Draft decision: Essential Energy 2019–24

We have made a draft decision on the distribution determination for Essential Energy, the electricity distribution network operator in in rural and regional NSW. Our draft decision would allow Essential Energy to recover $5292.1 million ($nominal) in revenue from its customers over five years commencing 1 July 2019.

Estimated impact on customer bills ($nominal)

The distribution network tariffs that will be set by reference to our final decision are only one contributor to electricity bills, and make up around 37 per cent of the total retail electricity bills Essential Energy's customers pay.

Holding all other components of the bill constant, the average annual electricity bill for a residential or small business customer on Essential Energy's distribution network would be 3.7 per cent higher by the end of the 2019–24 regulatory control period.

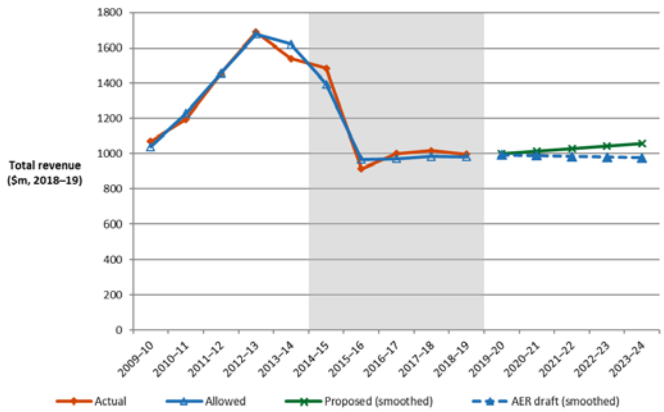
For Essential Energy's residential and small business customers, this suggests that the average annual electricity bill in 2023–24 would be $70 and $314 higher, respectively, by the end of the 2019–24 regulatory control period.

Overview

We, the Australian Energy Regulator (AER), regulate Essential Energy's revenue by setting the total revenue it may recover from its customers.

Our draft decision allows for a 7.1 per cent real reduction in Essential Energy's total allowed revenue from the current period.

Essential Energy's past and proposed total revenue and AER draft decision revenue allowance ($million, 2018–19)



Key elements of our draft decision

Essential Energy's proposal was well received by stakeholders. This result followed an extensive program of consumer engagement that commenced almost two years prior to submission of Essential Energy's proposal, and focussed on consumer priorities of affordability, reliability and safety and how best to address them.

Over the current period we have seen Essential Energy make significant progress in improving its efficiency. Our last decision expressed concerns that its operating expenditure in particular was materially above efficient levels. This draft decision, which largely accepts Essential Energy's proposal, reflects not only the considerable efficiency gains it has achieved in both operating and capital expenditure over the current period, but also the strategies and initiatives it now proposes to deliver further efficiencies in expenditure and improvements in productivity over 2019–24.

Our draft decision on Essential Energy's revenue for 2019–24 includes its forecast operating expenditure and (subject to some modelling corrections identified in the course of our review) its forecast capital expenditure.

However, our draft decision does not reflect the total revenue proposed by Essential Energy. The total revenue in this draft decision is 4.6 per cent lower than in Essential Energy's proposal.

Those areas of difference that remain relate to our ongoing consultations on the rate of return and corporate income tax allowance, conclusions on which we expect will be reached before Essential Energy submits its revised proposal.

We will continue to work with Essential Energy and stakeholders to ensure that our final decision, which will determine the revenue Essential Energy can recover from its customers for the 2019–24 regulatory control period, is in the long term interests of consumers and that Essential Energy's customers are paying no more than they should for safe and reliable electricity.

Next steps

Essential Energy's revised regulatory proposal is due by 8 January 2019. Stakeholders may make written submissions on our draft decision and Essential Energy's revised proposal by 5 February 2019. Our final decision is due for release by the end of April 2019.

Rate of return and gamma

The biggest contributor to the 4.6 per cent difference between our draft decision and Essential Energy's proposal is our proposed change to the rate of return (and therefore the return on capital). Our draft decision adopts the approach proposed in our draft 2018 rate of return guideline to calculate a placeholder rate of return of 5.96 per cent. This is lower than the 6.34 per cent placeholder Essential Energy applied in its proposal based on our current, 2013 guideline.

Also reflecting our draft 2018 rate of return guideline, our draft decision adopts a value of imputation credits (gamma) of 0.5 compared to Essential Energy's proposed 0.4 (again based on the application of our current, 2013 guideline), which has contributed to the reduction in the corporate income tax allowance relative to Essential Energy's proposal.

The possibility that we would change our approach to the rate of return and gamma as part of our rate of return guideline review was contemplated in Essential Energy's proposal. Consultation on our draft 2018 guideline is ongoing, and is expected to conclude in December 2018. Legislation before the South Australian Parliament at the time of this draft decision will (if passed) make our final 2018 rate of return guideline binding on this and other decisions. In that context, Essential Energy's proposal noted that it was "therefore anticipating that we will need to change our proposed rate of return once the 2018 Rate of Return Guideline is finalised".

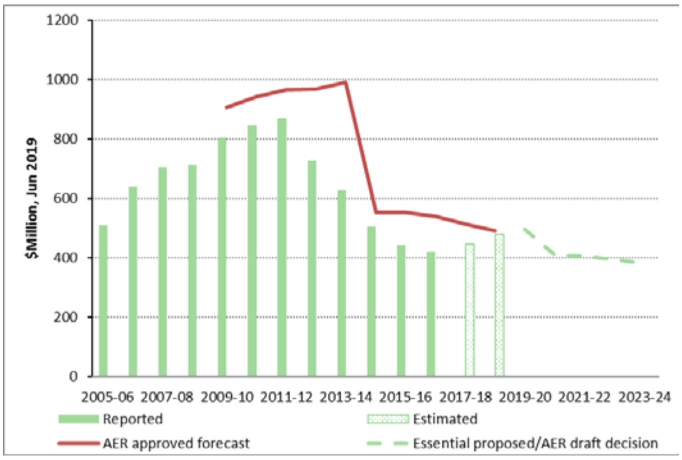
Capital expenditure (capex)

Capex—the capital costs and expenditure incurred in the provision of network services—mostly relates to assets with long lives, the costs of which are recovered over several regulatory control periods. Capex is added to Essential Energy's regulatory asset base (RAB), which is used to determine the return on capital and return of capital (regulatory depreciation) building block allowances. All else being equal, higher forecast capex will lead to a higher projected RAB value and higher return on capital and regulatory depreciation allowances.

Our draft decision addresses a modelling error in Essential Energy's capex forecast, but otherwise includes its corrected total forecast capex of $2081.2 million ($2018–19) for 2019–24.

The figure below highlights the peak in Essential Energy's capex over the 2009–14 regulatory control periods and the subsequent reduction in both forecast and actual capex in 2014–19. The capex proposal includes investments in Essential Energy's strategic initiatives program, which is expected to deliver ongoing capex and opex savings.

Essential Energy's past and proposed capex and AER draft decision capex allowance ($million, 2018–19)



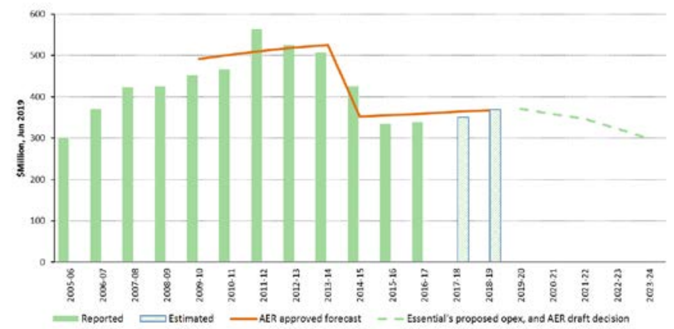
Operating expenditure (opex)

Opex is the forecast operating, maintenance and other non-capital costs incurred in providing network services.

Our draft decision on Essential Energy's revenue for the 2019–24 regulatory control period includes its proposed total forecast opex of $1,718.4 million ($2018–19). This is a reduction of 5.5 per cent from Essential Energy's opex in the current period.

The figure below shows the change in Essential Energy's opex over the last three regulatory control periods, and highlights the reductions in opex achieved over the current period. It also shows the further reductions that would follow from our draft decision to accept Essential Energy's forecast opex for 2019–24.

Essential Energy's past and proposed opex and AER draft decision opex allowance ($million, 2018–19)



For more information:

More information on Essential Energy's proposal, our draft decision and how to make a submission is on our website: www.aer.gov.au.