitigate the risk posed from natural disasters. Their operational expenditure (opex) should reflect an ability to restore electricity supply in a timely and cost effective manner to the damaged section of their distribution network whilst maintaining a work program for the undamaged section.

Historically the two regional network businesses have faced risks from different types of natural disasters; for AusNet the risk is bushfires and for Ergon the risk is cyclones.

Self-insurance refers to the practice of insuring one's own interests by maintaining a fund to cover possible losses, rather than by purchasing an insurance policy.

Pursuant to NER 6.4.3 (a)(7), a distribution network service provider's operational expenditure (opex) is one building block that forms part of its annual revenue requirement.

AusNet Services submitted that self-insurance costs should be accorded the same treatment for opex purposes as the costs of an insurance premium and that the Australian Energy Regulator is in error for basing its analysis on self-insurance losses rather than self-insurance costs.

The QEUN maintains that an insurance premium provides assurance to consumers that the network business does have the capacity to restore the network in a timely manner following a natural disaster. This minimises the financial and lifestyle hardship caused to consumers connected to that section of the national grid and to other parts of the national grid remote to the damaged section. The ability to self- insure is dependent on the profitability of the network business and the dividends declared to shareholders. Self- insurance can only provide assurance of timely restoration if the network business has a locked reserve for natural disasters.

If the request by AusNet Services for an additional $8.46 million to cover self-insurance was granted, the opex for AusNet Services and consequently its allowed revenue cap would rise by $8.46 million. The Australian Energy Regulator has informed the QEUN that the allowed revenue cap of a distribution network business can be spent as it sees fit. Consequently, the $8.46 million could be provided to shareholders as a dividend and AusNet Services could request a positive pass through if the cost of a bush fire exceeded 1% of AusNet's annual allowed revenue.

As consumers throughout the NEM vehemently believe that electricity prices are already at unsustainable levels, any further increase in power bills would further exacerbate the trend of consumers accessing hardship programs (see Table 1) and would cause bill shock.

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Table 1: Hardship program uptake by small residential customers in Queensland

Period	Participating in a hardship program (#)	% in a hardship program in Ergon area
March Quarter 2016	15832	
- Ergon only	4970	31.39%
Dec Quarter 2015	14245	
- Ergon only	4547	31.92%
Sept Quarter 2015	14779	
- Ergon only	4943	33.45%
June Quarter 2015	15003	
- Ergon only	5515	36.76%
March Quarter 2015	14438	
- Ergon only	5087	35.23%
Dec Quarter 2014	12757	
- Ergon only	3603	28.24%
Sept Quarter 2014	11422	
- Ergon only	3242	28.38%
June Quarter 2014	9402	
- Ergon only	3209	34.13%
March Quarter 2014	8633	
- Ergon only	2938	34.03%
Dec Quarter 2013	7104	
- Ergon only	2461	34.64%
Sept Quarter 2013	8497	
- Ergon only	2998	35.28%
Dec Quarter 2012	8950	
- Ergon only	5184	57.92%
Sept Quarter 2012	8653	
- Ergon only	5293	61.17%
Dec Quarter 2011	7512	
- Ergon only	4580	60.97%
Sept Quarter 2011	7309	
- Ergon only	4454	60.94%
Dec Quarter 2010	5311	
- Ergon only	2659	50.07%
Sept Quarter 2010	4932	
- Ergon only	2367	47.99%

Source: Compiled from statistics collected by the Queensland Competition Authority and the AER

Ergon Energy and parametric insurance

Ergon Energy submitted as part of its 2015-2020 regulatory proposal the inclusion in its opex of a $66 million parametric insurance policy for cyclones. The Australian Energy Regulator did not allow Ergon Energy to include parametric insurance as part of its opex citing that Ergon Energy had the ability to self- insure.

In the past Ergon Energy has self insured some cyclone events.

On 1st June 2011 Ergon Energy requested an extension of time within which to submit a written statement in accordance with clause 6.6.1 (c) of the National Electricity Rules seeking the Australian Energy Regulator's approval of a positive pass through amount following the occurrence of Severe Tropical Cyclone Yasi (STC Yasi).

In the same letter it also noted that on 30 May 2011, in accordance with the Government Owned Corporations Act 1993 (GOC Act), Ergon Energy's shareholders had issued a written notice to Ergon Energy indicating that a direction under section 115 of the GOC Act may be issued to Ergon Energy to require it to not make such a pass through application due to the exceptional circumstances and impacts of cyclones and other natural disasters affecting Queensland over the course of 2010-11.

STC Yasi crossed the Queensland coast between Cardwell and Tully on 3 Feb 2011 as a Category 5 cyclone.

The impact extended from Cooktown in the north to Sarina in the south (a 785 km stretch of coastline) and west to the Northern Territory border. STC Yasi's cyclonic winds and heavy rain and the consequent flying debris and vegetation, tidal surges and flooding led to widespread destruction across the Ergon Energy distribution network. A total of 226,967 customers in the impacted area were directly affected by STC Yasi.

Ergon Energy initially informed the Australian Energy Regulator that STC Yasi would materially increase Ergon Energy's costs of providing distribution services and would likely meet the requirements of a general pass through event as defined in clause 15.5.2 of its 2010-11 to 2014-15 regulatory control period. The initial preliminary cost was estimated at $40 million. The final cost was $100 million but Ergon Energy did not request a pass through.

Ergon Energy has also been affected by Cyclone Larry in 2006 and Cyclone Marcia in 2015. Ergon Energy sought and received a pass through of $43 million for Cyclone Larry. This means Ergon Energy self-insured for Cyclone Yasi ($100 million in 2011) and Cyclone Marcia ($32 million in 2015). Over 10 years from 2005-6 to 2014-15 cyclones in the Ergon Energy distribution network area have cost $175 million or $17.5 million per year compared to a parametric insurance policy rejected by the AER for $13 million per year.

The Queensland coast was hit by three category 5 cyclones in 2014-15. As per Ergon Energy's Asset Renewal submission to the Australian Energy Regulator's Preliminary 2015-2020 Determination "*It was fortuitous that these cyclones made landfall and weakened considerably before impacting major quantities of Ergon Energy infrastructure*."

In the same year i.e. 2014-15, the Queensland Government extracted a dividend of $1.925 Billion from Ergon Energy which far exceeded the performance target of $473 million. To fund the dividend payment Ergon Energy increased its borrowings.

In 2015-16 the declared dividend from Ergon Energy to the Queensland Government was $476 million.

In both 2014-15 and 2015-16, the dividend exceeded 100 percent of Ergon Energy's Net Profit after Tax and necessitated a drawn down of retained earnings.

Ergon Energy's gearing ratio (debt to fixed assets) has risen significantly to 67.5 percent since the dividend payment of $1.925 billion in 2014-15. This does not reflect the 60/40 split used by the Australian Energy Regulator to calculate the Weighted Average Cost of Capital (see Table 2 and 3). More borrowing costs caused by an adverse change to Ergon Energy's credit rating will, as a result of capped allowed revenue, leave less funds available for operational expenditure, particularly to self-insure for a cyclone event.

The dividend policy in Ergon Energy's 2015-16 Statement of Corporate Intent states that:

"The board will ensure that Ergon Energy's dividend policy also takes into account the return its shareholders expect on their investments. Ergon Energy's policy is to recommend and pay a dividend amount equivalent to 100% (or the percentage approved by shareholding Ministers, if different) of Ergon Energy's adjusted consolidated profit for 2015/16. The Board adopts such a policy on the basis of its shareholders agreeing to provide the necessary funding for projects which have received Board and shareholding Ministers' approval or for the maintenance of Ergon Energy's approved capital structure or for ensuring the operational viability of Ergon Energy. Ergon Energy's Board undertakes to adhere to the dividend policy."

The Australian Energy Regulator has made it clear that the 60/40 split is only a guide and therefore is not enforceable. The AER has also confirmed that once a final decision has been made regarding the capped allowed revenue of a distribution network business, the business can spend the allowed revenue cap as it sees fit.

For the 2015-2020 regulatory period, Ergon Energy is laden with debt and is continuing to experience falling overall consumption and a need to service increasing peak demand from its regional customers. Ergon Energy's ability to self-insure has been severely compromised.

The Bureau of Metrology's Tropical Cyclone Outlook for 2016-17 predicts a near average season which would result in 4 tropical cyclones on the east coast of Australia, with a 58 % chance of more tropical cyclones.

Conclusion

The 100 percent black system event in South Australia in September 2016 has caused consumers to re-evaluate the relative importance of reliability and affordability. It has been a reality check in terms of consumers understanding how reliant they are on the whole national grid operating as one big interconnected electricity supply system.

Due to Queensland's increasing reliance on other sections of the national grid, caused by a change in the generation mix, it is critical that all sections of the national grid can provide

affordable and reliable electricity. This requires all sections of the national grid to have adequate insurance to enable timely restoration after a natural disaster.

The insurance cover needs to be in the form of:

- an insurance policy or
- if self-insured a locked reserve for natural disasters.

Without these safeguards consumers are at risk of network businesses inflating their insurance cover to bolster dividends to shareholders or, network businesses inflicting another rise in power bills due to their successful application to the Australian Energy Regulator for a positive pass through for a natural disaster event such as a bush fire or cyclone.

The safeguards will ensure network businesses are acting in the long term interests of consumers by carrying sufficient insurance to enable the timely restoration of a network following a natural disaster.

Table 2: Ergon Energy Financial Performance Targets

Table 2: Financial Performance Targets							
Quarter 2015/16					2014/15 Budget	2014/15 Est Actual	2015/16 Forecast
Sep	Dec	Mar	Jun				
242.3	294.6	337.4	217.3	EBIT (consolidated)	1,187.4	1,300.7	1,091.6
128.8	155.2	180.5	95.9	Net Profit After Tax (NPAT) – Consolidated ($M)	590.7	693.0	560.4
-	-	-	-	Return on Assets[1] – Consolidated	9.7%	11.3%	9.2%
-	-	-	-	Return on Assets – Regulated	10.7%	11.5%	8.0%
-	-	-	-	Return on Assets – Non-Regulated	16.0%	13.9%	17.2%
-	-	-	-	Return on Assets – Group excluding EEQ	9.1%	9.4%	8.0%
53.0%	71.8%	70.0%	67.5%	Debt to Fixed Assets[2] (%) – Consolidated	48.1%	51.8%	67.5%
74.0%	78.3%	76.5%	79.4%	Debt / (Debt + equity (including reserves)) – (%) Consolidated	57.1%	74.6%	79.4%
-	-	-	-	Fixed Asset Turnover[3] – Consolidated	0.2	0.2	0.2
5.7	5.3	5.4	3.9	Interest Cover[4] (EBITDA Times) - Consolidated	4.7	5.4	5.0

Notes:

1. Return on Assets (%) = [EBIT/Average of opening & closing assets]. (Assets = "Total Assets")
2. Debt to Fixed Assets (%) = Debt/[Net PP&E]
3. Fixed Asset Turnover = [(Sales + grid services revenue)/Average PP&E]
4. Interest Cover (EBITDA Times) = [EBITDA/(Finance Charges]

Source: Ergon Energy Statement of Corporate Intent 2015-16

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Table 3: AER – Ergon Energy distribution determination – 2016-17 return on debt update

Ergon - Cost of Capital Parameters - DNSP PTRM - version 3

Year		2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Inflation Rate	Constant	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Value of Imputation Credits (gamma)	Constant	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%
Proportion of Equity Funding	Constant	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%
Proportion of Debt Funding	Constant	60%	60%	60%	60%	60%	60%	60%	60%	60%	60%
Post-tax Nominal Return on Equity	Constant	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%
Post-tax Real Return on Equity	Constant	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%	4.88%
Corporate Tax Rate	Varying	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%	30.00%
Nominal Pre-tax Return on Debt	Varying	5.01%	5.06%	5.06%	5.06%	5.06%	5.06%	5.06%	5.06%	5.06%	5.06%
Real Pre-tax Return on Debt	Varying	2.45%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
		Formula approximations of WACC									
Nominal Vanilla WACC	**Varying**	**6.01%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**	**6.04%**
Real Vanilla WACC	Varying	3.42%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%
Post-tax Nominal WACC	Varying	5.47%	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%	5.49%
Post-tax Real WACC	Varying	2.89%	2.92%	2.92%	2.92%	2.92%	2.92%	2.92%	2.92%	2.92%	2.92%
Pre-tax Nominal WACC	Varying	6.54%	6.57%	6.57%	6.57%	6.57%	6.57%	6.57%	6.57%	6.57%	6.57%
Pre-tax Real WACC	Varying	3.94%	3.97%	3.97%	3.97%	3.97%	3.97%	3.97%	3.97%	3.97%	3.97%
Nominal Tax Allowance	Varying	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%	1.08%
Real Tax Allowance	Varying	1.05%	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%

Source: Australian Energy Regulator

Appendix 1

The following is a list of organisations involved in the Queensland Electricity Users Network:

1. Cairns Regional Council
2. Tablelands Regional Council
3. Cook Shire Council
4. Far North Queensland Regional Organisation of Councils
5. Advance Cairns
6. Tourism Tropical North Queensland
7. Regional Development Australia FNQ & Torres Strait
8. Cairns Chamber of Commerce
9. Mareeba Chamber of Commerce
10. Atherton Tablelands Chamber of Commerce
11. Innisfail District Chamber of Commerce, Industry and Tourism
12. Urban Development Institute of Australia (Cairns branch)
13. Canegrowers - Tablelands
14. North Queensland Miners Association
15. Australians in Retirement (Cairns branch)
16. Queensland Dairyfarmers Organisation (Northern Division)
17. Mareeba District Fruit and Vegetable Growers Association
18. Mareeba Shire Council