

The Hon. Josh Frydenberg, MP
Minister for the Environment and Energy

Via email: Josh.Frydenberg.MP@aph.gov.au, josh.frydenberg@environment.gov.au

CC: Senator the Hon. Matthew Canavan, Minister for Resources and Northern Australia, Member of the COAG Energy Council

Via email: minister.canavan@industry.gov.au

21st October 2016

Dear Minister

Re: National legislation to ensure network businesses have the capacity to restore the network in a timely manner

Queensland and in particular Far North Queensland, is at risk of the same black system event that occurred in South Australia on 28th September 2016. This risk has been identified by the Australian Energy Market Operator.

The time required and the cost to restore a network is highly dependent on the financial capacity and/or the insurance cover of a network business.

The Bureau of Meteorology'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.

Queensland has one of the most dispersed networks in the world with major generation capacity being located in central Queensland. Cyclones are primarily viewed as a risk for the northern areas of Queensland. However, in February 2015 Cyclone Marcia hit the Queensland coast north of Rockhampton. The risk of a separation event affects not just northern Queensland but also central and southern Queensland. The untimely restoration of the network would impose a significant financial burden on business and the Queensland Government, with substantial hardship and life threatening situations for Queensland residents.

The Queensland Government owned Ergon Energy proposed a \$65.9 million parametric insurance policy for its \$11 billion asset as part of its operational expenditure in its 2015-2020 regulatory proposal to the Australian Energy Regulator. The Australian Energy Regulator refused to include the parametric insurance citing self-insurance was the most efficient option to manage the risk of cyclone damage.

In 2014-15 the Queensland Government declared a dividend from Ergon Energy of \$1.925 Billion which far exceeded the performance target of \$473 million. To fund the dividend payment Ergon Energy increased its borrowings. Ergon Energy's net asset position will reduce to approximately \$1.8 billion to effect the 2014-15 dividend payment.

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."

In 2015-16 the declared dividend from Ergon Energy to the Queensland Government is \$476 million compared to a performance target of \$560 million. The dividend is based on 100 % of Ergon Energy's Net Profit after tax of \$443 million necessitating a further \$33 million to be drawn from retained earnings.

Ergon Energy states that it *“will request equity contributions from its shareholders (the Queensland Government) if this is required to maintain an investment grade credit rating of BBB- to ensure compliance with its lending documentation.”*

Ergon Energy’s gearing ratio (debt to fixed assets) has risen significantly to 67.5 % since the dividend payment of \$1.925 Billion in 2014-15, which included a special dividend payment of \$1.229 million (see Table 1 and 2). This does not reflect the 60/40 split used by the Australian Energy Regulator to calculate the annual Weighted Average Cost of Capital (see Table 3). More borrowing costs caused by an adverse change to Ergon Energy’s credit rating will, as a result of the capped revenue, leave less funds available for operational expenditure, particularly in the event of a cyclone.

If the cost of a cyclone event is more than 1 percent of the annual revenue cap, Ergon Energy can apply to the Australian Energy Regulator for a pass through event. The pass through event increases the retail price for business and residential customers. Retail electricity prices are already at unsustainable levels and consumers cannot absorb any further increases in retail electricity prices.

Network businesses are now operating in a challenging environment of falling revenue and falling demand caused by a network tariff structure that is forcing consumers to reduce their demand for grid supplied electricity (see Figure 1) . The ownership structure of the various sections of the national grid is a mixture of state and private ownership. An intact national grid is increasingly important as states increase their renewable energy generation placing greater reliance on generation outside their jurisdictional areas.

We urgently request that the Federal Government clarify how the national electricity rules ensure network businesses have the financial capacity and/or insurance policies to restore the network in a timely manner and the timeframe specified for a timely restoration of a network following a cyclone or natural disaster.

Yours faithfully

A handwritten signature in blue ink that reads 'J. Brownie'.

Jennifer Brownie
Coordinator

Table 1: 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

Table 2: Ergon Energy Statement of Financial Position

Quarters 2015-16				Statement of Financial Position Ergon Energy Group	Actual 2013-14 \$'000s	SCI 2014-15 \$'000s	Est Actual 2014-15 \$'000s	Budget 2015-16 \$'000s
Sept	Dec	Mar	Jun					
\$'000s	\$'000s	\$'000s	\$'000s					
481,062	471,507	449,735	267,636	Cash & Cash Equivalents	224,420	244,578	323,690	267,636
476,431	680,063	644,963	653,052	Current Receivables	750,495	934,616	525,277	653,052
99,673	98,742	97,460	96,174	Inventories	110,866	103,786	103,641	96,174
52,960	52,960	52,960	52,960	Financial Assets Current	27,679	38,136	52,960	52,960
38,409	38,409	38,409	38,409	Other Current Assets	38,479	43,120	38,409	38,409
1,148,534	1,341,680	1,283,527	1,108,230	CURRENT ASSETS	1,151,939	1,364,236	1,043,977	1,108,230
0	0	0	0	Long Term Receivables	300,619	128,008	0	0
0	0	0	0	Non-Current Inventories	0	2,400	0	0
10,293,906	10,409,982	10,525,141	10,775,334	Property, Plant & Equipment	9,879,543	10,989,487	10,182,578	10,775,334
0	(0)	(0)	(0)	Deferred Tax Equivalent Assets	0	3	0	0
129,094	136,573	143,985	151,332	Intangible Non-Current	76,232	119,537	121,550	151,332
132,580	126,580	120,580	117,580	Superannuation Surplus	79,105	23,300	137,580	117,580
10,555,581	10,673,135	10,789,706	11,044,246	NON-CURRENT ASSETS	10,335,499	11,262,735	10,441,708	11,044,246
11,704,115	12,014,815	12,073,233	12,152,476	ASSETS	11,487,438	12,626,971	11,485,685	12,152,476
347,404	357,284	365,059	341,356	Current Payables	317,342	272,462	333,504	341,356
204,831	428,975	316,720	26,206	Interest Bearing Liabilities Current	275,879	43,026	26,584	26,206
32,296	32,296	32,296	32,296	Financial Liabilities Current	127,009	80,999	32,263	32,296
20,147	22,732	23,986	24,117	Current Provisions	27,782	26,230	28,030	24,117
169,951	172,538	174,781	175,129	Employee Benefits Current	152,600	143,538	163,605	175,129
1,922,040	(0)	(0)	560,385	Dividends	391,609	472,585	1,922,040	560,385
260,381	174,827	199,226	185,539	Other Current Liabilities	50,802	309,699	228,044	185,539
2,957,049	1,188,652	1,112,067	1,345,028	CURRENT LIABILITIES	1,343,023	1,348,539	2,734,070	1,345,028
11,405	12,286	11,769	11,900	Employee Benefits Non-Current	14,625	14,311	11,639	11,900
467	467	467	467	Payables Non-Current	255	1,787	467	467
5,273,418	7,073,418	7,073,418	7,273,418	Interest Bearing Liabilities Non-Current	4,865,457	5,273,409	5,273,418	7,273,418
1,531,112	1,654,265	1,609,397	1,623,571	Deferred Tax Equivalent Liabilities	1,792,569	1,998,243	1,664,516	1,623,571
4,409	4,438	4,485	4,396	Non-Current Provisions	4,512	4,176	4,027	4,396
5,973	5,837	5,702	5,306	Other Non Current Liabilities	6,842	6,362	6,109	5,306
6,826,784	8,750,711	8,705,238	8,919,058	NON-CURRENT LIABILITIES	6,684,260	7,298,288	6,960,176	8,919,057
9,783,833	9,939,363	9,817,305	10,264,086	LIABILITIES	8,027,283	8,646,827	9,694,246	10,264,085
942,393	942,393	942,393	942,393	Share Capital	2,294,582	2,294,582	942,393	942,393
0	0	0	0	Unissued Capital	(1,352,190)	(1,352,190)	0	0
942,393	942,393	942,393	942,393	Contributed Equity	942,392	942,392	942,393	942,393
711,962	711,962	711,962	808,913	Asset Revaluation	1,768,192	2,234,676	711,962	808,913
0	0	0	0	General Reserves	0	0	0	0
40,028	40,028	40,028	40,028	Hedging Reserves	0	0	40,028	40,028
(10,572)	(10,572)	(10,572)	(10,572)	Government Contribution Reserve	(10,572)	(66,056)	(10,572)	(10,572)
741,418	741,418	741,418	838,369	Reserves	1,757,620	2,168,620	741,418	838,369
104,367	104,367	104,367	104,367	Retained Profits	771,698	774,123	1,333,367	104,367
128,843	284,014	464,490	0	Current Year Profit	11,520	118,146	(1,229,000)	0
3,261	3,261	3,261	3,261	Ret Earn DB Super Surplus/Deficit	(23,077)	(23,138)	3,261	3,261
236,471	391,642	572,118	107,628	Retained Earnings	760,141	869,131	107,628	107,628
1,920,282	2,075,453	2,255,929	1,888,390	EQUITY	3,460,153	3,980,143	1,791,439	1,888,390

Source: Ergon Energy Statement of Corporate Intent 2015-16

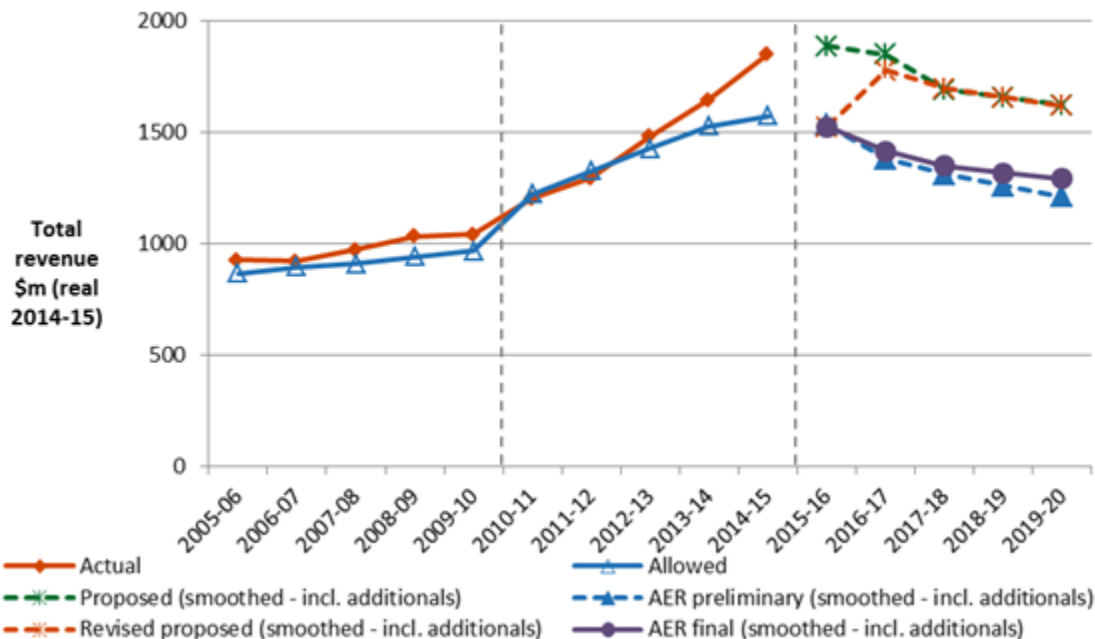
Table 3: AER – Ergon Energy distribution determination – 2016-17 return on debt update

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

Figure 1: Ergon Energy’s past total revenue, proposed total revenue and AER total revenue allowance – including additional (\$ million, 2014-15)



Source: Australian Energy Regulator