

16 April 2012

Mr Richard Khoe  
Director  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235



positive energy

Dear Mr Khoe

### **Direction Paper - Network Regulation Rule Changes**

Energex welcomes the release of the Australian Energy Market Commission's (AEMC) Directions Paper on the rule change requests from the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (EURCC) and is pleased to make this submission.

The Energy Network Association (ENA), the peak national body representing Australia's electricity and gas network service providers will be making a submission on behalf of its members. As a member of the ENA, Energex endorses the ENA's submission which comprehensively addresses the questions raised in the Directions Paper. To supplement the ENA's submission, Energex would like to submit additional comments on a number of key areas namely:

- Drivers of Price Increases;
- Capex and Opex Allowances;
- Treatment of Shared Assets;
- Rate of return frameworks and Cost of Debt; and
- Regulatory Determination Process.

#### Drivers of Price Increases

Energex appreciates the concerns of our customers in relation to rising electricity prices. In seeking to address the AEMC's question and also explain the reasons for the recent increases in network prices in a constructive and objective way the ENA has commissioned a study of recent regulatory decisions. Analysis undertaken by NERA Economic Consulting, forming part of the ENA submission, concludes the increase in the allowed weighted average cost of capital (WACC) between regulatory periods had the most significant impact on network prices for Energex, contributing 18.9% to the observed 45% increase in weighted average prices. Increases in the forecast capital and operating allowance contributed 8.8% and 2.7% respectively.

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Other factors contributing to the Energex's price increase are:

- In the previous regulatory control period (2004/05 to 2009/10), Energex spent above its capex allowance, primarily to address compliance obligations arising from the Electricity Distribution Service Delivery review and to meet demand growth on its network. This contributed to a higher starting Regulatory Asset Base (RAB) for the current regulatory period;
- The tax allowance component under the Queensland Competition Authority's building block approach was based on actual tax paid, which is substantially lower than the assumed benchmark tax costs adopted by the AER; and
- In the previous regulatory control period (2005/06 to 2009/10), Energex's revenue was reduced to account for over-recoveries, adjustments to asset lives and opex carry forward from the 2001/02 to 2004/05 regulatory control period. These adjustments, totalling \$234 million, understated the efficient costs in the previous regulatory control period. In addition, the 2009/10 revenue included a downward adjustment of approximately \$20.4 million for over recovery in 2007/08 which further understated the starting revenue resulting in a higher  $P_0$ .

The first two points account for the majority of the difference.

#### Capex and Opex Allowances

There are many reasons why a network service provider (NSP), such as Energex, may be required to incur expenditure above its forecasts allowed for under the regulatory determination. These include, changes to reliability standards, previously (at the time of regulatory proposal) unknown, asset condition issues, unexpected growth in peak demand and customer connections. In Energex's view expenditure in excess of a forecast does not necessarily imply that the additional expenditure is inefficient.

In the case of Energex, the capital overspend for the previous two regulatory control periods (2001/02 to 2004/05 and 2005/06 to 2009/10) was primarily driven by the high demand growth in South East Queensland and the introduction of new security and reliability standards.

Under chapter 6/6A of the National Electricity Rules (NER), the AER is able to employ, and has employed, benchmarking in determining both capex and opex allowances for NSPs. However, Energex is concerned with extensive use of benchmarking if there is little regard for individual service providers' circumstances such as jurisdictional obligations (including reliability and security standards), customer density and environmental factors. Benchmarking will only enhance regulatory outcomes to the extent that any analysis is based on accurate data and takes into account NSP individual factors, such that comparisons are made on a like with like basis.

#### Treatment of Shared Assets

Energex believes that the regulatory framework should provide incentives for NSPs to use assets for delivery of other services which earn additional revenue as this supports the National Electricity Objective (NEO).

The mechanism to provide incentives for NSPs to pursue alternative uses should recognise the associated risks and be administratively simple to implement and be consistent with appropriate guiding principles. The guiding principles for allocation compensation arising from sharing of assets between regulated and unregulated services are outlined further in the ENA's submission.

To the extent that assets included in the RAB are used to deliver alternative control services (and the users of the alternative control services are charged for use of these assets), it is appropriate that that network customers should receive some compensation. Under the transitional arrangements for Queensland, a small proportion of assets in the RAB are used to provide alternative control services and a revenue adjustment is recognised in the building block revenue for standard control services for Energex and Ergon Energy.

#### Rate of Return Frameworks and Cost of Debt

Energex recognises the complexity in estimating a forward-looking WACC and believes that the WACC determination framework could benefit from a broader review. On the issue of convergence of WACC frameworks, Energex strongly supports the retention of the persuasive evidence test under chapter 6 of the NER as it provides necessary rigour and accountability, given the substantial financial implications of WACC decisions for NSPs and customers alike (as noted above in the drivers of price increases discussion). The persuasive evidence requirement is symmetrical in nature and provides equivalent safeguards to both NSPs and customers, such that any shift in WACC parameters which results in either a higher or lower WACC outcome needs to be credibly and persuasively demonstrated. Critically, the persuasive evidence test also offers NSPs some level of stability in WACC parameters and overall WACC estimates (than would otherwise be the case), and therefore greater investment certainty in long life infrastructure assets.

Energex considers that there are merits in exploring the adoption of a trailing average approach for the WACC debt parameters (both debt risk premium and risk free rate). Both the ENA and Queensland Treasury Corporation have explored alternative options in their submissions which deserve further and appropriate consideration. Taking account of the complexity and material impact of the matter, Energex supports the ENA's proposition for a separate review process.

Energex strongly supports the AEMC's initial findings that different cost of debt allowances for government owned NSPs and privately owned NSPs would not be appropriate. The case refuting this proposal has been well articulated by many including the AEMC. No commercial advantage exists from being Government owned, with competitive neutrality fees applied to Energex's cost of debt to reflect its standalone credit rating. Furthermore, any such discriminatory treatment will likely create market distortions and have adverse implications for the value of government owned NSPs.

#### Regulatory Determination Process

Energex does not support any extension of the final determination timeline as this has flow-on consequences for the application of network prices for customers and their retailers. Early commencement of the regulatory determination process is seen to be beneficial, providing NSPs with additional time for preparation of revised proposals over the disrupted holiday period of December/January. The benefits of early commencement should be balanced against the challenges of presenting a greater proportion of estimated financial data in the initial regulatory proposal.

Energex supports the AEMC's proposal that there be a mandatory issues paper published by the AER as part of the regulatory process. An issues paper that summarises the key information and identifies key issues will assist and facilitate stakeholder engagement. Energex is also supportive of early and constructive engagement with customer advocacy groups and third party stakeholders as part of the

regulatory determination process, particularly so as not to delay the final determination timing.

Energex looks forward to participating in the consultation process and would be pleased to discuss this matter further. Should you have any enquiries please contact Sue Lee, Manager Regulatory Initiatives on (07) 3664 4055.

Yours sincerely

A handwritten signature in black ink, appearing to read "Kevin Kehl". The signature is written in a cursive, slightly slanted style.

Kevin Kehl  
Executive General Manager Strategy and Regulation