

Chapter 2

Allegations regarding the performance and management of Energex

2.1 An impetus for this inquiry was the allegation that a Queensland distribution network business, Energex, manipulated its weighted average cost of capital (WACC). As explained in the first interim report, the Australian Energy Regulator (AER) determines, on a periodic basis, the maximum amount of revenue a distribution or transmission network business can recover from its customers. The WACC is one of the inputs to the calculation of a network business's maximum allowed revenue. The AER is required to set a WACC that would provide the business with a rate of return commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk, in respect to regulated services.¹ As part of the determination process, network businesses submit to the AER the WACC they consider is required to meet this objective.

2.2 In addition, the committee also received evidence alleging that the same state government-owned network business:

- is not being managed in an efficient and prudent manner, with unnecessary costs that result being passed on to consumers in the form of higher electricity bills; and
- had misled the AER, and others, about the necessity of certain infrastructure.

2.3 This chapter outlines these allegations and Energex's response to them. This chapter also considers the powers available to the AER for obtaining the information necessary for it to perform its regulatory functions, as well as the penalties for providing the AER with false or misleading information. Finally, the chapter considers the proposal outlined in the terms of reference for the creation of a new agency to consider these types of allegations in the future.

Allegations about data manipulation at Energex

2.4 Claims of data manipulation regarding Energex's cost of debt were made by Ms Cally Wilson, a former Energex employee turned whistleblower. Ms Wilson was a treasury analyst at Energex between June 2012 and September 2014.² When she resigned from Energex, Ms Wilson took her concerns about various practices to the *Courier Mail*, which published her allegations in a series of articles. Ms Wilson

1 The overall rate of return is estimated using a 'vanilla' WACC, which is a weighted average of the return on equity and the return on debt. For more information, see paragraph 4.42–4.43 of the committee's first interim report.

2 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 2.

subsequently wrote to the AER regarding her concerns and appeared as a witness during this inquiry.

2.5 An incident at Energex that greatly concerned Ms Wilson was when she was asked to find a cost of debt rate that would result in a higher WACC. The following description of the task was provided:

What I was asked to do was to find a cost of debt rate that would support management's target WACC of 8.23%. This is called reverse engineering. I found a rate on Bloomberg that gave management the targeted number they were after, however, it was an outlier from a US bank. At the time I did think it was extremely odd that an outlier rate was used as normally they are discarded.³

2.6 Ms Wilson explained that she did not, at the time, realise the implications of identifying a rate that would substantiate a higher WACC, as 'normally a company tries to reduce their WACC'. However, Ms Wilson claimed the reasons for diverging from regular corporate finance theory become clearer when it is understood that regulated electricity network companies are not 'reimbursed on their actual cost of funding, but rather what the AER determined their cost of funding to be'. Ms Wilson noted that as interest rates had fallen dramatically, compared to the start of the regulatory period in 2010, this had resulted in 'a big profit (and probably unexpected profit) for Energex'. According to Ms Wilson, Energex management was concerned that the fall in interest rates to historic lows would mean the next WACC approved by the AER would be substantially lower than the 9.72 per cent that was in place for the 2010–15 regulatory control period.⁴ To put it another way:

What they wanted to try to find was a WACC that was not going to, as they called it, 'jump off a cliff'—so it was not too low and it was not too high. I know they spent a lot of time actually figuring out what would be a politically sensitive WACC to put in place.⁵

Energex's response

2.7 Energex strongly rejected the allegations levelled against it by Ms Wilson. In particular, Energex highlighted the various obligations imposed on it that seek to ensure the information provided to the AER as part of a regulatory proposal is fair and reasonable. In its submission, Energex stated:

Energex's Regulatory Proposal is required to identify the key assumptions that underlie the capital and operating expenditure forecasts which are included in it, and the directors of Energex must certify the reasonableness of these assumptions. In order to enable the directors to make this certification, Energex has established comprehensive governance

3 Ms Cally Wilson, *Submission 68*, p. 1.

4 Ms Cally Wilson, *Submission 68*, p. 1.

5 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 6.

arrangements that require Energex management to certify the accuracy and reasonableness of the information on which those forecasts are based. Energex, through its Board and management, takes its regulatory obligations very seriously and has at all times complied with all applicable regulatory requirements, including the requirement for director certifications.⁶

2.8 Both Energex and Ms Cally Wilson were in agreement that Ms Wilson was not working on Energex's regulatory proposal. Energex's chief executive officer, Mr Terence Effeney, stated that Ms Wilson was working on Energex's corporate plan. Mr Effeney explained that Energex was examining various scenarios for its corporate plan because 'the WACC has varied enormously over the last period'. He stated:

Of course we are modelling, as a prudent organisation, a whole range of scenarios about what the WACC outcomes might be, what the debt parameters might be, what the equity outcomes would be. Of course we would model all those things. A prudent business would do that. But that does not mean that we are manipulating the regulatory outcome.⁷

2.9 In her evidence to the committee, Ms Wilson readily acknowledged that she was not working on the regulatory proposal. However, Ms Wilson suggested that the executive in charge of her team who was interested in the WACC 'probably would have been talking to the strategy and regulation team as well'; that is, the team that prepares the AER submissions.⁸ In any case, Ms Wilson observed that the corporate plan and statement of corporate intent are for the Queensland government and reflect 'what Energex believe at that point in time they can reasonably achieve'. To put it another way, the corporate plan represents the key performance indicators that Energex is signing up to.⁹ Ms Wilson stated that she believed the corporate plan figure 'ended up being 8.13, so it was fairly similar to the rate that we were currently looking at'.¹⁰

2.10 Energex explained that, each year, it provides its shareholding ministers with a statement of corporate intent and corporate plan. Among other things, the documents forecast future financial outcomes for the business. When these documents were prepared in early 2013, it 'was necessary for Energex to try and predict the WACC that would be determined by the AER for the next regulatory period'.¹¹ Energex noted

6 Energex, *Submission 14*, pp. 9–10.

7 Mr Terence Effeney, Chief Executive Officer, Energex, *Committee Hansard*, 16 February 2015, p. 6.

8 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 6.

9 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 3.

10 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 7. The WACC included in Energex's October 2014 regulatory proposal was 7.75 per cent. See Energex, 'Our five year future plan: Regulatory Proposal Overview 2015–2020', *Tabled document 4*, p. 32.

11 Energex, *Submission 14.1*, p. 4.

that market conditions have changed substantially since 2009, when the AER last determined Energex's WACC:

In 2009, the global financial crisis was still creating uncertainty and significantly impacting debt and equity markets. In contrast, at the moment, the current market condition reflect a stable, low interest rate environment and lower debt and equity market expectations. This positive change in sentiment was almost certain to lead to a lower WACC for the 2015–20 regulatory period.¹²

2.11 Energex maintained that the results of the modelling exercise did not form part of the regulatory submission. That is, the work undertaken by Ms Wilson did not affect the WACC determined by the AER, prices paid by consumers or profits for Energex's shareholders.¹³ Energex also emphasised that the AER ultimately determines the WACC, not the regulated entity. Mr Effeney concluded that the suggestion:

...that we can somehow or other manipulate the outcomes from the AER: there is no substance to that; there is no fact. And it has been clearly set out in the submissions by the people who set the rules and administer the rules that that is not something that can be done.¹⁴

2.12 However, Ms Wilson noted that both Energex and Ergon Energy, the other Queensland distributor, departed from the AER guidelines in their regulatory submissions to justify their proposed WACC. Despite the statements by Energex that the AER sets the revenue, Ms Wilson claimed the divergence from the AER guidelines demonstrates that the network businesses seek to apply pressure for a higher WACC.¹⁵

Claims of inefficiencies and other concerning practices at Energex

2.13 Ms Cally Wilson's evidence also criticised the culture and certain practices at Energex that she claimed directly result in customers paying more for electricity. Ms Wilson also raised these concerns in a submission to the AER on Energex's most recent regulatory proposal.¹⁶

2.14 In Ms Wilson's evidence to the committee, three broad areas of concern can be identified. The first concern is the level of staffing at Energex and the expertise of Energex management. Ms Wilson described the staffing level at Energex as 'excessive

12 Energex, *Submission 14.1*, pp. 6–7.

13 Energex, *Submission 14.1*, p. 8.

14 Mr Terence Effeney, Energex, *Committee Hansard*, 16 February 2015, p. 6.

15 Ms Cally Wilson, *Submission 68*, p. 1.

16 The submission to the AER was received and published by the committee as Attachment 1 to Ms Wilson's submission (*Submission 68*).

for its actual needs'. To provide some insight into this, Ms Wilson recounted her observations of staff at Energex:

Walking around the building saw row upon row of employees spending large amounts of their day engrossed in personal activities while the inefficient dissemination of information means employees often spend large parts of their days in unproductive meetings.

Employees are hired to do roles that became redundant in commercial organisations a decade prior and any attempts to modernise, streamline the workforce seem to be a very touchy subject due to labour constraints. Treasury departments often look at work-place efficiencies but all attempts by me to discuss cost-less technological changes that would affect a personnel and cost reduction were quashed so Treasury wouldn't upset other departments.¹⁷

2.15 Ms Wilson further noted that Energex employees can only be made voluntarily redundant,¹⁸ meaning that Energex 'cannot get rid of people that probably need to be gotten rid of, unfortunately'.¹⁹ Ms Wilson concluded that the 'sheer wastage of people's time' as a result of over-staffing at Energex is 'mind-boggling'.²⁰ Further, Energex's staff costs are, in Ms Wilson's view, 'astronomical'. According to Ms Wilson, Energex staff received 'exceedingly generous income and benefits compared to commercial standards for the same roles'. As an example, Ms Wilson referred to a treasury officer at Energex employed on a salary of \$85,000 per annum despite not having a university degree or any previous training.²¹

2.16 Ms Wilson also questioned the qualifications and competence of certain executives. As an example, Ms Wilson remarked that during her time at Energex, an individual who acted as the chief financial officer did not have accounting qualifications.²² On the expertise of Energex executives more generally, Ms Wilson stated:

There are a lot of very nice people there, but I do not think they are fully qualified to run a company of this size. There are no real risk managers. There should be a lot more commercial expertise and people with real-world experience in this company, not just government experience. They have come up through the ranks—they like the job and they have been sitting there for 15 years—but they have no training or educational qualifications in it.²³

17 Ms Cally Wilson, *Submission 68*, Attachment 1, p. 2.

18 Ms Cally Wilson, *Submission 68*, Attachment 1, p. 2.

19 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, pp. 10–11.

20 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 11.

21 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 3.

22 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 4.

23 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 11.

2.17 The second area that Ms Wilson suggested required attention was the treatment of capital and operating expenditure. Ms Wilson told the committee that 'Energex had a culture where it was always better to overspend on your capital expenditure'.²⁴ Ms Wilson outlined several rumours that she had heard while employed at Energex 'of things that probably were operating expenditure were rolled up into capital expenditure'.²⁵

2.18 The third area where Ms Wilson considered inadequate procedures at Energex were contributing to higher electricity bills for consumers relates to the business's financial practices, particularly with respect to risk management. Ms Wilson noted that appropriate risk management techniques and skilled treasury and procurement teams can often provide savings that amount to many millions of dollars. Ms Wilson stated that, although Energex's hedging methodology would work well with a skilled team, she considered it was an area of concern due to the mismanagement she witnessed while employed there. The following example was provided of how the risk associated with capital expenditure could be treated:

At Energex, the concept that they should be able to quantify the values of commodities and foreign exchange used was disregarded with the viewpoint that it wasn't feasible as they didn't know what contracts would be taken up. This is in direct contradiction with other multi-nationals and large corporations that undertake a detailed and quantified understanding of their capital expenditure exposures in order to better mitigate the risk of price fluctuations.²⁶

2.19 Another example involved an occasion where Ms Wilson 'spent many hours trying to explain to senior people within the procurement and finance departments at Energex that just because a country is within Europe, does not mean it uses the euro'. She explained:

On one multi-million dollar contract, Energex took a position against the euro which it had no currency exposure to while not hedging against its currency exposure to the Norwegian krone.²⁷

24 As explained in the first interim report, both capital expenditure (capex) and operating expenditure (opex) are received from customers (up to the forecasts approved by the AER). However, opex is recovered from customers over a single regulatory control period (typically five years), based on the AER's determination of the base year opex and the rate of change. Capex is added to the regulatory asset base (RAB), which is multiplied by the allowed rate of return and then passed on to consumers. The RAB is rolled forward from one regulatory control period to the next with an adjustment to account for actual inflation. See *Interim report*, pp. 30–34.

25 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 8.

26 Ms Cally Wilson, *Submission 68*, Attachment 1, pp. 2–3.

27 Ms Cally Wilson, *Submission 68*, Attachment 1, p. 3.

2.20 Ms Wilson also expressed concern that Energex employees faced potential risks as a result of endorsements they supposedly had given for particular transactions. Ms Wilson explained that, on at least one occasion, financial analysis and commentary she had prepared for Energex's board that argued a contract was not commercially beneficial to Energex was 'substituted for wording that agreed with the financial viability of the procurement contract'.²⁸ Further, Ms Wilson stated that she found 'at least 50' documents with her name on them that she had not approved. Ms Wilson reported that management's response to her concerns about this was to 'agree that it was not a very good thing to have happened and that they would try to ensure that it did not happen again, but they could not guarantee it'.²⁹

2.21 Ms Wilson also suggested there were significant weaknesses in the auditing arrangements for the treasury section at Energex. Ms Wilson explained:

Normally when you are in a treasury department you get audited very, very regularly because the moneys are flowing through you, because you are the one inputting stuff into the bank account. When I was at Energex, when I went through all the books, there had only been one internal audit done—and they did not understand what questions to ask—and there wasn't even any external auditing done. When I was in previous companies, at one company I remember being audited quarterly but most of the time we were audited half-yearly. While I was at Energex, we never had one of the big four audit the treasury section; they audited other sections but never the treasury section, which I thought was very unusual.³⁰

2.22 Finally, Ms Wilson expressed concern about the Energex board's ability to assess the proposals put to it. Although she agreed that the board has a fiduciary duty, Ms Wilson observed it would be difficult to fulfil this duty if the board is being 'lied to'. Ms Wilson stated that she 'definitely saw evidence of people covering up things, so they did not go to the board'. Ms Wilson considered the board was unlikely to know of any problems with data or other concerning practices within the business, as Energex management is very good at what Ms Wilson termed 'marketing'. Ms Wilson stated:

If you do not understand the intricacies, it would be very, very easy to be taken in, because it sounds right. It is only when you look at it that it is not right.³¹

28 Ms Cally Wilson, *Submission 68*, Attachment 1, p. 3.

29 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 4.

30 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 11. 'Big four' refers to the largest international audit firms: Deloitte, EY, KPMG and PricewaterhouseCoopers. In Australia, these firms audit 95 per cent of listed entities by market capitalisation. See Senate Economics References Committee, *Performance of the Australian Securities and Investments Commission: Final report*, June 2014, p. 34.

31 Ms Cally Wilson, *Committee Hansard*, 24 March 2015, p. 9.

2.23 Ms Wilson concluded that the problems at Energex were caused by 'a culture that in effect has no accountability or transparency'. Ms Wilson called on the AER to cut Energex's operating expenditure; Ms Wilson reasoned that by doing so, Energex's management would be provided with an incentive 'to stop sloppy, expensive habits that would not be tolerated in a commercial environment'.³²

Energex's response

2.24 Energex responded in detail to the issues about its operations that Ms Wilson outlined. The following paragraphs outline Energex's response.

Energex's staffing

2.25 In response to the claim that Energex is over-staffed, Energex asserted that, in the role Ms Wilson was employed in, it 'would be difficult for any person to reasonably assess the Energex human resource requirements to maintain a safe and reliable electricity network that meets our customers' expectations'.³³ More specifically, Energex advised that a strategy was initiated in 2012 that has resulted in Energex's workforce being reduced by 'more than 20 per cent'. This strategy was implemented in response to reduced electricity demand and capital works. Energex added that its 'staffing levels and expenditure are also regularly externally benchmarked and assessed'.³⁴

2.26 Energex also refuted the claim that its management did not have the necessary expertise to run the business. The following statement was provided:

Energex strongly rejects any allegation that its staff members are not appropriately qualified or lack commerciality. Energex has expert employees in a wide range of fields. Many have experience within government and government owned corporations but many others have private sector backgrounds.

Energex is very proud of the Energex staff and their commitment to the community of South East Queensland. Energex will continue to drive efficiency and seek to deliver quality and cost effective outcomes for our customers.³⁵

2.27 The evidence given about the qualifications of the acting chief financial officer was specifically addressed. In its response to Ms Wilson's evidence on this matter, Energex wrote that it 'rejects the allegation that there was an acting chief financial officer with no accounting qualifications'. Energex explained:

32 Ms Cally Wilson, *Submission 68*, Attachment 1, p. 3.

33 Energex, *Submission 14.1*, p. 18.

34 Energex, *Submission 14.1*, p. 3.

35 Energex, *Submission 14.1*, pp. 18–19.

Following the departure of Energex's Chief Financial Officer in 2013, Energex undertook a temporary restructure and the finance department reported to an incumbent executive general manager with extensive experience in the electricity industry.³⁶

At no stage did the individual hold the title Chief Financial Officer and at all times Energex had an appropriate level of skill, expertise and qualifications in its finance department with appropriate controls and oversight.³⁷

2.28 Energex added that it 'is not unusual that temporary restructures such as this take place during recruitment processes'. Following an open recruitment process, a chief financial officer, with accounting qualifications, was appointed in 2014 on an ongoing basis.³⁸

Treatment of expenditure and auditing arrangements

2.29 In addressing the whistleblower's concerns about the treatment of capital and operating expenditure within Energex, the response from Energex first questioned whether a treasury analyst in the financial accounting area of the business could 'reasonably assess whether Energex has appropriately allocated its expenditure between capital and operating expenses'.³⁹ Nevertheless, Energex also addressed the claims by outlining its policies. Energex provided the following statement about the classification of its capital expenditure:

Energex capitalises expenditure in compliance with its Finance Policy Manual which complies with Australian Accounting Standards and cost attribution principles as outlined by the AER. Energex's statutory and regulatory accounts are subject to external audit each year. No evidence of incorrect costings to capital has been found as part of these audits.

Energex performs periodic reviews of the outcome of the application of its internal business rules to verify ongoing compliance with its Finance Policy Manual, Australian Accounting Standards and cost allocation principles approved by the AER. Most recently in 2014, Energex also engaged a large accounting firm to perform an independent review of material items being capitalised to ensure ongoing compliance with Australian Accounting Standards.

An explanation of Energex's capitalisation process and rules and a copy of the capitalisation policy are furnished to the AER on an annual basis under Energex's regulatory reporting obligations.⁴⁰

36 Energex, *Submission 14.1*, p. 19.

37 Energex, *Submission 14.1*, p. 20.

38 Energex, *Submission 14.1*, p. 20.

39 Energex, *Submission 14.1*, p. 13.

40 Energex, *Submission 14.1*, pp. 13–14.

2.30 The evidence given about the auditing arrangements for Energex's treasury section was specifically addressed. Energex contended that the evidence received by the committee about this was inaccurate. Energex advised that external audits of 'the key activities of Energex's treasury team to the extent that they impacted the financial outcomes of Energex' were conducted in 2012, 2013 and 2014. Energex also noted the internal audit Ms Wilson referred to, which Energex described as 'comprehensive'.⁴¹

2.31 Another issue that Energex responded to was the evidence about its board processes. Energex prefaced its comments on this matter by emphasising that the Energex board 'takes its fiduciary and legal duties very seriously and complies with its obligation to oversee and question management'. Further, Energex stated that the board 'processes and sub-committee structure are extremely robust'.⁴²

2.32 Energex questioned the level of involvement that Ms Wilson had with board processes and decision-making. Energex stated that the treasury analyst is 'responsible for providing advice to the procurement department on risk mitigation of treasury risks arising from foreign currency and commodity prices'. The treasury analyst does not have a role in approving a transaction. Energex commented:

Accountability for the correctness and accuracy of the relevant procurement board papers lay with the executive in charge of procurement and the CEO, not Ms Wilson or the treasury department.⁴³

2.33 Regarding the claim that Energex's procurement department changed sections of board documentation Ms Wilson had written, Energex advised that after 'an extensive investigation, no supporting evidence could be found for Ms Wilson's claims'.⁴⁴ Further, Energex stated that the claims of mismanagement and fraud have been 'extensively investigated' by Energex, with both internal and external investigators used. Energex reported that following these investigations, 'none of the allegations were substantiated'.⁴⁵

41 Energex, *Submission 14.1*, p. 19.

42 Energex, *Submission 14.1*, p. 15.

43 Energex, *Submission 14.1*, p. 21.

44 Energex, *Submission 14.1*, p. 21.

45 Energex, *Submission 14.1*, p. 22.

Concern about the need for infrastructure investment

2.34 Another set of allegations made in evidence taken during this inquiry is that network businesses have misled the AER in relation to the necessity for proposed infrastructure. The Agriculture Industries Electricity Taskforce provided the following projects it considered were examples of unnecessary expenditure:

- Transgrid's proposal for a transmission line in the Manning Valley in 2011;
- AusNet Services' proposed terminal station augmentations at Brunswick, Melbourne in 2012; and
- power lines proposed by Energex in the Logan River valley.⁴⁶

2.35 The Logan River proposal involves the construction of a second 110 kilovolt sub-transmission power line from Loganlea to Jimboomba. The committee received evidence from the Veto Energex Towers Organisation (VETO), a community organisation formed in 2008 by Logan residents in response to Energex's proposal. VETO advised that it, and Logan City Council, opposed the proposal because:

...it will turn the already fragile Logan River valley into a power line easement, clear Logan koala habitat, directly impact 90 rural residential landowners and destroy the amenity of the historic township of Logan village.⁴⁷

2.36 VETO outlined at length the history of this project, including that its cost has increased to \$64.2 million from an initial amount of \$26 million.⁴⁸ VETO argued that alternative proposals the community considered were more acceptable were not adequately contemplated by Energex. According to VETO, documents released under freedom of information reveal that Energex employees were 'deliberately jacking up land acquisition costs' to weaken an alternative proposal developed by the Logan City Council.⁴⁹ VETO concluded that Energex does not 'genuinely respect the needs of the communities in which they expect to operate'.⁵⁰

2.37 Finally, VETO noted that the AER had expressed concerns about Energex's compliance with the National Electricity Rules. Following complaints lodged by the Logan City Council and VETO, the AER conducted a review of the regulatory test used by Energex. The AER's review identified 'several compliance issues', including that the Energex regulatory test consultation report 'did not adequately contain details of the two alternative options proposed by Energex'.⁵¹ The AER reported that it would

46 Agriculture Industries Electricity Taskforce, *Submission 21*, p. 9.

47 Veto Energex Towers Organisation (VETO), *Submission 55*, p. 2.

48 Mr Paul Casbolt, President, VETO, *Committee Hansard*, 16 February 2015, p. 52.

49 Ms Laurie Koranski, Spokesperson, VETO, *Committee Hansard*, 16 February 2015, p. 49.

50 VETO, *Submission 55*, p. 9.

51 Australian Energy Regulator (AER), *Quarterly compliance report: April – June 2011*, p. 25; cited in VETO, *Submission 55*, p. 33.

monitor future regulatory test processes undertaken by Energex. However, VETO considered the AER's actions were 'inadequate'. In particular, VETO was disappointed that Energex was not required to substantiate its proposal 'or assess any alternatives that could have delivered lower cost outcomes for consumers and our community'.⁵²

Energex's response

2.38 Energex responded to the allegations made by VETO. In a letter to the committee, Mr Effeney stated that Energex appreciates the proposed power line project 'has been a long running and controversial development which has brought about diverse views within the community'.⁵³ Mr Effeney also acknowledged there had 'been shortcomings in the public consultation process surrounding the initiation of this project in 2008'. In relation to the areas for improvement found by the AER, Mr Effeney wrote:

Energex has taken these recommendations seriously and fully implemented each of them. We continue to strive for improvements in the way we talk to, and work with, the community we service.⁵⁴

2.39 However, Mr Effeney advised that Energex rejects 'the assertion that it has in any way manipulated cost estimates'. The following statement was provided:

The cost forecasts, including land cost, and other assumptions which underpin this project have been subject to extensive public consultations. Commencing with a Corridor Selection Report, followed by an Initial Assessment Report, a Supplementary Initial Assessment Report and a Final Initial Assessment Report issued in 2010.⁵⁵

2.40 The response noted that these reports are publicly available on a website, as is a consultant's report that was commissioned by the Queensland government. Energex claimed that its internal processes in this matter 'have been extensively scrutinised and reviewed'.⁵⁶

52 VETO, *Submission 55*, pp. 6–7.

53 Energex, Response to *Submission 55*, p. 1.

54 Energex, Response to *Submission 55*, p. 2.

55 Energex, Response to *Submission 55*, p. 1.

56 Energex, Response to *Submission 55*, p. 1.

Responses to the allegations from the AER and other interested parties

2.41 Ultimately, when a regulator is presented with information, it needs to carefully assess that information and identify and act on any data manipulation, claims of inefficient expenditure or evidence indicating a contravention of the laws it administers.

2.42 The potential for regulated entities to attempt to mislead the regulator is not a problem that is unique to the AER; the Economic Regulation Authority (ERA), which performs tasks in Western Australia similar to the AER, recognised the risk of data anomalies and manipulation. The ERA informed the committee that, when exercising its regulatory functions:

...the ERA always undertakes its own research and analysis to arrive at its determination of the efficient WACC. In undertaking this research, the ERA is able to identify any anomalies in data presented by the service provider and thereby to form its own view as to its credibility.

The ERA is aware of the potential for data manipulation. To minimise the risk of this occurring, the ERA pays particular attention to verifying original data sources and to replicating analysis. The ERA also forms its own independent views on issues, rather than relying on the assertions of service providers and their consultants.⁵⁷

2.43 It is also instructive to consider another statement made by the ERA on this matter. The ERA noted that profit-maximising entities should be expected to 'seek to legitimately present the best possible case for them' and warned that this 'should be distinguished from deliberately misleading the regulator'.⁵⁸

2.44 The Energy Networks Association (ENA) told the committee it is 'not aware of any evidence that any network has provided misleading information to the AER in relation to any cost of capital or regulatory valuation issue'. The ENA added that it would expect to be aware of any issue that had arisen given its regular engagement with the AER.⁵⁹

2.45 The AER advised that it has raised Ms Wilson's claims with Energex. The information received by the AER as a result of its discussions with Energex 'will be taken into account, and reflected in', the AER's preliminary revenue determination (which is discussed at paragraphs 2.54–2.55).⁶⁰ The AER added:

More generally, our analysis in examining the proposals is aimed at ensuring that data is robust and resulting costs are efficient such that

57 Economic Regulation Authority (Western Australia), *Submission 30*, pp. 5–6.

58 Economic Regulation Authority (Western Australia), *Submission 30*, p. 4.

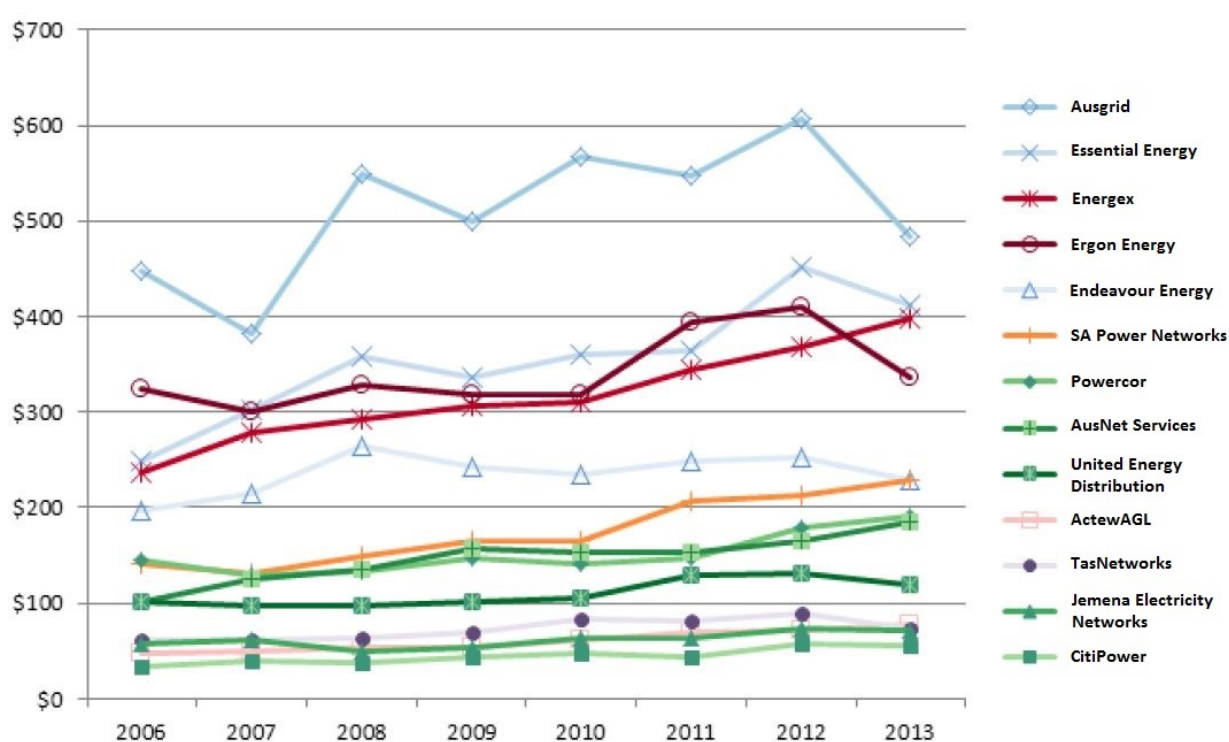
59 Energy Networks Association, *Submission 31*, p. 5.

60 AER, *Answer to questions on notice 8*, received 10 April 2015, pp. 4, 6.

consumers are paying no more than necessary for safe and reliable electricity services.⁶¹

2.46 The AER also responded to questions from the committee about Energex's operating expenditure. The AER noted that there is 'considerable difference' in operating expenditure across distribution businesses in the National Electricity Market (NEM).⁶² In 2013, Energex had the third highest operating expenditure (Figure 2.1), which compares favourably to Energex's customer numbers.⁶³ On the other hand, as Figure 2.1 shows, Energex's operating costs have increased significantly, rising from approximately \$300 million in 2009 to around \$400 million in 2013.

Figure 2.1: Operating expenditure by distributor (\$ millions, 2013)



Source: AER, *Answer to questions on notice 8*, received 10 April 2015, p. 6 (chart edited to replace abbreviated names of network businesses with unabbreviated names).

61 AER, *Answer to questions on notice 8*, received 10 April 2015, pp. 4, 6.

62 AER, *Answer to questions on notice 8*, received 10 April 2015, p. 5.

63 Between 2009 and 2013, Energex had, on average, the second highest number of customers of distribution businesses in the NEM. AER, *Electricity distribution network service providers: Annual benchmarking report*, November 2014, www.aer.gov.au/sites/default/files/2014%20Annual%20distribution%20benchmarking%20report%20-%20November%202014_0_0.pdf (accessed 21 April 2015), p. 12.

The AER's information gathering powers and penalties for providing false or misleading information

2.47 In light of the various allegations regarding the information provided to the AER, it is necessary to consider the regulator's powers to gain information and the penalties for providing false or misleading information to the regulator. This section examines the current powers and sanctions. The evidence received about the need for a new Commonwealth agency to investigate misconduct is also discussed.

Overview of information gathering powers and penalties

2.48 In its submission, Energex highlighted the information gathering powers that the AER has to conduct its regulatory functions. Under these statutory powers,⁶⁴ the AER 'requires network businesses to collect and maintain information in a manner approved by the AER and to submit it annually or as part of the regulatory reset process'. Energex explained that the accuracy and the quality of the information supplied to the AER is typically certified by its board and/or the chief executive officer. Energex noted that section 28R of the National Electricity Law (NEL) prohibits the provision of false or misleading information to the AER in purported compliance with a requirement to provide information to the AER.⁶⁵ It is a criminal offence to contravene this provision, punishable by a maximum penalty of \$2000 for an individual and \$10,000 for a body corporate.⁶⁶

2.49 Energex suggested that another protection against false or misleading information being supplied to the AER is the public nature of the determination process. Although network businesses such as Energex can seek confidentiality over parts of documents, in Energex's view, the AER strictly applies the confidentiality rules 'with the intention of providing the community and market participants with the maximum possible information'. Energex acknowledged that the 'greater scrutiny that can be applied where information is publicly available also increases the weight that the AER is able to ascribe to such information'.⁶⁷

2.50 The Department of Industry added that the Commonwealth Criminal Code contains offences for providing false or misleading information or documents that have general application to all Commonwealth entities. Specifically:

Section 137.1 of the Criminal Code makes it an offence to give information to Commonwealth entities knowing it to be false or misleading or omitting any matter or thing without which the information is misleading. The penalty for contravention of this section by a person is imprisonment

64 Regulatory Information Notices (section 280 of the National Electricity Law) and Regulatory Information Orders (section 28C of the National Electricity Law).

65 Energex, *Submission 14*, p. 6.

66 Department of Industry, *Submission 34*, p. 11.

67 Energex, *Submission 14*, p. 6.

for 12 months. By virtue of the operation of section 4B(3) of the *Crimes Act 1914* (Cth), a court may impose on a body corporate a penalty not exceeding \$51,000.⁶⁸

2.51 Finally, the AER may revoke a determination that is in place if it considers the determination is affected by certain types of material errors or deficiencies. One category of deficiencies that the AER may rely on for revoking a determination is if the AER was provided with false or materially misleading information.⁶⁹

The need for a new Commonwealth agency to investigate misconduct

2.52 The terms of reference for this inquiry asked the committee to consider whether an independent Commonwealth authority should be established to investigate anomalies identified in relation to price structuring or allegations of price rorting by electricity companies.

2.53 There was little support for this proposal. The Electrical Trades Union stated it would support 'the principle' that allegations of price rorting should be investigated by an independent Commonwealth body with the required powers and reach to investigate and prosecute.⁷⁰ However, other stakeholders that commented on this aspect of the inquiry's terms of reference—including electricity businesses (both network and retail), the Department of Industry and agricultural industry bodies—did not support the creation of a new agency.⁷¹

The AER's preliminary decision on Energex's revenue for 2015–2020

2.54 On 30 April 2015, the AER released its preliminary decision on Energex's revenue for the 2015–16 to 2019–20 regulatory control period. The AER accepted Energex's forecasted operating expenditure for this period, which results in an average operating expenditure of around \$347 million a year.⁷² However, the AER decided on a significantly lower rate of return than that proposed by Energex. In its October 2014 regulatory proposal, Energex submitted that a rate of return of 7.75 per cent was required. The AER agreed to a rate of return of only 5.85 per cent for 2015–16, to be updated annually until the end of the regulatory control period in 2020.⁷³

68 Department of Industry, *Submission 34*, p. 11.

69 National Electricity Rules, rules 6.13 and 6A.15.

70 Electrical Trades Union Australia, *Submission 22*, p. 30.

71 See Energex, *Submission 14*, p. 6; Agriculture Industries Electricity Taskforce, *Submission 21*, p. 13; EnergyAustralia, *Submission 23*, p. 7; Department of Industry, *Submission 34*, p. 11.

72 AER, *Preliminary decision: Energex determination 2015–16 to 2019–20 – Overview*, April 2015, www.aer.gov.au/sites/default/files/AER%20-%20Preliminary%20decision%20Energex%20distribution%20determination%20-%20Overview%20-%20April%202015.pdf (accessed 30 April 2015), pp. 30–31.

73 AER, *Preliminary decision: Energex determination 2015–16 to 2019–20 – Overview*, p. 13.

2.55 Overall, the AER's preliminary decision is that Energex can recover around \$6.5 billion from consumers over the 2015–20 regulatory control period.⁷⁴ This is significantly lower than the over \$8.3 billion sought by Energex in its regulatory proposal.⁷⁵

Committee view

2.56 The committee has noted with concern the various allegations levelled against Energex, a distribution network service provider that operates in Queensland. The wide-ranging allegations went to the modelling of Energex's cost of debt, various internal financial practices, Energex's staffing levels, and unnecessary network investment undertaken by the business to the detriment of electricity customers generally and local affected residents.

2.57 The majority of these allegations were put to the committee by a former Energex employee. The committee appreciates that a whistleblower was prepared to come forward and recount their experiences. There are many examples in the public and private sectors where serious wrongdoing, malpractice or other troubling practices only come to light because of whistleblowers.

2.58 The first allegation the committee will address is the evidence regarding the modelling of the cost of debt. The committee's first interim report discussed the perverse incentives currently enshrined in the process by which the maximum allowable revenue for a network business is determined, including how network businesses appear to 'game' the regulator.⁷⁶

2.59 The committee notes that, since the current framework was introduced, the AER has never agreed to a WACC that network businesses have initially proposed.⁷⁷ Despite this, stakeholders are concerned that the network businesses benefit from the current method for considering revenue proposals, as businesses can 'frame the discussion' by submitting detailed regulatory proposals containing proposed revenues that are higher than what the regulator can accept.⁷⁸ The AER must effectively disprove the business's original proposal by determining an alternative WACC based on a hypothetical benchmark of an efficient business. The regulator must do this while being inundated with information and documents during the revenue determination process.⁷⁹

74 AER, *Preliminary decision: Energex determination 2015–16 to 2019–20 – Overview*, p. 8.

75 Energex, 'Our five year future plan: Regulatory Proposal Overview 2015–2020', *Tabled document 4*, p. 32. This figure excludes revenue from Solar Bonus Scheme payments.

76 This issue is discussed in chapter 6 of the first interim report.

77 See paragraph 4.46 of the first interim report and Energy Networks Australia, *Submission 31*, p. 6.

78 See paragraph 6.7 of the first interim report.

79 This issue is discussed in chapter 6 of the first interim report.

2.60 The evidence regarding the modelling of the cost of debt at Energex provides a case study of some of these issues. The committee notes Energex's position that the modelling exercise was not directly used in the regulatory proposal lodged with the AER in October 2014. In any case, it is clear that the AER has not accepted Energex's proposal. Energex's October 2014 regulatory proposal to the AER used a figure of 7.75 per cent for its rate of return. The AER's April 2015 decision provides Energex with a significantly lower rate of return of 5.85 per cent for 2015–16, to be updated annually.⁸⁰

2.61 However, the Energex case study provides further evidence of the apparent mindset of network business executives that the WACC must be as high as possible, regardless of the circumstances. The use of an outlier to establish a WACC for a corporate document, or for any other purpose, does not appear to be a reasonable action. More significantly, the AER's preliminary determination for Energex's rate of return was 190 basis points lower than Energex's proposal. In light of this, it is difficult to see how Energex's initial estimate was reasonable.

2.62 The evidence regarding various internal matters in Energex also concerned the committee. The committee notes the evidence that Energex provided about the reduction in its staffing levels since 2012. However, the committee is concerned that one of the reasons put forward by Energex to dismiss the whistleblower's concerns about over-staffing is that the whistleblower was employed as a treasury analyst and had no involvement in the human resources aspects of the business. While that is the case, employees, particularly employees who have previously worked in other organisations, do not need management or human resources responsibilities to observe, and be concerned about, inefficiencies. Energex's evidence does not indicate it supports a culture where employees are encouraged to identify and speak up about inefficiencies and waste.

2.63 Similarly, the committee notes that Energex highlighted the whistleblower's job description to suggest that an individual working in that role would have a limited insight into other parts of the business, such as regulatory issues. The committee was cognizant of the scope of the treasury analyst's responsibilities when considering the evidence put forward. However, the committee does not accept that an employee working in one area of the business will not gain a detailed awareness of practices in other areas. Within any organisation, information is shared with other employees and quickly spreads. Of course, it is necessary to separate unfounded gossip from those claims that have merit, but concerns should not be dismissed out of hand.

2.64 The committee has considered each claim on its merits, taking into account Energex's response. However, the role of this committee is not to make findings against particular individuals or organisations; rather, the committee gathers and tests information for the purpose of formulating recommendations for changes in policy, legislation or administration. Based on the evidence before it, the committee considers

80 AER, *Preliminary decision: Energex determination 2015–16 to 2019–20 – Overview*, p. 13.

there are lingering questions about various practices within Energex. Accordingly, there is a case for a thorough external audit of the performance of Energex's financial risk management practices, with a focus on Energex's treasury section. A well-resourced external performance audit, as distinct from a financial audit, would enable the operations of the business to be closely inspected and a wider range of Energex employees interviewed. As Energex is a Queensland government-owned business, this is a matter for the Queensland government to consider.

2.65 Finally, the terms of reference for this inquiry asked the committee to consider whether a new Commonwealth body should be established to investigate allegations of misconduct by electricity businesses. The committee does not consider there is sufficient evidence to support this proposal. Clearly, the regulator that determines the maximum revenue of network businesses—the AER—must be provided with accurate and relevant information to ensure that optimal decisions are made. However, it was not demonstrated that there were problems with the existing arrangements that prohibit the provision of false and misleading information to the AER. In the committee's opinion, the crux of the matter is that the regulator needs to ensure it employs adequate scepticism when assessing the information provided to it. Further, as discussed in the first interim report, the regulator must also be resourced appropriately. The committee emphasises the recommendations it made in the first interim report regarding these matters.

Recommendation 1

2.66 The committee recommends that the Queensland Government request the Queensland Auditor-General to conduct a performance audit of financial risk management practices at Energex.

Senator Anne Urquhart
Chair

