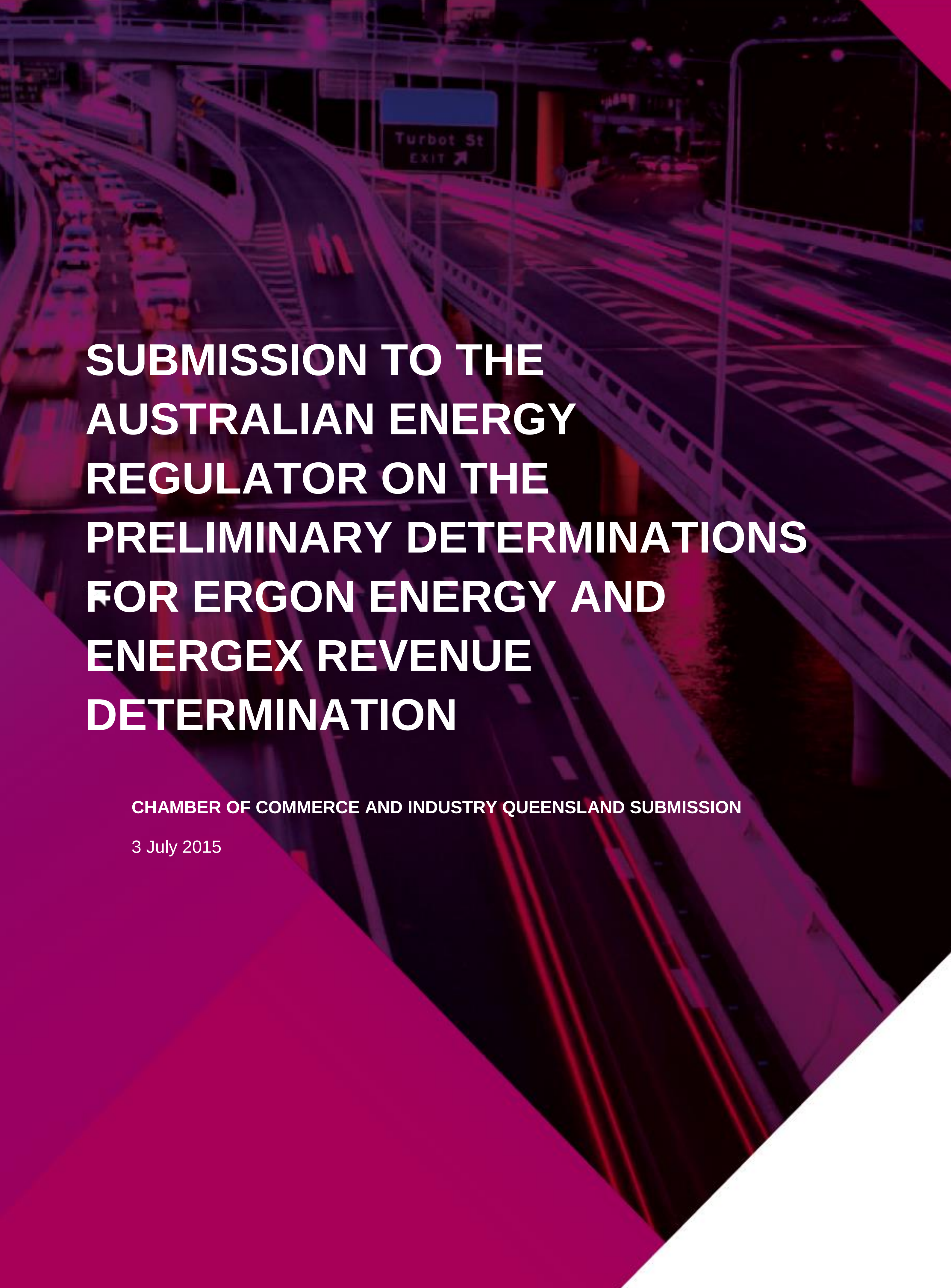


SUBMISSION TO THE AUSTRALIAN ENERGY REGULATOR ON THE PRELIMINARY DETERMINATIONS FOR ERGON ENERGY AND ENERGEX REVENUE DETERMINATION

CHAMBER OF COMMERCE AND INDUSTRY QUEENSLAND SUBMISSION

3 July 2015

1.0 About the Submission

The Chamber of Commerce and Industry Queensland (CCIQ) makes this submission in response to the Australian Energy Regulator's (AER) preliminary decision for Ergon Energy and Energex for the 2015-20 revenue determination.

CCIQ believes that the energy sector must deliver certainty, operational efficiency, strategic future focused planning and investment, service excellence and integrated with energy efficiency policy. Above all it must be conducive to and support business and economic growth in Queensland.

Currently there are a number of drivers that should be resulting in significant downward pressure on prices namely:

- Significantly lower cost of capital requirements;
- The downturn in electricity demand and consumption;
- Less onerous network security and reliability standards;
- Excess system capacity; and
- Reforms driven by the Queensland Government

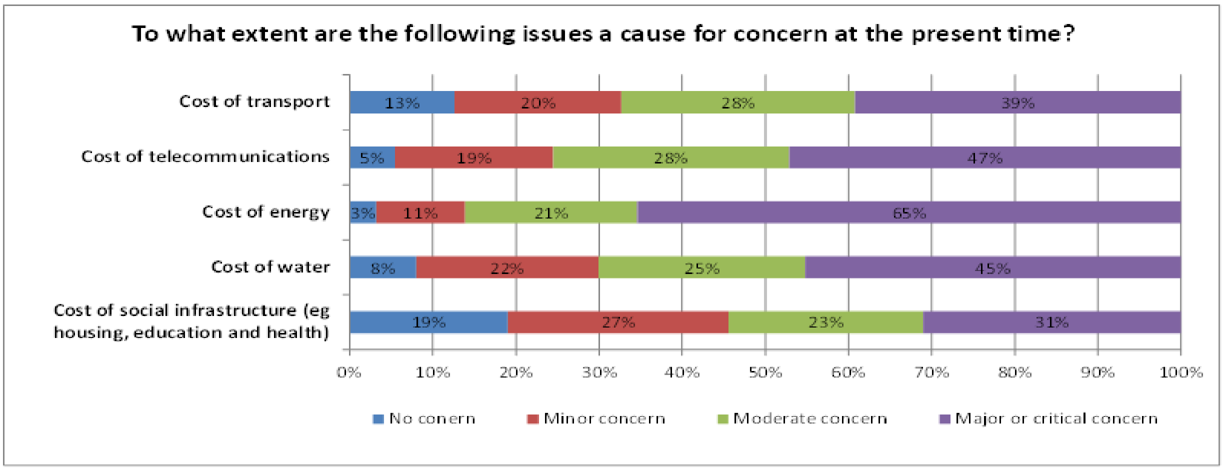
In light of these factors, CCIQ believes further opportunity exists to appropriately reduce the Ergon Energy and Energex revenue allowances, and cease the continuation of excessive network prices.

2.0 Pricing Impacts on Small and Medium Businesses

Queensland small businesses have seen unsustainable increases in electricity prices in recent years. Electricity prices have, on average, doubled for business over the past seven years, which has created an enormous hurdle for businesses trying to remain competitive.

CCIQ recently surveyed more than 1100 small businesses across the state ahead of the Queensland state election to determine key issues. Of those businesses surveyed it was identified that increasing electricity prices is currently the most significant business issue with 65% of Queensland businesses surveyed indicating a major or critical concern with the cost of energy.

Figure 1:



Source: Refer to https://www.cciq.com.au/assets/2015-State-Election/2015-State-election-Super-7-Foldout.pdf

3.0 WACC

The preliminary AER Weighted Average Cost of Capital (WACC) is set at 5.85%. The AER provided that this allowed rate of return is commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the distribution businesses in providing standard control services. CCIQ believe that the WACC applying to both Ergon Energy and Energex is based on conservative estimates.

3.1 Equity Beta

In recent years Energex and Ergon Energy have achieved returns on equity of around 3 -4 times the level that the AER assumed in it's return on equity allowance. These returns are being achieved despite the electricity networks being very low risk businesses as well as Queensland's networks being amongst the least efficient in the National Electricity Market (NEM).

The equity beta has been set at 0.7, which is at the top end of range of estimates of 0.4 to 0.7 for low risk electricity distribution businesses. As CCIQ previously submitted to the AER the assessment of the equity beta is an important factor in determining the overall return on equity. It is widely accepted and acknowledged that Australian utilities face a much more stable business environment than the market as a whole. Network businesses are able to present themselves to investors as providing stable long term regulated cash flows and as regulated monopolies with high barriers to entry.

It was decided during the 2013 Better Regulation process that an equity beta of well below 1 reflects the very low risks of the regulated network businesses compared to the market as a whole. Additionally the AER conducted a number of empirical studies, including the extensive 2009 study undertaken by Professor O Henry which included multiple analyses of Australian utility data returns. The AER concluded from these studies that the range of equity betas derived from the empirical analysis was between 0.4 and 0.7.

Accordingly CCIQ recommends an equity beta of lower than 0.7 be used.

3.2 Return on Debt

CCIQ does not agree with the AER's adoption of the broad BBB+ rating on estimating the return on debt. CCIQ acknowledge that the limitations in the availability of Australian BBB+ data means in practice BBB ratings were used. As a result, the AER has provided significantly higher cost of debt allowances than appropriate. In addition, Energex and Ergon Energy's actual borrowing costs are much lower than the costs implied by their credit ratings.

CCIQ believe that the credit ratings of BBB and BBB+ are both too low for the network businesses given their low cash flow volatility and thus a higher rating should be applied.

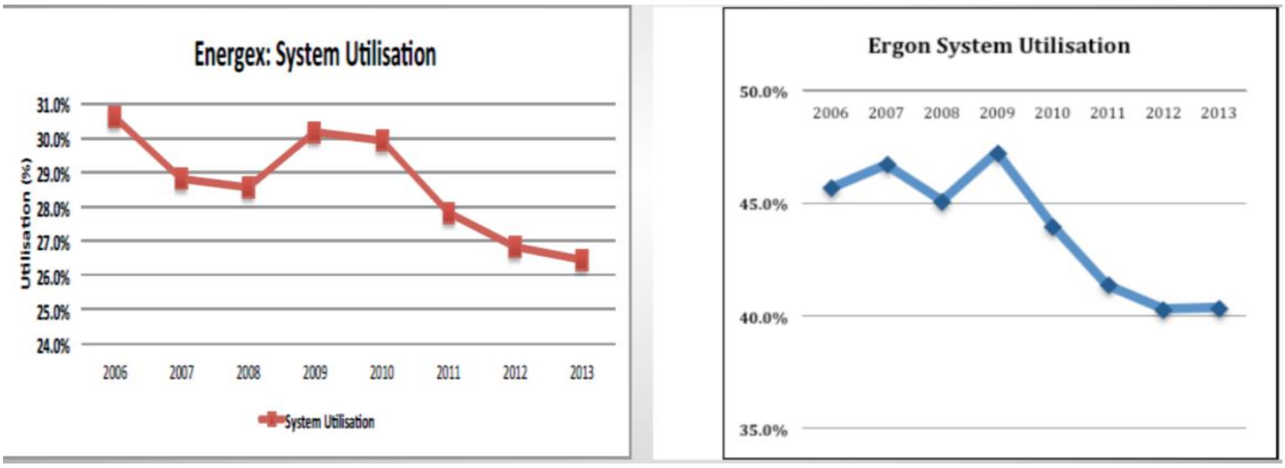
4.0 Capital Expenditure

CCIQ remains concerned about the capex expenditure levels for both Energex and Ergon Energy. The AER cut Energex's overall capex by 27%; and Ergon Energy's by 36%. Most of the reductions were made to the network businesses replacement expenditure (repex) as the AER didn't feel there was a strong enough case to increase it from historical levels. CCIQ commends the AER on the reductions made to the repex, particularly as the repex makes up over half of the capex calculation. The levels of repex proposed by the network businesses were concerning given the average age of assets have been rapidly decreasing since 2006.

However, there are a number of concerns surrounding the augmentation capex forecasts for the network businesses. CCIQ is not satified that adequate reductions have been made to the networks' augmentation capex, particularly when peak demand has been falling since 2010.

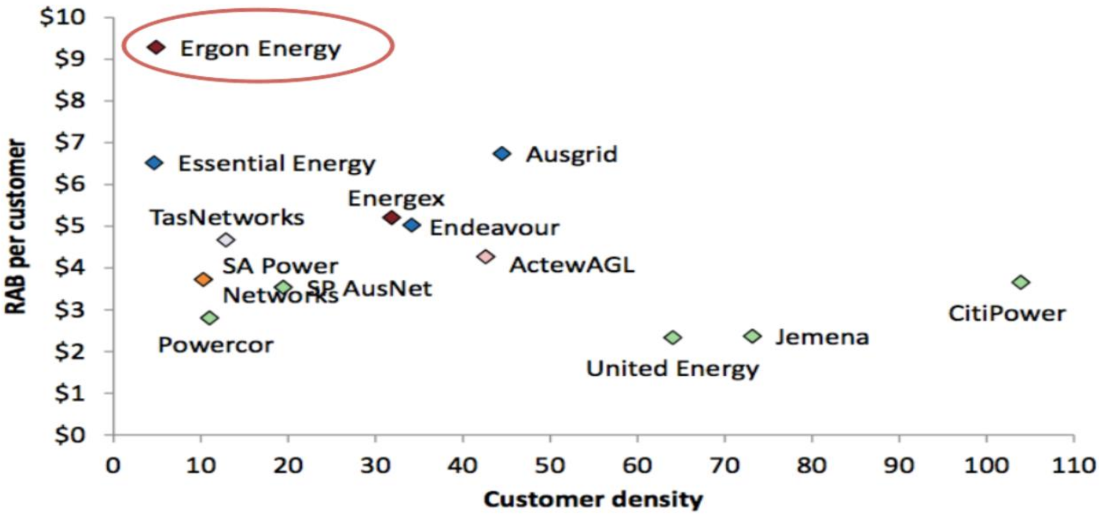
CCIQ urges the AER to take greater consideration of the networks' excess system capacity and declining system utilisation. The networks' major capex programs over the previous decade have produced significant levels of excess capacity on the network. Additionally, there has been exessive captial investment in growth in the regulated asset base (RAB); growth in the RAB per customer, RAB per connection, and RAB per unit of peak demand.

Figure 2: System utilisation



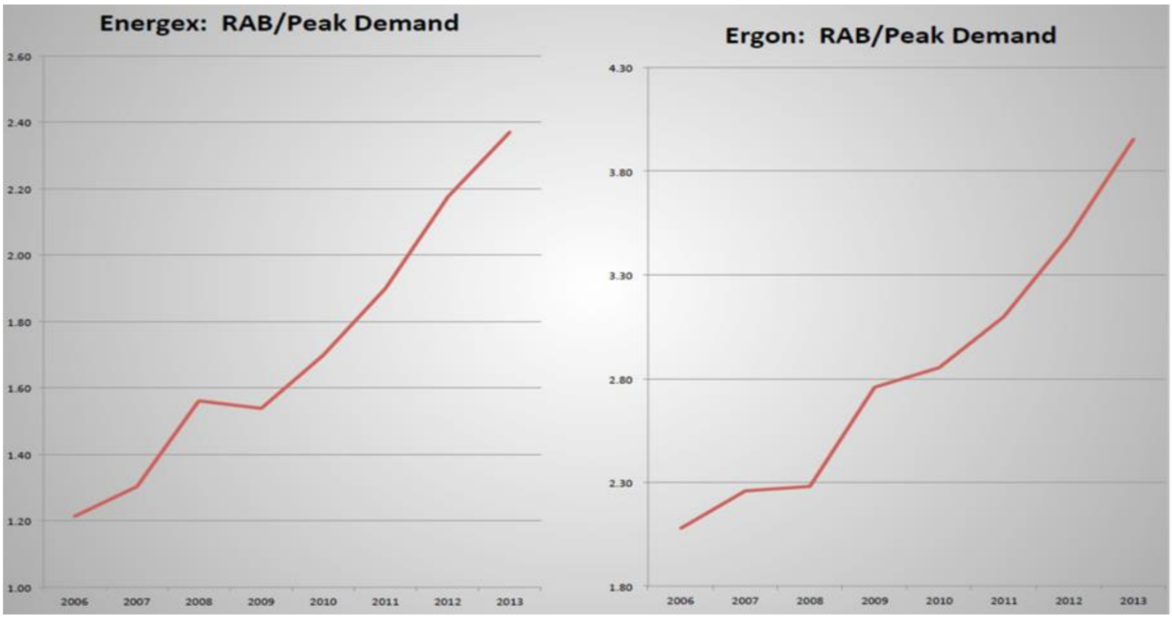
Source: Bev Hughson analysis of Energex and Ergon Energy RINS Data

Figure 3: RAB per customer (000s, $2013-14), against customer density



Source: AER analysis

Figure 4: Excess Network Capacity



Source: Energex and Ergon Energy RINS Data

CCIQ believes the excess capacity will ensure that the networks exceed the requirements of their reliability standards into the future. If these unsustainable trends continue, the networks' RABs will continue to grow into the next period when demand is expected to remain flat or decline.

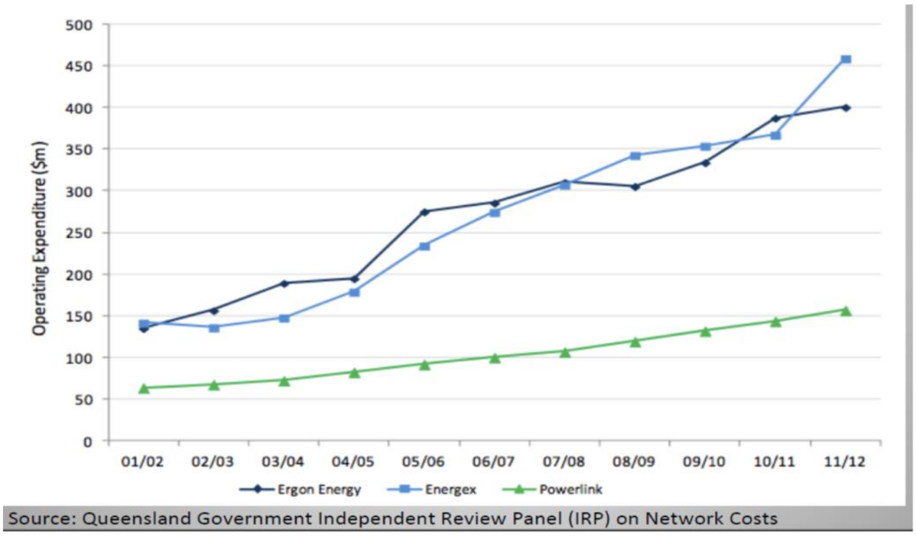
5.0 Operational Expenditure

The AER has applied very conservative adjustments to the determination of efficient operational expenditure (opex) for Energex and Ergon Energy. The AER has proposed a 10% reduction for Ergon Energy and no reduction for Energex.

Excessive opex allowances could lead to a culture of inefficiency and excessive prices. Deloitte Access Economics identified in their report on Queensland Distribution Network Service Providers that Ergon Energy has very high labour costs and employee numbers compared to interstate networks.

Additionally the Queensland Government's Independent Review Panel (IRP) Report revealed that there was a noticeable cultural disregard for cost within the distribution network businesses. The IRP noted that opex has been trending upwards sharply since 2001 as shown in the following graph.

Figure 5: Opex trends



CCIQ urges the AER to take a more efficient approach when determining appropriate opex allowances for Energex and Ergon Energy.

6.0 Demand Management

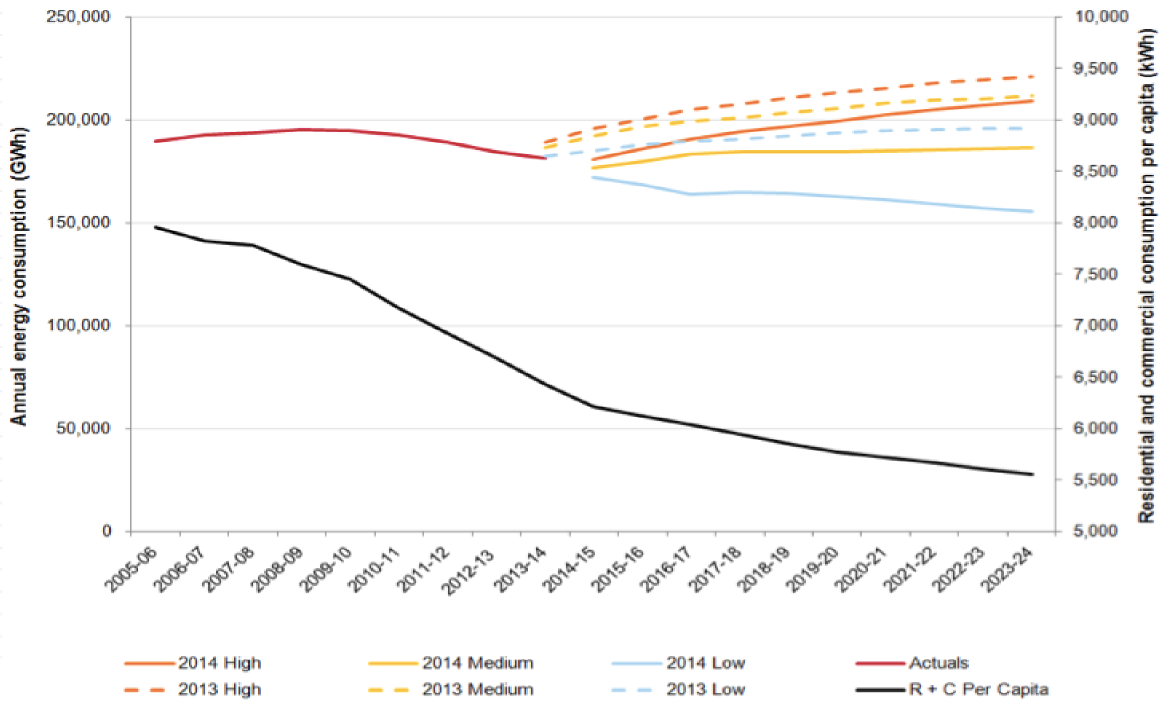
CCIQ encourages the AER to ensure the networks calculate accurate demand forecasting. CCIQ note that the AER preliminary decision accepted Energex and Ergon Energy's demand forecasts. Energex and Ergon Energy forecast rises in demand and peak demand.

However, all credible energy forecasters are predicting that Queensland's recent flat/declining peak demand and consumption trends will continue due to factors such as:

- High electricity bills;
- Increased penetration of renewable energy (solar PV systems);
- Subdued economic growth; and
- Subdued population growth in Queensland.

Historically over-forecasts of demand have resulted in higher revenue allowances and thus higher prices for consumers at present. The AER have indicated their intention to rely on forthcoming AEMO forecasts on demand. CCIQ highlights AEMO and distributors have traditionally over-estimated their forecasts for demand.

Figure 6: AEMO's latest energy forecasts – Annual energy forecasts for the NEM (as at December 2014)



Note: R + C is residential and commercial annual energy consumption.

The IRP provides that where demand is over-estimated, capital programs will be excessive to requirements and accordingly network tariffs to customers will be higher than necessary during the regulatory control period to ensure the network service providers are able to recover the allowable revenue.

7.0 Solar Bonus Scheme

Additionally significant costs have been incurred by distributors in complying with the Queensland Governments Solar Bonus Scheme (SBS). Solar feed-in tariffs under the SBS will continue to be a major cost for small business customers. The costs of the SBS have almost doubled since 2013-14 and were expected to spike in 2015-16.

The impact of the 44c Solar Feed in Tariff (FIT) on Ergon Energy and Energex's revenue prices is significant. Energex FIT recoveries are forecast at $910 million over 2015-20. Ergon Energy's FIT recoveries is forecast at $619 million over 2015-20.

CCIQ notes that the Queensland Government have committed to establishing the Queensland Productivity Commission to investigate fair prices for solar feed-in-tariffs. CCIQ believes the Queensland Government should commit to removing the impost of costs associated with the solar bonus scheme to relieve pressure from consumers subsiding excessive feed-in-tariff rates.

8.0 Conclusion

CCIQ believes that the AER has applied very conservative reductions to the otherwise excessive revenue proposals of both Energex and Ergon Energy. CCIQ believes there is further opportunity for the AER to influence the result of real price savings for Queensland businesses over the next 5 years.

CCIQ expected to see price reductions for the network businesses of around 40% in capex and opex, similar to the preliminary determinations made for the New South Wales businesses. These reductions would continue to deliver significant returns to the networks and achieve better outcomes for consumers in the long term.

Additionally CCIQ urges the AER to work together with the Queensland Government to inform and educate Queensland businesses - as energy consumers – about future energy costs and reforms.