



**Electricity Distribution Businesses
Financial Performance for the
Financial Year 2001-02**

August 2003

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1. INTRODUCTION AND SUMMARY

In May 2001, the Queensland Competition Authority published its Final Determination on the Regulation of Electricity Distribution¹. As part of the Final Determination, the Authority required the Queensland Distribution Network Service Providers (DNSPs) to provide annual information on financial performance and service quality. The financial information is required to be submitted in accordance with the Authority's Regulatory Accounting and Information Guidelines and the DNSPs' approved Cost Allocation Guidelines.

This Report provides an assessment of the financial performance of the two Queensland DNSPs for 2001-02, including a comparison with the financial forecasts that were included in the Authority's Final Determination. As this is the first Financial Performance Report, the Authority is unable to make any comparisons with the past financial performance of the DNSPs. The structure and content of the report will evolve as information is accumulated and, over time, the Authority will be able to provide more in-depth commentary and analysis of the information presented.

From a broad perspective, the financial performance of both DNSPs for 2001-02 is reasonably consistent with the outcomes forecast in the Final Determination (see Tables 1 and 2). Importantly, both DNSPs' actual revenue was close to that forecast by the Authority. Consequently, only minor adjustments to the DNSPs' allowable revenue were required in 2003-04 (the 2001-02 data was not available in time for adjustments to be made to 2002-03 allowable revenue).

Table 1: Summary of Energex 2001-02 Financial Performance

	Forecast	Actual	Variance from forecast	
	(\$ mill)	(\$ mill)	(\$ mill)	(%)
Allowable revenue	467.3	468.4	1.1	0.2
Capital contributions	23.3	23.9	0.6	2.6
Operating and maintenance expenditure	161.7	130.2	(31.5)	(19.5)
Capital expenditure	254.3	270.6	16.3	6.4

Table 2: Summary of Ergon Energy 2001-02 Financial Performance

	Forecast ²	Actual	Variance from forecast	
	(\$ mill)	(\$ mill)	(\$ mill)	(%)
Allowable revenue	447.5	443.9	(3.6)	(0.8)
Capital contributions	16.8	16.9	0.1	0.6
Operating and maintenance expenditure	150.9	135.0	(15.9)	(10.5)
Capital expenditure	255.0	235.0	(20.0)	(7.8)

¹ The cost of electricity distribution represents approximately 40 per cent of an average residential customer's final bill, with the remainder consisting of costs associated with generation, high-voltage transmission and retailing of electricity.

² Adjusted where necessary.

As part of the Final Determination, the Authority also approved an efficient level of operating costs and capital expenditure required to deliver prescribed distribution services for each of the DNSPs. While forecasts were provided for each year of the regulatory period, operating and capital expenditure are likely to vary in response to a range of external circumstances which at times will not be foreseen. While it is important to examine deviations from annual forecast expenditure, operating and capital expenditure over the entire regulatory period are likely to be of more interest than that occurring in any particular year.

During 2001-02, both Energex (19.5 per cent) and Ergon Energy (10.5 per cent) underspent on operating costs relative to those forecast in the Final Determination. Energex indicated that the identification of surplus superannuation payments (\$9 million) and the reclassification of pole replacement expenditure (\$8.2 million) explained part of its under-spend on operating expenditure, while the remaining \$14.3 million was claimed to represent an efficiency gain during the year. However, Energex has yet to provide sufficient information to support this interpretation. Ergon Energy indicated that its reduced operating expenditure primarily represented an under-spend on maintenance. This shortfall in maintenance expenditure was expected to be caught up over the remainder of the regulatory period.

Capital expenditure was higher-than-forecast for Energex (\$16.3 million or 6.4 per cent) and lower-than-forecast for Ergon Energy (\$20 million or 7.8 per cent) during the year. In addition, the composition of capital expenditure was somewhat different to that forecast, reflecting both changes to the categorisation of expenditure and revised expenditure plans.

The Authority will be in a better position to comment on the effectiveness or otherwise of operating and capital expenditure once more data is available and the DNSPs' service quality data is introduced in next year's report.

2. GENERAL OPERATING BACKGROUND

Presently, there are two DNSPs operating in Queensland, Energex and Ergon Energy³. Energex was incorporated under the Corporations Law on 1 July 1997 and operates a distribution network that is geographically located in the urban area of South East Queensland. Ergon Energy was created effective 1 July 1999 as a result of the amalgamation of a number of government owned electricity entities and operates a distribution network spread across the remainder of Queensland. Both distribution entities are owned by the Queensland Government and have legally separate but subsidiary retailing operations.

While the retailing subsidiaries of Energex and Ergon Energy were initially given exclusive franchises to retail in specified geographic areas, licences for retailing have been opened up to allow new retailers into the market. At the same time, franchises granting exclusive retailing rights to incumbent retailers have been progressively phased out through the staged introduction of customer contestability.

Currently, all customers with an average consumption of more than 200MWh a year, approximately 7,000 customers, are eligible to become contestable customers.

The contestable customer groups of Energex and Ergon Energy consist of: individually calculated customers (those customers whose electricity consumption is sufficiently large to warrant individually calculated prices); connection asset customers (those customers whose electricity consumption is sufficient to warrant individually calculated connection charges but their remaining charges are averaged); and standard asset customers (customers who pay averaged charges). The non-contestable customer group incorporates all franchise customers (customers who access a franchise price). The number of customers in each category and the corresponding units of electricity sold to each is presented below for both Energex and Ergon Energy.

Table 3: Customer numbers and units sold - 2001-02

Customer type	Energex		Ergon Energy	
	Number	Units sold (MWh)	Number	Units sold (MWh)
Contestable customers				
Individually calculated customers	22	1,315,666	54	3,618,418
Connection asset customers	301	3,046,390	41	533,258
Standard asset customers	2,345	1,728,466	275	239,925
Non-contestable customers				
Franchise customers	1,102,431	11,113,857	574,355	7,939,510
Embedded generators	1	2,695	2	-
Total	1,105,100	17,207,074	574,727	12,331,110

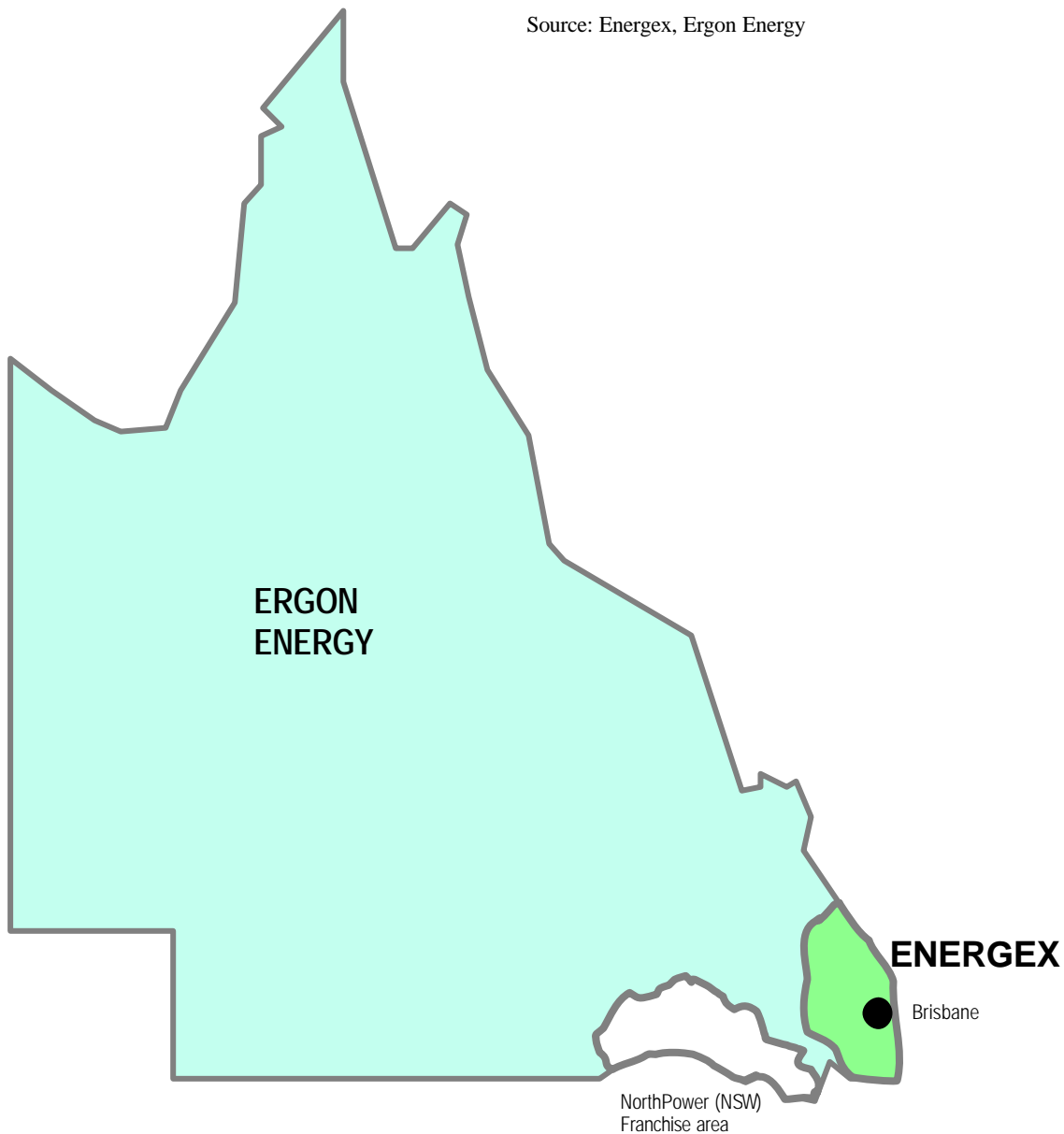
The distribution entities have considerably different network characteristics (see Figure 1), with Ergon Energy having a geographically dispersed network with low customer density, and Energex having a largely urban network with significantly higher customer density.

³ NorthPower (NSW) operates a franchise network on the Queensland/New South Wales border extending into Queensland.

Figure 1: Energex and Ergon Energy’s franchise areas

Key Statistic 2001-02	Energex	Ergon Energy
Customer numbers	1,060,000	550,000
Kilometres of lines	50,000	140,000
Customers per km of line	21.2	3.9

Source: Energex, Ergon Energy



Source: Electricity Supply Association of Australia (modified)

3. REVENUE AND EXPENDITURE

3.1 Introduction

This chapter summarises the financial performance of the revenue cap regulated business segments of the Queensland DNSPs.⁴ The information is for the year ended 30 June 2002. The data used in the analysis has been drawn mainly from the DNSPs' audited 2001-02 Regulatory Accounting Statements. These accounts were submitted in accordance with the Authority's Electricity Distribution: Regulatory Accounting and Information Guidelines.

The overall financial performance is driven by the net effect of the DNSPs' results in three areas: revenue; operating and maintenance expenditure; and capital expenditure. The DNSPs' reported results on these components compared with the corresponding forecasts that were included in the Final Determination are presented below. Detailed financial data tables for Energex and Ergon Energy are provided at Appendix A.

3.2 Revenue

Under/Over Recovery of Distribution Revenue

In the Final Determination, the Authority set a maximum revenue cap for each of the four years of the initial regulatory period for each DNSP. The maximum revenue cap allows the DNSPs to earn a return on assets, plus an allowance for depreciation and operating expenditure incurred in the delivery of prescribed distribution services. The Final Determination also acknowledged the possibility of within-period adjustment to revenue caps to allow for agreed cost pass-throughs or corrections to the underlying revenue cap calculations. However, no cost pass-throughs were sought by the DNSPs in 2001-02.

As part of the Final Determination, the Authority stated its intention to use an "unders and overs" account applying to each DNSP to ensure compliance with the annual revenue caps set in the Determination. The unders and overs process compares actual revenue earned in the year against the annual revenue cap for that year as determined by the Authority (and adjusted where appropriate).

The DNSPs had the following under/over recovery in network revenue in 2001-02.

⁴ In addition to the revenue cap regulated activities, there were also a small number of distribution services regulated by the Authority in 2001-02 on a cost plus 5 per cent margin basis. These were worth around \$9.4 million and \$4.2 million to Energex and Ergon respectively in revenue.

Table 4: Under/over recovery of revenue – 2001-02

\$ million (nominal)	Energex	Ergon Energy
Actual Revenue earned during 2001-02		
Revenue from distribution tariffs	468.4	443.9
Revenue from capital contributions	23.9	16.9
<i>less</i> Allowable annual revenue		
Allowable distribution tariff revenue	467.3	447.5
Allowable capital contributions revenue	23.3	16.8
<i>equals</i> Over/(under) recovery for 2001-02		
Over/(under) recovery of distribution tariff revenue (a)	1.1	(3.6)
Over/(under) recovery of capital contributions revenue (b)	0.6	0.1
Net over/(under) recovery for 2001-02 (a) + (b)	1.7	(3.5)
(Under) / over recovery as a % of aggregate annual revenue requirement	0.3	(0.8)
Over/(under) recovery for 2001-02 rolled forward to 2002-03 (indexed by (WACC*))	1.8	(3.8)

* Weighted Average Cost of Capital – set at 8.054 per cent in the Final Determination.

Table 4 indicates that Energex over-recovered its allowed revenue by \$1.7 million (0.3 per cent) during 2001-02, while Ergon Energy under-recovered its allowed revenue by \$3.5 million (0.8 per cent). As per the Final Determination, an under/over-recovery balance of less than 2 per cent requires each of the distributors to clear the balance of their unders and overs account during the subsequent (2003-04) pricing period.⁵ Accordingly, the revenue over-recovery by Energex and the under-recovery by Ergon Energy during 2001-02 will be rolled-forward and reflected in their respective allowable revenue for 2003-04 to be returned to/recovered from all customer classes through the 2003-04 distribution prices.

Under/Over Recovery of Transmission Use of System (TUOS) Charges

Transmission Use of System (TUOS) charges are calculated by the DNSPs each year to pass-through to distribution customers the cost levied by Powerlink for the use of the transmission system.⁶ Electricity transmission charges are regulated by the ACCC and paid by DNSPs. The Authority approves TUOS charges to be levied by the distributors that are intended to allow them to recover the TUOS charges they have paid to Powerlink. In approving the (DNSPs') TUOS charges, the Authority's main aim is that these charges should reflect, as closely as possible, the structure of Powerlink's charges. Any difference between TUOS revenue recovered by the DNSPs from customers and the charges they paid to Powerlink is recouped from/returned to customers through future (DNSP) TUOS charges.

⁵ Distribution prices for 2002-03 were required to be set in May 2002, before the receipt of the distributor's 2001-02 Regulatory Accounting Statements. This timing will always be the case meaning there will always be a lag between establishing an under/over recovery and its recoupment/return.

⁶ TUOS charges are separately identified from DUOS charges under the Queensland electricity distribution pricing regime.

Table 5: TUOS Unders and Overs Account – 2001-02¹

\$ million (nominal)	Energex	Ergon Energy
Opening balance	N/A	N/A
TUOS charged by Powerlink	126.0	139.6
less actual TUOS revenue earned during 2001-02	126.2	139.0
equals over/(under) recovery for 2001-02	0.2	(0.6)
Over/(under) recovery as a % of TUOS charged (%)	0.2	(0.5)
Over/(under) recovery for 2001-02 rolled forward to 2002-03 (indexed by (WACC ²))	0.2	(0.7)

¹ Numbers are rounded.

² Weighted Average Cost of Capital – set at 8.054 per cent in the Final Determination.

Table 5 indicates that Energex's customers were overcharged by \$0.2 million during 2001-02 for transmission costs while Ergon Energy's customers were undercharged \$0.6 million for transmission costs. Accordingly, Energex will be required to return its over-recovery of TUOS charges to customers as part of its 2003-04 pricing while Ergon will need to recoup its under-recovery of TUOS costs from customers in its 2003-04 TUOS charges.

3.3 Operating and Maintenance Expenditure

The regulatory framework is designed to give the distribution businesses an incentive to exceed the forecast return by reducing costs. The Final Determination outlined the Authority's desire to enable distributors to retain the benefits of out-performance of operating efficiency targets for a rolling five-year period, after which they would be passed back to customers in the form of reduced prices.

Table 6 shows network operating and maintenance expenditure reported by the DNSPs for 2001-02, compared with the forecast operating and maintenance expenditure allowed in the Final Determination.

Table 6: Actual and forecast operating and maintenance expenditure – 2001-02

\$ million (nominal)	Energex	Ergon Energy
Actual operating and maintenance expenditure		
Operating expenditure	49.7	34.6
Maintenance expenditure	80.5	100.4
Total	130.2	135.0
Forecast operating and maintenance expenditure	161.7	150.9
Difference	(31.5)	(15.9)

Energex

Energex's operating and maintenance expenditure was \$31.5 million (19.5 per cent) lower than forecast during the year. Energex has indicated that changes to its organisational structure and accounting systems mean that costing information presented for regulatory purposes prior to July 2001 is not comparable with the information presented subsequent to July 2001 that is reflected in the 2001-02 accounts. However, Energex provided three explanations for the variance between forecast and actual operating and maintenance expenditure:

- a superannuation contribution holiday following actuarial review (\$9.0 million);
- capitalisation of pole replacements that had previously been expensed (\$8.2 million); and
- internal efficiencies, overhead reductions and other savings (\$14.3 million).

The superannuation contribution holiday is expected to be a one-off reduction and reflects past contributions in excess of current actuarial requirements. The capitalisation of pole replacements will result in lower operating expenditure for the whole of the regulatory period as the costs are simply transferred from operating costs to capital costs. Energex has yet to provide sufficient information to establish that the \$14.3 million saving in operating expenditure represented an efficiency gain as opposed to, for example, a simple underspend on operating costs.

Ergon Energy

Ergon Energy's operating and maintenance expenditure was \$15.9 million (10.5 per cent) lower than forecast during 2001-02. Ergon indicated that it introduced a new asset inspection and management system (AIDM) during the year and that all maintenance expenditure (excluding expenditure for emergency maintenance) was put on hold while the change-over occurred. This meant that some planned maintenance did not occur. Ergon anticipates meeting its expenditure forecasts for each of the remaining years of the regulatory period, as well as catching up this shortfall in maintenance over the remainder of the regulatory period.

Given that the under-spend in operating and maintenance expenditure during 2001-02 was primarily due to a reduction in maintenance activity, rather than any identified measure of improved efficiency and that Ergon Energy anticipates catching-up the maintenance expenditure, there is no efficiency carry-over to be considered in relation to 2001-02.

The Authority is currently in the process of developing an efficiency carryover framework that will provide guidelines for identifying and assessing efficiency gains and losses.

3.4 Capital Expenditure

In the 2001-02 regulatory accounts, the DNSPs reported actual capital expenditure as shown in Table 7.

Table 7: Capital expenditure and capital contributions – 2001-02

\$ million (nominal)	Energex			Ergon Energy		
	Actual	Forecast	Difference	Actual	Forecast	Difference
Capital expenditure						
Asset replacement	43.3	35.0	8.3	62.9	42.3	20.6
Demand related	187.0	172.6	14.4	110.2	108.8	1.4
Reliability and quality improvements	19.3	29.5	(10.2)	8.8	22.7	(13.9)
Other	21.0	17.2	3.8	53.0	81.2	(28.2)
Total	270.6	254.3	16.3	235.0	255.0	(20.0)
Capital contributions	23.9	23.3	0.6	16.9	16.8	0.1

Energex

Energex recorded capital expenditure of \$270.6 million during 2001-02, which was \$16.3 million (6.4 per cent) higher than forecast.

In terms of purpose of expenditure, Energex was significantly higher-than-forecast on asset replacement expenditure (23.7 per cent) and “other” expenditure (22.1 per cent). The higher asset replacement expenditure represented an accounting adjustment to reflect the capitalisation of pole replacement expenditure. The higher-than-forecast “other” expenditure reflected a different categorisation of expenditure between demand related and other expenditure than at the time of the Final Determination.

Energex indicated that lower-than-forecast expenditure on reliability/quality improvement (34.6 per cent lower-than forecast) was due to a reduction in network computer facilities. This included deferral of IT and telecommunications projects and cessation of core IT platform expenditure pending a review of the overall Energex enterprise. Energex have yet to determine if this expenditure will be incurred over the remainder of the regulatory period.

Higher-than-forecast demand related expenditure (8.3 per cent) reflected increased expenditure on customer connections and enhancements to the network, largely to cope with increased demand for air conditioning in south-east Queensland.

Ergon Energy

Ergon Energy recorded capital expenditure of \$235.0 million during 2001-02, which was \$20.0 million (7.8 per cent) lower than forecast during the year.

Ergon was significantly higher-than-forecast on asset replacement expenditure (48.7 per cent) and significantly lower-than-forecast on reliability/quality improvement expenditure (61.2 per cent). Ergon attributed both these outcomes to the new AIDM system. Because AIDM is a condition-based (rather than elapsed life-based) asset replacement program, assets which may have previously given rise to quality-related expenditure were replaced and the expenditure classified as asset replacement rather than quality improvement.

Ergon indicated that the AIDM system has produced an inherent improvement in system performance and reliability as deteriorating assets are more likely to be replaced before they begin to have a significant impact on system performance.

‘Other’ capital expenditure was 34.7 per cent lower than expected. The AIDM system is part of an Enterprise Resource Planning (ERP) system that Ergon is introducing to replace old systems. While the AIDM module was completed and is in operation, Ergon deferred work on another components of the ERP system. Ergon expects that this work will go ahead at a later date.

4. SERVICE QUALITY

The Authority's Service Quality Reporting Guidelines require the DNSPs to provide data on specific service quality measures, such as reliability and customer service, on a quarterly and annual basis. In February 2003, the Authority commenced publishing the quarterly service quality data (the DNSPs' September quarter 2002 reports), accompanied by a brief assessment of the data by the Authority.

Publication of the DNSPs' annual service quality reports will commence with the DNSPs' reports for 2002-03. The Authority intends to incorporate service quality information into this performance report starting from 2002-03 so that both financial and service quality information will be presented together. The addition of service quality information will allow the Authority to examine the relationship between the DNSPs' expenditure and changes in service quality. This information will also feed into the Authority's formal service quality incentive regime to be introduced in the next regulatory period starting in July 2005.

APPENDIX A

FINANCIAL DATA TABLES – 2001-02

Table A 1: Aggregate financial information – Energex

	\$ million (nominal)
Revenue	
Actual income from sales	468.4
Forecast income from sales	467.3
Expenditure	
Actual operating and maintenance expenditure	
Operating expenditure	49.7
Maintenance expenditure	80.5
Total	130.2
Forecast operating and maintenance expenditure	161.7
Actual depreciation	
Forecast depreciation	157.0
Total expenditure (actual)	260.8
Total expenditure (forecast)	318.7
Customer contributions	
Actual	23.9
Forecast	23.3
Capital expenditure	
Actual	270.6
Forecast	254.3
Fixed assets	
Actual	2,977.6
Forecast	3,020.4
Energy Sales (million MWh)	
Actual	17.2
Forecast	17.1
Number of customers	
Actual	1,105,100

Table A 2: Aggregate financial information – Ergon Energy

	\$ million (nominal)
Revenue	
Actual income from sales	443.9
Forecast income from sales	447.5
Expenditure	
Actual operating and maintenance expenditure	
Operating expenditure	34.6
Maintenance expenditure	100.4
Total	135.0
Forecast operating and maintenance expenditure	150.9
Actual depreciation	163.3
Forecast depreciation	171.9
Total expenditure (actual)	298.3
Total expenditure (forecast)	322.8
Customer contributions	
Actual	16.9
Forecast	16.8
Capital expenditure	
Actual	235.0
Forecast	255.0
Fixed assets	
Actual	2,640.7
Forecast	2,707.6
Energy Sales (million MWh)	
Actual	12.3
Forecast	11.8
Number of customers	
Actual	574,259

Table A 3: Revenue

\$ million (nominal)	Energex	Ergon Energy
Income from sales		
Network services	468.4	443.9
Public lighting	Not separately identified	Not separately identified
Other	126.0	131.9
Total	594.4	575.8
Capital contributions	23.9	16.9
Proceeds from sale of assets*	6.3	1.5
Other revenue	2.3	-
Total	626.8	594.2

* Book value of assets sold by Energex and Ergon Energy equals \$5.2 million and \$1.7 million respectively.