



# **Final Decision**

## **Essential Energy 2014–19 electricity distribution determination**

May 2018

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# 1 Executive Summary

The Australian Energy Regulator (AER) regulates energy markets and networks under national energy market legislation and rules. Our network regulatory functions, which relate to energy networks in all Australian states and territories, except Western Australia, include setting the amount of revenue that monopoly network businesses can recover from customers for using networks (electricity poles and wires and gas pipelines) that transport energy.

The National Electricity Law (NEL) and Rules (NER) provide the regulatory framework governing electricity networks. Our work under this framework is guided by the national electricity objective (NEO):<sup>1</sup>

“... to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, safety, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.”

This is our remade final decision on the distribution determination for NSW electricity distributor, Essential Energy, for the 2014-19 regulatory control period, commencing 1 July 2014 to 30 June 2019. Our remade final decision is in essence unchanged from our remade draft decision, with minor differences (totalling \$0.3 million less than our remade draft decision) attributable to updated information incorporated into our models.<sup>2</sup>

Our remade final decision is to accept Essential Energy’s proposal to recover total revenues of \$5102.6 million (\$, nominal) from consumers over the five-year 2014-19 regulatory control period.<sup>3</sup> Our remade final decision results in a maximum revenue allowance that is \$100 million above the revenue we approved in our 30 April 2015 final decision that was set aside by the Australian Competition Tribunal (Tribunal). The remade final decision provides consumers with tariff stability and predictability and will maintain distribution network charges at current levels.<sup>4</sup>

We have remade our decision in response to Tribunal directions. Our April 2015 revenue decision allowed Essential Energy to recover \$1719.6 million (\$, nominal) less than what it proposed at the time. In response, Essential Energy sought limited merits review of our decision by the Tribunal. The Tribunal remitted our decision to us, specifically requiring that

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<sup>1</sup> NEL, s. 7.

<sup>2</sup> AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>3</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017. Essential Energy’s proposal cites a revenue amount of \$5102.2 million (\$, nominal). We have since adjusted this revenue amount to reflect updated input information, such as lower annual cost of debt updates, actual CPI and STPIS amounts.

<sup>4</sup> In May 2016, we accepted undertakings given by Essential Energy under section 59A of the NEL that set out how network revenues and tariffs will be determined in 2016–17. Essential Energy’s Network Use of System (NUoS) tariffs in 2016–17 were set as their 2015–16 approved tariffs, adjusted for changes in the CPI. As of May 2017, the Full Federal Court had not yet handed down its decision, so we accepted further undertakings given by Essential Energy to establish new interim arrangements to govern the setting of network tariffs in 2017–18. Essential Energy undertook to continue to apply the terms of, including the price path determined in, our April 2015 final decision for 2017-18 and 2018-19, and to account for and give effect to the new tariff structure statements from 1 July 2017.

we remake our operational expenditure (opex) and cost of debt decisions, and otherwise vary our decision as we consider appropriate.<sup>5,6</sup> This remade final decision for Essential Energy brings this long-running 2014-19 revenue determination process to a close.<sup>7</sup>

On 30 November 2017, and following a series of consultations with its stakeholders, Essential Energy submitted a proposal to resolve all outstanding issues.<sup>8</sup> Essential Energy proposed total revenue of \$5102.6 million (\$, nominal) for the five-year 2014-19 regulatory control period based on:<sup>9</sup>

- our April 2015 final decision, including the constituent decisions we made on opex and the rate of return (including the cost of debt)
- the revenue that Essential Energy has recovered thus far for the 2014-19 regulatory control period, up to a maximum limit of \$100 million above our April 2015 final decision

This document sets out our reasons for accepting Essential Energy's proposal. We have remade our decision in accordance with the NEL and NER. Among other things, this means we have taken into account the revenue and pricing principles (RPP) and the NEO. We are satisfied our remade final decision is likely to contribute to the achievement of the NEO to the greatest degree. The reasons for our decisions are outlined in section 5.

Our remade final decision has been informed by our analysis and stakeholder engagement and submissions.

Energy Consumers Australia (ECA), Energy Users Association of Australia (EUAA), Public Interest Advocacy Centre (PIAC) and the AER's Consumer Challenge Panel (CCP) all provided support that our remade draft decision and Essential Energy's proposal are in the long-term interests of Essential Energy's consumers.

The remade final decision has been made under novel circumstances as set out in section 5.1.1. The novel circumstances we find ourselves in heighten the importance of us remaking our decision in a timely manner. Timely decision-making is a tenet of best regulatory practice and, in our view, is a principle that is in the long-term interests of consumers.<sup>10</sup>

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<sup>5</sup> *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1.

<sup>6</sup> We have remade the constituent decisions for operational expenditure and rate of return, as well as the other matters referenced in section 5.4 of this document. Please refer to our 30 April 2015 final decision for Essential Energy for all other constituent decisions which are unamended: <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19/final-decision>

<sup>7</sup> We have remade the constituent decisions for operational expenditure and rate of return, as well as the other matters referenced in section 5.4 of this document. Please refer to our 30 April 2015 final decision for Essential Energy for all other constituent decisions which are unamended: <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19/final-decision>

<sup>8</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017.

<sup>9</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017. Essential Energy's proposal cites a revenue amount of \$5102.2 million (\$, nominal). We have since adjusted this revenue amount to reflect updated input information, such as lower annual cost of debt updates, actual CPI and STPIS amounts.

<sup>10</sup> Regulatory best practice is also the way in which we have committed to act in undertaking our functions and powers: AER, *Statement of Intent 2017-18*, p. 5.

## 1.1 Structure of this document

This document is structured as follows:

- Section 2 presents our remade final decision for Essential Energy
- Section 3 presents Essential Energy's proposal
- Section 4 presents stakeholders' submissions on our remade draft decision
- Section 5 presents the reasons for our remade final decision

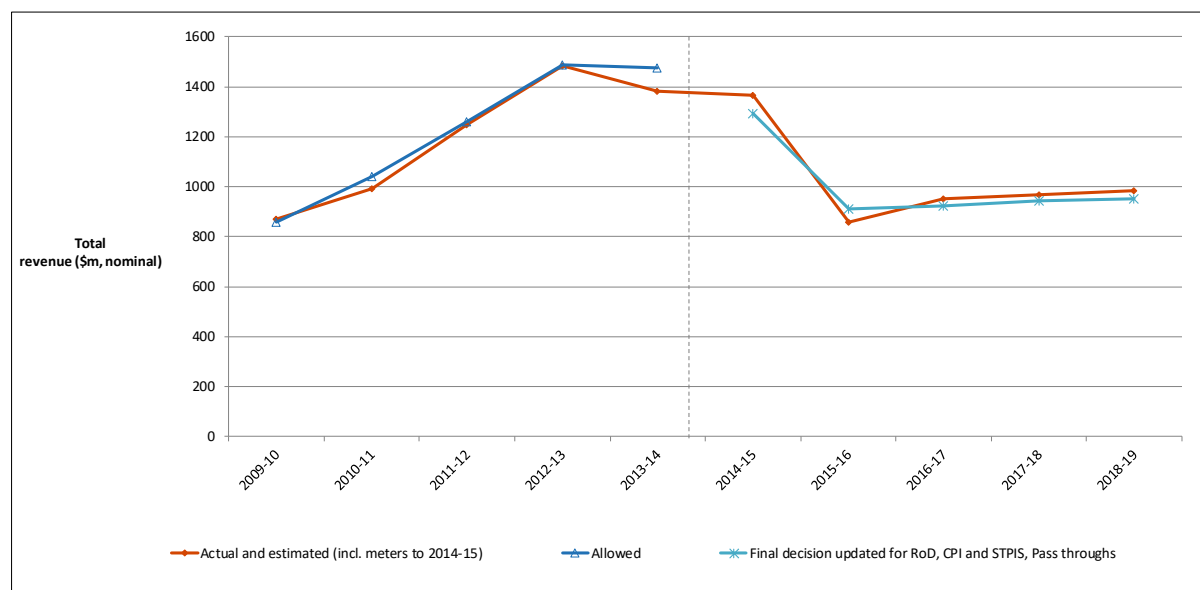
## 2 Our remade final decision

Our remade final decision, after remaking the constituent decisions for opex and the rate of return, as well as correcting some other minor aspects relating to our April 2015 final decision in accordance with the Tribunal's directions, is to accept Essential Energy's proposal.<sup>11</sup>

This means Essential Energy can recover total revenues of \$5102.6 million (\$, nominal) from consumers over the 2014–19 regulatory control period.<sup>12</sup> This outcome is in essence unchanged from our remade draft decision, with minor differences (totalling \$0.3 million less than our remade draft decision) attributable to updated information incorporated into our models.<sup>13</sup> The remade final decision is \$100 million above the revenue allowance we set in our April 2015 final decision.

We are satisfied that this remade final decision, taking into account the RPP, is likely to contribute to the achievement of the NEO to the greatest degree.<sup>14</sup> Figure 2-1 below illustrates our overall decision.

**Figure 2-1 Essential Energy's past total revenue and AER final decision total revenue allowance (\$million, nominal)**



Source: AER analysis.

<sup>11</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017.

<sup>12</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017. Essential Energy's proposal cites a revenue amount of \$5102.2 million (\$, nominal). We have since adjusted this revenue amount to reflect updated input information, such as lower annual cost of debt updates, actual CPI and STPIS amounts.

<sup>13</sup> AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>14</sup> NEL, ss. 16(1)(d)(i) and 16(2).

Customers' bills were set by our April 2015 final decision and following the Tribunal's decision, by interim pricing measures in 2016–17, 2017–18 and 2018–19.

In the 2014-15 transitional year, distribution network charges reduced, on average, by 1.7 per cent.<sup>15</sup>

In 2015-16, distribution network charges fell significantly, reflecting a 31 per cent reduction in Essential Energy's real revenues resulting from our April 2015 final decision. At the time of our decision, this impact was estimated as a \$313 (11.9 per cent) reduction in the average bill for a residential customer and a \$528 (11.9 per cent) reduction in the bill for a small business customer.<sup>16</sup>

During 2016-17, 2017-18 and 2018-19, distribution network charges increased by changes in the consumer price index (CPI) in accordance with enforceable undertakings we accepted. The undertakings from Essential Energy addressed pricing uncertainties arising from the limited merits and judicial review processes.

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<sup>15</sup> AER, *Transitional Decisions: NSW/ACT 2014–15 Factsheet*, April 2014.

<sup>16</sup> AER, *Final Decision Essential Energy distribution determination - Fact Sheet*, April 2015. The analysis assumed distribution network charges made up 43 per cent of customers' bills on average.



### 3 Essential Energy's proposal

On 30 November 2017, we received Essential Energy's proposal for the remaking of the decision pertaining to its revenue determination for the 2014–19 regulatory control period.<sup>17</sup> The proposal for a revenue allowance comprises three parts:<sup>18</sup>

- Between 1 July 2014 and 30 June 2016, Essential Energy proposes to accept the revenue allowance as set out in our April 2015 final decision for 2014–19.
- Between 1 July 2016 and 30 June 2019, Essential Energy proposes to accept the revenue allowance calculated in accordance with the enforceable undertakings it provided to us to govern prices for the 2016–17, 2017–18 and 2018-19 regulatory years under section 59A of the NEL.
- A maximum revenue allowance of \$100 million above that which we set out in our April 2015 final decision. This additional revenue is due to differences between actual and forecast consumption, resulting in a difference between the revenue Essential Energy actually recovered during the 2014-19 regulatory control period and the revenue allowance set out in our April 2015 final decision.

Essential Energy's proposal is a total revenue proposal. It is not directly presented in terms of the building block components as was the case in its initial and revised regulatory proposals which preceded our April 2015 final decision (and the associated constituent decisions).

Essential Energy submitted that its proposal reflects extensive customer and stakeholder engagement and will avoid significant price shocks in both the 2014–19 and 2019–24 regulatory control periods. It further submitted:<sup>19</sup>

“The proposal also provides far greater clarity and certainty for customers, stakeholders and Essential Energy. More specifically, the benefits include:

- A 35 per cent reduction in typical residential customer Distribution Use of System (DUoS) bills in real terms from 2014–15 to 2018–19;
- Future price certainty for consumers, particularly for 2018–19, with an increase on 1 July 2018 forecast at CPI;
- A 28 per cent reduction in revenue from 2014–15 to 2018–19, keeping downward pressure on network charges;
- Delivering stable network charges for our customers while enabling Essential Energy to recover its efficient costs;

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<sup>17</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017.

<sup>18</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017, p. 2.

<sup>19</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017, p. 1.

- Maintaining the capital expenditure sharing scheme and service target performance incentive scheme to ensure benefits continue to be delivered to customers into the future;
- Establishing customer prices in accordance with tariff structure statement requirements; and
- The submission of Essential's 2019–24 regulatory proposal by the end of April 2018, based on a remade 2015 determination.”

## 4 Stakeholder submissions on our remade draft decision

We received three stakeholder submissions on our remade draft decision:

- Essential Energy
- Public Interest Advocacy Centre (PIAC)
- our Consumer Challenge Panel, Sub-panel 10 (or CCP10)

All stakeholders supported our remade draft decision as being in the long-term interest of Essential Energy's customers. Key points raised in submissions are summarised below.

We also note that our remade draft decision included a summary of supporting comments received from the following stakeholders with respect to Essential Energy's proposal following its pre-lodgement engagement with stakeholders:<sup>20</sup>

- Energy Consumers Australia (ECA)
- Energy Users Association of Australia (EUAA)
- PIAC
- CCP10

All of the above stakeholders' submissions are available on our website.<sup>21</sup>

### 4.1 Essential Energy

In response to our remade draft decision, Essential Energy submitted:<sup>22</sup>

"We support the AER's draft decision noting it is in line with our proposed approach to the remittal. Minor corrections are required to be made to the over-recovery calculation, and the treatment of the service target performance incentive scheme within that calculation, to ensure adherence to the formulas outlined in the Control Mechanism attachment of the AER's April 2015 final decision.

Essential Energy consulted extensively with key consumer groups in developing our proposed remittal agreement. Ultimately, the proposed approach will promote price certainty

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<sup>20</sup> Refer to our remade draft decision for a summary of these stakeholders' comments on Essential Energy's proposal for the 2014-19 regulatory control period. ECA, EUAA, PIAC and CCP10 considered the proposal to be in the long-term interest of Essential Energy's customers: AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018, pp. 15-16. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>21</sup> AER: <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal>

<sup>22</sup> Essential Energy, *Submission on draft decision for the remittal of Essential Energy's 2014-19 distribution determination*, 4 April 2018.

and stability for consumers, as well as providing a timely and certain resolution for the 2014-19 regulatory control period that will benefit both consumers and Essential Energy.”

In accordance with the comments we made in our March 2018 remade draft decision – and to address the above submitted comments from Essential Energy – we have updated the revenue amount for any new information received since that decision was published.<sup>23</sup> Overall, our remade final decision is \$0.3 million (\$, nominal) lower than our remade draft decision.

## 4.2 Public Interest Advocacy Centre

In response to our remade draft decision, PIAC submitted:<sup>24</sup>

“PIAC supports Essential Energy’s proposal to accept the AER’s 2015 final determination and retain some over-recovered revenue with a limit of \$100 million across the period...

Essential Energy has engaged effectively with the AER, CCP and consumer advocates in making its remittal proposal...

PIAC contends that the AER’s draft determination promotes the long-term interest of consumers...

PIAC concurs with the AER that the timely resolution of this process, and the removal of the potential for judicial review of the re-made decision by Essential Energy, is in consumers’ interests.

On balance, PIAC considers it reasonable for Essential Energy to recover a maximum of \$100 million over the revenue allowance set in the 2015 final determination, on the basis that this appears to be a lower cost than the revenue forgone by Essential Energy on opex and return on debt.”

## 4.3 Consumer Challenge Panel

In response to our remade draft decision, CCP10 submitted:<sup>25</sup>

“The draft decision from the AER to accept the Essential Energy proposal for the remittal 2014-19 regulatory period is supported by the CCP, through Sub-panel 10 (CCP10)...

Prior to making its draft decision, the AER sought advice from CCP10 and some key consumer groups, we said:

‘CCP10 supports Essential’s proposal for resolving its regulatory allowance for 2014-19 following the remittal of that determination to the AER by the Federal Court. We commend Essential Energy on its genuine and transparent consumer engagement on its proposal and on the way it has listened to that feedback and

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<sup>23</sup> See footnote 16 of: AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>24</sup> Public Interest Advocacy Centre, *Essential Energy Remittal – Draft Determination*, 10 April 2018.

<sup>25</sup> Consumer Challenge Panel, *CCP10 response to AER Draft Decision, Essential Energy 2014-19 electricity distribution determination (remittal decision)*, 6 April 2018.

reflected it in its revised proposal. CCP10 believes that the Essential proposal is in the long-term interests of Essential's customers.'

We maintain this perspective now that the proposal has been formally lodged and is under consideration by the AER...

Submissions have also been made to the AER remitted decision issues paper dealing with operating expenditure and the position paper on debt decisions. Consistent with the arguments that we have presented in these two papers, we support the AER's draft decisions regarding operating costs and debt as presented in the Essential Energy remade draft decision for 2014-19...

CCP has observed very high levels of engagement between Essential Energy, consumer groups and the regulator in developing a sensible proposal for the remitted decision...

Compared to the original AER decision for 2014-19, the draft decision allows for an extra \$100m in revenue to be collected by Essential Energy...we conservatively estimate the total saving for consumers for the remade 2014-19 decision to be well over a billion dollars compared to the initial proposal; savings that will be retained for future periods...

Regulatory judgment has been carefully exercised and has involved assessing the decision as a whole in unique circumstances, with the National Electricity Objective being achieved."

## 5 Reasons for our remade final decision

Our remade final decision is in essence unchanged from the remade draft decision we published in March 2018, with minor differences (totalling \$0.3 million less than our remade draft decision) attributable to updated information incorporated into our models.<sup>26</sup> Similarly, our reasons for arriving at our final position are unchanged from our draft position.

### 5.1 Our approach

As is the case with making any distribution determination, there may be several possible overall decisions that we could potentially make that will, or are likely to, contribute to the achievement of the NEO. In these circumstances, the NEL directs us to make the decision that we are satisfied will, or is likely to, contribute to the achievement of the NEO to the greatest degree.<sup>27</sup>

Determining whether any particular decision will, or is likely to, contribute to achieving the NEO is a matter of regulatory judgment which involves assessing the decision as a whole, taking into account the RPP and complying with the specific requirements of the NER. Implicit in this task is recognising that a distribution determination is more than just the sum of its constituent decisions or component parts as determined in accordance with Chapter 6 of the NER.

#### 5.1.1 The novel circumstances we face now

The approach we have applied in remaking this final decision has necessarily been influenced by the novel circumstances that we face now. These are novel circumstances because they materially differ from those we faced when we made our April 2015 final decision, and what we would generally face in making a distribution determination.

Specifically, we are making this remade final decision at a time:

- that is almost four years into the applicable five-year 2014-19 regulatory control period
- when we have applied interim pricing measures for the 2016-17, 2017-18 and 2018-19 regulatory years by accepting enforceable undertakings to address pricing uncertainties arising from the limited merits and judicial review processes
- when we have had a number of Tribunal and Federal Court processes, since the Tribunal's decision on Essential Energy, that have considered and clarified the law in relation to 'efficient financing costs' and the determination of the cost of debt
- when we have information on Essential Energy's actual performance for the first three years of the five-year 2014–19 regulatory control period

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<sup>26</sup> AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>27</sup> NEL, ss. 16(1)(d)(i) and 16(2).

- when our decision has the potential to create significant retail price fluctuations if it differs materially from our April 2015 final decision<sup>28</sup>
- when we have received Essential Energy’s revenue proposal for the forthcoming 2019-24 regulatory control period
- when there is strong support from a range of consumer groups that our remade draft decision and Essential Energy’s proposal is in the long-term interest of Essential Energy’s consumers

### 5.1.2 Assessing the overall decision

Ultimately, assessing whether this remade final decision achieves the NEO to the greatest degree involves us exercising our judgment to determine whether the overall decision will promote efficiencies in relation to investment, and the operation and use of Essential Energy’s network that is in the long-term interest of consumers. This involves us balancing the various, and at times competing, factors referred to in the NEO. We must also take into account the RPP in determining how the NEO may be achieved to the greatest degree.<sup>29</sup>

This is the same approach that we applied in our March 2018 draft decision<sup>30</sup> and in our April 2015 final decision.<sup>31</sup> This approach was also affirmed by the Tribunal in its reasons of 26 February 2016.<sup>32</sup>

In considering whether this remade final decision is likely to contribute to the achievement of the NEO to the greatest degree, in respect of our assessment of Essential Energy’s proposal, we note that there are potentially a range of possible outcomes that may meet the Tribunal’s directions.

## 5.2 Assessment of Essential Energy’s proposal

In light of the novel circumstances we are faced with, and the information before us, we are satisfied that accepting Essential Energy’s proposal will result in an outcome that is likely to contribute to the achievement of the NEO to the greatest degree and is in the long-term interests of consumers.

Key reasons for our decision to accept Essential Energy’s proposal are outlined below.

<sup>28</sup> Recognising that this prospect is to some extent alleviated by the rule made by the Australian Energy Market Commission (AEMC) on 1 August 2017 that allows us to let Essential Energy recover any additional revenues that result from our decision across both 2014–19 and 2019–24 regulatory control periods. See AEMC, *Rule Determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017*, 1 August 2017; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6*, commencing 15 August 2017.

<sup>29</sup> See NEL, s. 16(2). As affirmed by the Federal Court in *Australian Energy Regulator v Australian Competition Tribunal (No 2)* [2017] FCAFC 79, [36].

<sup>30</sup> AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>31</sup> AER, *Final Decision, Essential Energy distribution determination 2015–16 to 2018–19, Overview*, April 2015, pp. 53–54.

<sup>32</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1, [77] and [78].

First, remaking the opex and cost of debt constituent decisions reveals a result that is in essence unchanged from our March 2018 remade draft decision (\$0.3 million lower) and consistent with the overall level of total revenues that we arrived at in our April 2015 final decision. This is discussed below in sections 5.3.1 and 5.3.2, respectively. This result also aligns with Essential Energy's proposal that is in part premised on the revenue allowance set in our April 2015 final decision.

Second, the novel circumstances we find ourselves in heighten the importance of us remaking our decision in a timely manner. Timely decision-making is a tenet of best regulatory practice and, in our view, is a principle that is in the long-term interests of consumers.<sup>33</sup> Resolving the uncertainty created by the limited merits and judicial review processes in a timely manner, by expediting this remittal process where possible compared to an extended timeframe of potentially up to 18 months for a regular determination process, is supported by several consumer groups and Essential Energy (particularly in light of its 2019-24 regulatory proposal which has now been submitted to the AER).<sup>34</sup> This remade final decision resolves this uncertainty and addresses the crucial issue of price stability, which informs consumers of their budgetary and investment decisions on the use of electricity services. Price stability, or minimising price volatility, is also in the long-term interests of consumers and is one of the primary reasons we accepted the enforceable undertakings that Essential Energy gave to us to govern prices for the 2016–17, 2017–18 and 2018–19 regulatory years.<sup>35</sup>

Third, we consider that Essential Energy's overall revenue proposal represents an efficient level of expenditure necessary for it to provide safe and reliable electricity services to its consumers. As discussed at section 5.1.2, the approach we have applied in this remade final decision involves us exercising our judgment to determine whether the overall decision will promote efficiencies in relation to investment, and the operation and use of Essential Energy's network that is in the long-term interest of consumers. In other words, the long-term interests of consumers are served by us identifying how the level of electricity supply services delivered by Essential Energy so far during the 2014-19 regulatory control period may be done at least cost to the consumer. The following observations are relevant. Essential Energy's proposal:

- is effectively \$914 million less than the revised regulatory proposal it submitted to us on 20 January 2015 on the issues of opex and the cost of debt
- represents a 28 per cent reduction in revenue in comparison to 2014–15
- represents a reduction in annual opex of around 30 per cent

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<sup>33</sup> Regulatory best practice is also the way in which we have committed to act in undertaking our functions and powers: AER, *Statement of Intent 2017-18*, p. 5.

<sup>34</sup> For example, several participants expressed support to expedite this remittal process at the NSW and ACT remittal roundtable we held on 16 August 2017: AER, *NSW and ACT remittal roundtable summary note*, p. 4. Similarly, the EUAA stated in its letter of support: "We appreciate Essential's approach to expediting the remittal process to reach an acceptable resolution of this long running matter and we hope this approach is an example for others to follow": EUAA, *Re: Essential Energy - Determination 2014-19 – Remittal*, 30 November 2017, p. 1. See also, Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017, pp. 1 and 3.

<sup>35</sup> See AER, *Open letter to Stakeholders: Electricity network charges in the ACT and NSW from 1 July 2017*, 19 April 2017.



As noted above, Essential Energy's proposal reflects the revenues it has been able to recover under our April 2015 final decision and through the enforceable undertakings. It is important to highlight that the revenue provided for in our April 2015 final decision has not limited Essential Energy's ability to provide safe, reliable and secure electricity throughout the 2014-19 regulator control period. Nor has Essential Energy submitted to us that it faces any such risks in the forthcoming 2018–19 regulatory year. We also note that Essential Energy has forecast further opex reductions in its 2019–24 regulatory proposal.<sup>36</sup>

Fourth, we consider that a remade final decision that is \$100 million above the revenue allowance set out in our April 2015 final decision fits within an overall decision that contributes to the NEO to the greatest degree. In support of this \$100 million cap, Essential Energy submitted:<sup>37</sup>

“This cap provides revenue certainty for the two year[s] ending 30 June 2018 and 2019 and ensures that the revenue impact of unexpected increases in actual energy consumed in those years are returned to customers by way of revenue adjustments in the 2019–24 regulatory period.”

Generally, under a revenue cap form of price control, any difference between what a network service provider actually recovers in comparison to a revenue allowance set out in a distribution determination, as a result of differences between forecast and actual consumption in any given regulatory year, is reconciled through the annual pricing or revenue determination process. However, the \$100 million cap that Essential Energy has proposed is not subject to this reconciliation.

In this case, our view is that the \$100 million, as part of Essential Energy's overall proposal, which incorporates significant cost reductions in opex to date, will contribute to price stability for its consumers and result in an outcome that is likely to contribute to the achievement of the NEO to the greatest degree. In coming to this view, we have considered the following factors:

- The maximum revenue allowance of \$100 million above that which we set out in our April 2015 final decision represents an outcome that quantifies and appropriately balances the risk and uncertainty faced by affected stakeholders, including consumers. This is in the context where stakeholders have stated a clear preference for us to remake the decision in a timely manner and to resolve uncertainty in light of the novel circumstances described above.
- The maximum revenue allowance of \$100 million above that which we set out in our April 2015 final decision represents approximately 1.9 per cent of the total revenues Essential Energy is otherwise proposing to recover during the 2014–19 regulatory control period. This is relatively immaterial within the context of the overall revenue determination.
- By allowing for a maximum revenue allowance of \$100 million above that which we set out in our April 2015 final decision, Essential Energy's proposal forecasts annual price

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<sup>36</sup> Essential Energy, *2019–24 Regulatory Proposal*, April 2018: <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2019-24>

<sup>37</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017, p. 2.

movements for a typical residential customer in its service area using 5 MW/h per annum of zero per cent in both 2017–18 and 2018–19. As Essential Energy submitted, this provides it with revenue stability over 2017–18 and 2018–19, and therefore also goes some way to reducing any further price instability.

We have given weight to the expressions of support from the CCP10, ECA, EUAA and PIAC in respect of our remade draft decision and Essential Energy’s proposal. Notably, given the circumstances, each of these stakeholders considers that allowing for a maximum revenue allowance of \$100 million above that which we set out in our April 2015 final decision as part of a remade decision results in an outcome that is in the long-term interests of Essential Energy’s customers.<sup>38</sup>

In response to our remade draft decision, the CCP10 submitted:<sup>39</sup>

“Submissions have also been made to the AER remitted decision issues paper dealing with operating expenditure and the position paper on debt decisions. Consistent with the arguments that we have presented in these two papers, we support the AER’s draft decisions regarding operating costs and debt as presented in the Essential Energy remade draft decision for 2014-19...”

The variations to our control mechanism constituent decision that we have made in order to give effect to the maximum revenue allowance of \$100 million above that which we set out in our April 2015 final decision is discussed in section 5.4.1.

### 5.3 Remaking the operational expenditure and return on debt constituent decisions

As noted in section 1, following the Court’s decision, the Tribunal’s directions that we are to comply with in remaking our decision for Essential Energy are as follows:<sup>40</sup>

- “(a) the AER is to make the constituent decision on opex under r 6.12.1(4) of the National Electricity Rules in accordance with these reasons for decision including assessing whether the forecast opex proposed by the applicant reasonably reflects each of the operating expenditure criteria in r 6.5.6(c) of the National Electricity Rules including using a broader range of modelling, and benchmarking against Australian businesses, and including a “bottom up” review of Essential’s forecast operating expenditure;

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<sup>38</sup> Consumer Challenge Panel, *CCP10 response to AER Draft Decision, Essential Energy 2014-19 electricity distribution determination (remittal decision)*, 6 April 2018; Public Interest Advocacy Centre, *Essential Energy Remittal – Draft Determination*, 10 April 2018; Consumer Challenge Panel, *Letter to AER on Essential Energy 2014-19 revenue allowance remittal proposal*, 26 November 2017; Energy Consumers Australia, *ECA Support for Application for Extension to Submit 2019 – 24 Regulatory Proposal*, 27 November 2017; Energy Users Association of Australia, *Re: Essential Energy – Determination 2014–19 – Remittal*, 30 November 2017; Public Interest Advocacy Centre, *Submission – Remitted decisions for NSW/ACT 2014-19 electricity distribution determinations – Operating Expenditure*, 30 November 2017.

<sup>39</sup> Consumer Challenge Panel, *CCP10 response to AER Draft Decision, Essential Energy 2014-19 electricity distribution determination (remittal decision)*, 6 April 2018.

<sup>40</sup> *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1. Note direction 1(c) is omitted following the Court’s decision in relation to gamma: *Australian Energy Regulator v Australian Competition Tribunal (No 3)* [2017] FCAFC 80, [738]-[784].

- (b) the AER is to make the constituent decision on return on debt in relation to the introduction of the trailing average approach in accordance with these reasons for decision;
- ...
- (d) the AER is to consider, and to the extent to which it considers appropriate to vary the Final Decision in such other respects as the AER considers appropriate having regard to s 16(1)(d) of the National Electricity Law in the light of such variations as are made to the Final Decision by reason of (a)-(c) hereof.”

The rules in the NER and provisions in the NEL that govern our assessment of opex and debt remain unchanged on remittal.

In the following sections, we set out our remade constituent decisions for operational expenditure (opex) and the cost of debt, as well as the variations to our control mechanism constituent decision.

### 5.3.1 Opex constituent decision

In this remade final decision, our remade opex constituent decision has not changed from our March 2018 remade draft decision.<sup>41</sup>

Opex refers to operating, maintenance and other non-capital expenses. Forecast opex for prescribed distribution services is one of the building blocks that typically make up a service provider’s total revenue requirement.

As noted in section 3, Essential Energy’s revenue proposal implicitly retains the efficient opex forecast we provided for in our April 2015 final decision. We have re-examined this opex forecast in light of the Tribunal’s directions and updated information, where available, since our original decision. For the reasons set out in this section, we are satisfied that this opex forecast is consistent with the opex criteria. Table 5-1 sets out this opex forecast.

**Table 5-1 AER final decision opex forecast (\$million, 2013–14)**

2014-15	2015–16	2016–17	2017–18	2018–19	Total
316.3	319.6	322.9	326.4	330.0	1615.3

#### 5.3.1.1 Reasons for our decision

As the Tribunal refers to in its directions, we must remake our opex decision under clause 6.12.1(4) of the NER. This means we must either accept a distributor’s proposed opex forecast, or reject it and determine our own substitute estimate. The Tribunal found that our decision to reject Essential Energy’s opex forecast was not in error. However the Tribunal determined that we erred in the reliance we placed on benchmarking in arriving at

<sup>41</sup> See section 5.3.1 of: AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

our substitute estimate. Our task here is to reconsider our substitute estimate in accordance with the Tribunal's order and reasoning (as clarified by the Federal Court).

Clause 6.5.6 of the NER sets out the opex objectives, opex criteria and opex factors, under which we must make our constituent decision on opex. In summary, we must identify a level of forecast opex that is efficient and prudent and at a level that sustainably maintains the safety and reliability of the network in the long-term interests of consumers.

Setting an opex forecast is part of the incentive-based regulatory regime established in Chapter 6 of the NER. Incentive regulation is designed to encourage network businesses to improve their efficiency over time. Where a distributor is responsive to the financial incentives under the regulatory framework, the actual level of opex it incurs should provide a good estimate of the efficient costs required for it to operate a safe and reliable network and meet its relevant regulatory obligations. This is because opex is largely recurrent and stable at a total level between years and regulatory periods. This is known as the 'revealed cost approach'. So long as we do not identify any material inefficiency in a distributor's revealed costs, our preference is to rely on these costs in assessing the distributor's proposed opex forecast, and if necessary, in determining a substitute estimate.<sup>42</sup>

In remaking our opex decision, we have considered Essential Energy's actual costs over the first three years of the 2014–19 regulatory control period, and its cost estimates for the remainder of the period. Essential Energy has achieved significant reductions in opex since 2012–13 and its recent opex is now consistent with our opex forecast set in our April 2015 final decision. Essential Energy appears to have responded to the strong incentives imposed by our regulatory regime, including the use of economic benchmarking.

Having regard to the Tribunal's directions, we have tested the efficiency of Essential Energy's revealed opex with:

- Additional economic benchmarking results, including updates for 2015–16. This shows that Essential Energy has significantly improved its opex productivity and its recent revealed opex is not materially inefficient when compared to its peers.
- Category level cost analysis that examines some of the underlying reasons for Essential Energy's reductions in opex since 2012–13. This shows that Essential Energy has made significant reductions in vegetation management and labour costs – two areas we identified as materially inefficient in our April 2015 final decision.

Taken together, we are satisfied that Essential Energy's proposed opex forecast reasonably reflects the opex criteria.

Further information on our analytical approach and the data we used to inform our analysis is outlined in our remade draft decision.<sup>43</sup> We note that the submissions to our remade draft decision did not raise any new issues or provide any additional information that necessitates a change to our opex decision as outlined in the remade draft decision.

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<sup>42</sup> AER, *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p.22.

<sup>43</sup> See section 5.3.1 of: AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018.  
<https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

### 5.3.2 Return on debt constituent decision

In this remade final decision, our remade debt constituent decision has not changed from our March 2018 remade draft decision.<sup>44</sup>

The allowed rate of return provides a network service provider a return on capital that a benchmark efficient entity would require to finance (through debt and equity) investment in its network.<sup>45</sup> The return on capital building block is calculated as a product of the rate of return and the value of the regulatory asset base (RAB).

Essential Energy's revenue proposal has implicitly adopted our return on capital allowance that we set in our April 2015 final decision (with minor revisions for updated return on debt data). This was based on a transition to a trailing average methodology for calculating the return on debt.

Since our April 2015 final decision, having regard to the decisions of the Tribunal and Court, we have revised our general approach to determining the return on debt. We now apply a revenue neutral transition when moving from the on-the-day methodology for estimating the cost of debt to a trailing average methodology. While our approach, and the reasoning to support it, has changed since the April 2015 final decision, the revenue outcome of our new approach is approximately the same as in the April 2015 final decision.<sup>46</sup> Essential Energy's proposal is consistent with our new approach to determining the return on debt.

The revised rate of return allowance is set out in Table 5-2. These numbers reflect our April 2015 final decision with respect to the return on equity and the gearing ratio and a revenue neutral transition calculated using updated debt yield data from the Reserve Bank of Australia (RBA) and Bloomberg.<sup>47</sup> They also reflect the debt averaging periods we determined to use in our April 2015 final decision.

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<sup>44</sup> See section 5.3.2 of: AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>45</sup> The term network service provider relates to service providers that provide gas and electricity transmission and distribution services.

<sup>46</sup> We note a very small change in revenue occurs due to the use of the most recent debt yield data available.

<sup>47</sup> The RBA made two changes to its yield curve estimates over the relevant period and Bloomberg has removed a period of data from publication.

**Table 5-2 Essential Energy return on debt and return on capital, 2015 final decision (\$million, 2013-14) and percentage debt portfolio rate of return<sup>48</sup>**

	2014-15	2015-16	2016-17	2017-18	2018-19	Total
Final decision debt portfolio rate of return	6.51%	6.40%	6.25%	6.10%	5.93%	
Final decision return on debt	264.46	275.98	284.86	292.35	297.47	1415.13
Final decision return on capital	456.85	480.10	500.50	519.03	534.95	2491.42

For the reasons set out below, our remade final decision is to accept the ex ante rate of return revenue allowance as set out in Table 5-3 below.

**Table 5-3 Essential Energy updated return on debt and return on capital, 2018 final decision (\$million, 2013-14) and percentage debt portfolio rate of return<sup>49</sup>**

	2014-15	2015-16	2016-17	2017-18	2018-19	Total
Final decision debt portfolio rate of return	6.51%	6.41%	6.26%	6.10%	5.93%	
Final decision return on debt	264.71	276.30	285.09	292.32	297.41	1415.84
Final decision	457.10	480.42	500.72	519.00	534.89	2492.14

### 5.3.2.1 The NER requirements

We must determine a rate of return such that it achieves the allowed rate of return objective (ARORO).<sup>50</sup> The ARORO is that the rate of return is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of its regulated services (its standard control

<sup>48</sup> These numbers reflect the final decision including annual debt updates.

<sup>49</sup> These numbers use updated RBA and Bloomberg data and include annual debt updates.

<sup>50</sup> NER ss. 6.5.2(b), 6A.6.2(b).

service in the case of electricity distributors).<sup>51</sup> Therefore, each remade debt decision must contribute to achieving the ARORO.

Other legislative requirements relevant to remaking our debt decision include the NEO, the RPP and any interrelationships with other related components of a distribution determination.<sup>52, 53, 54</sup>

### 5.3.2.2 The Tribunal's decision

On 26 February 2016, the Tribunal handed down its decisions.<sup>55</sup> The Tribunal instructed us to remake the constituent decision on the return on debt in relation to the introduction of the trailing average in accordance with the Tribunal's reasons for its decisions without giving a clear clarification of the directions for the remittal.<sup>56</sup> The Tribunal found us in error in our definition of a benchmark efficient entity as a 'regulated' entity. The Tribunal also found us in error in our construction of NER rule 6.5.2(k)(4), based on the information available to the Tribunal at that time.

### 5.3.2.3 Judicial Review

On 24 March 2016, we applied to the Federal Court for judicial review of the Tribunal's decisions. On 24 May 2017, the Court dismissed our appeals on the return on debt and opex and upheld the Tribunal's decisions in relation to these issues. It upheld the AER's appeal in relation to the value of imputation credits (gamma).<sup>57</sup>

We have carefully considered the full reasoning of the Court in considering what to do to achieve the ARORO, NEO and RPP in this decision. Of relevance, in relation to the Court's decision:

- the Court clarified that a benchmark efficient entity is not necessarily either regulated or unregulated
- the important characteristic of a benchmark efficient entity is that it has a similar degree of risk to the service provider with respect to the provision of its regulated services
- a change in debt estimation methodology does not necessarily result in any impacts for a benchmark efficient entity

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<sup>51</sup> NER ss. 6.5.2(c), 6A.6.2(c).

<sup>52</sup> NEL, ss. 7 and 16(1)(d).

<sup>53</sup> The RPP that are directly relevant to remaking our debt decision are set out at NEL, ss. 7A(2), 7A(3), 7A(5), 7A(6) and 16(2).

<sup>54</sup> NEL, s. 16(1)(c).

<sup>55</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1; *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2; *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3; *Application by ActewAGL Distribution* [2016] ACompT 4.

<sup>56</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1, direction 1(b); *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2, direction 1(b); *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1(b); *Application by ActewAGL Distribution* [2016] ACompT 4, direction 1(b); *Application by Jemena Gas Networks (NSW) Ltd* [2016] ACompT 5, direction 1(a).

<sup>57</sup> *Australian Energy Regulator v Australian Competition Tribunal (No 3)* [2017] FCAFC 80.

In relation to both the decisions of the Tribunal and Court, we also make the following observations:

- The decisions of the Tribunal and Court were not focussed on the interpretation of 'efficient financing costs' in the ARORO. We consider this to be an important factor.
- Neither decision removes the requirement to apply a debt methodology that we consider will achieve the relevant legislative objectives for each of the respective service providers affected by the remittals.
- Neither decision requires the use of a trailing average methodology for determining the cost of debt in this remittal.

In subsequent decisions involving other parties, the Tribunal and Full Federal Court have made various findings and comments which are also relevant to these matters. In particular, both the Tribunal and Federal Court have made comments about our new approach to estimating the return on debt that help to clarify how the Tribunal's decision for Essential Energy should be interpreted.<sup>58</sup> This is discussed in more detail below.

#### 5.3.2.4 Other relevant legal processes

Other legal decisions that we have had regard to in our remade final decision are:

- the decision of the Australian Competition Tribunal for SA Power Networks and the subsequent decision of the Full Federal Court on the appeal of this decision<sup>59</sup>
- the decisions of the Australian Competition Tribunal for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd<sup>60</sup>

The decisions of the Tribunal for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd are particularly important as they are directly concerned with the application of our new approach to estimating the return on debt.

After the Tribunal handed down its decisions for Essential Energy, we reconsidered our approach to debt estimation methodology. The new approach, which we adopted in our decisions for ActewAGL (Gas) Distribution and Jemena Electricity Networks, does not rely upon a conceptualisation of a benchmark efficient entity as a regulated entity. It recognises that different service providers may have a different benchmark efficient entity. The new approach also does not rely on a change in methodology impacting a benchmark efficient entity to justify our revenue neutral transition. Our new approach does not rely upon an assessment of historical financing practices. Instead, it considers the efficient financing costs (being the costs of equity and debt) in a forward looking manner. Our new approach was subject to review by the Tribunal.

The Tribunal upheld our new approach. It explained more clearly how each of the Tribunal's and Court's decisions should be read together consistently. It provided clarification for the earlier Tribunal's decision on the directions of the Tribunal for the remittal that were

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<sup>58</sup> See eg *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3 at [295].

<sup>59</sup> *Application by SA Power Networks* [2016] ACompT 11; *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3.

<sup>60</sup> *Application by ActewAGL Distribution* [2017] ACompT 2.



previously unclear to us. We consider these decisions support a revenue neutral transition when moving to a trailing average methodology based on our new approach, or the continuance of an on-the-day methodology for determining the cost of debt, to achieve the NEO.

An important aspect of the decisions for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd is the consideration in those decisions of the interpretation of the 'allowed rate of return objective' (or ARORO) and the meaning of 'efficient financing costs'.<sup>61</sup> We consider these decisions support our ex ante interpretation of efficient financing costs. These decisions and our view on them are covered in further detail in our debt Position Paper on our remitted debt decisions.<sup>62</sup>

On 18 January 2018, the Full Federal Court handed down its decision on *SA Power Networks v Australian Competition Tribunal*.<sup>63</sup> This was a review brought by SA Power Networks from a decision of the Tribunal.<sup>64</sup>

The Full Federal Court noted that the Court had not had the benefit of hearing a number of issues in relation to Essential Energy's review that had been subsequently put to it in *SA Power Networks vs Australian Competition Tribunal*.<sup>65</sup> We consider this Full Court decision also supports our new revenue neutral debt transition approach which we have applied in this remitted debt decision.

### 5.3.2.5 Reasons for our decision

For the reasons set out in our debt Position Paper<sup>66</sup> on our remitted debt decisions and in our APA VTS final decision, we consider a revenue neutral transition to a trailing average debt estimation methodology will lead to an allowed rate of return that will achieve the ARORO and contribute to the achievement of the NEO to the greatest degree. This rate of return will both reflect ex ante efficient financing costs and result in an approximately zero NPV investment outcome which is important to achieving efficient investment incentives. A revenue neutral transition will also substantially eliminate any wealth impact on Essential Energy from changing the debt estimation methodology.

We rely on the reasoning in our APA VTS decision in making this final decision for Essential Energy, as set out in Attachment 3 of our APA VTS determination.<sup>67</sup> This includes an

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<sup>61</sup> *Application by ActewAGL Distribution* [2017] ACompT 2.

<sup>62</sup> AER, *Position paper– Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

<sup>63</sup> *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3.

<sup>64</sup> *Application by SA Power Networks* [2016] ACompT 11.

<sup>65</sup> See section 5.3.2.4 of: AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>66</sup> AER, *Position paper– Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

<sup>67</sup> AER, *Final Decision APA VTS gas access arrangement 2018 to 2022, Attachment 3 - Rate of return*, November 2017. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/apa-victorian-transmission-system-access-arrangement-2018-22/final-decision>. This decision discusses and applies substantively identical provisions for rate of return as those applicable to electricity distribution.

explanation of how our approach has changed in response to relevant legal decisions. We also rely on our explanation and reasoning as set out in the debt Position Paper on our remitted debt decisions in making this remade final decision.<sup>68</sup>

We have used the most up to date debt data from the RBA and Bloomberg for estimating the cost of debt over the relevant averaging periods. We consider that by using the most updated debt data, our cost of debt estimates will be better estimates of the efficient cost of debt than if we used the earlier data from Bloomberg and the RBA.

In relation to the timing of the initial debt averaging period (for the commencement of the trailing average), we have used the initial averaging period set out in our April 2015 final decision for the introduction of the trailing average. We also have used the debt averaging periods for the later years of the regulatory control period, as set out in our April 2015 final decision, because we consider these will lead to a rate of return that achieves the ARORO and contribute to the achievement of the NEO. All averaging periods were chosen in advance of their commencement and we consider their use should result in an ex ante efficient return on debt allowance. We consider choosing averaging periods after the periods have finished (or post commencement) is generally inappropriate due to the potential incentive on various stakeholders to advocate for averaging periods that give particular results.

We also consider our overall approach will lead to an overall allowed rate of return that will achieve the ARORO and contribute to achieving the NEO because:

- the return on equity we determined in our April 2015 final decision was upheld on appeal as was the gearing ratio and we consider these values remain appropriate
- our combination of the yield from two debt series we used to estimate the return on debt in the April 2015 final decision, a simple average of yields estimated from the Bloomberg and RBA yield curves, was upheld on appeal in the Tribunal and we consider remains appropriate
- we consider the overall allowed rate of return estimated using our return on debt, return on equity and gearing estimates will result in an allowed rate of return that will achieve the ARORO and contribute to achieving the NEO

Our remade return on debt constituent decision has been informed by our examination of submissions received on our debt Position Paper<sup>69</sup> and remade draft decision.<sup>70</sup> Further information on our analytical approach and the data we used to inform our analysis is outlined in our remade draft decision. We note that the submissions to our remade draft decision did not raise any new issues or any additional information that necessitates a change to our return on debt decision as outlined in the remade draft decision.<sup>71</sup>

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<sup>68</sup> AER, *Position paper– Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

<sup>69</sup> AER, *Position paper– Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

<sup>70</sup> AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal/draft-decision>

<sup>71</sup> See section 5.3.2 of: AER, *Draft Decision Essential Energy distribution determination 2014-19*, March 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19->

## 5.4 Other aspects of the 2015 final decision to be varied

### 5.4.1 Control mechanism

The control mechanism was not a subject of Essential Energy's appeal of our April 2015 final decision. However, this remade final decision has implications for the operation of the control mechanism for the 2014–19 and 2019–24 regulatory control periods. The Tribunal's directions that we are to comply with in remaking our decision includes:

- (d) the AER is to consider, and to the extent to which it considers appropriate to vary the Final Decision in such other respects as the AER considers appropriate having regard to s 16(1)(d) of the National Electricity Law in the light of such variations as are made to the Final Decision by reason of (a)-(c) hereof.

This remade final decision is \$100 million above our April 2015 final decision. In order to effect the additional \$100 million in our control mechanism formula, we must vary the control mechanism as set out in our Framework and Approach paper for Essential Energy's 2014–19 revenue determination and adopted in our April 2015 final decision.<sup>72</sup>

As per the approach we took in our March 2018 remade draft decision, this remade final decision removes the following requirement from our April 2015 final decision on the form of control mechanism:<sup>73</sup>

“In proposing variations to the amount and structure of DUoS charges, Essential Energy is to achieve an expected zero balance on their DUoS unders and overs accounts in each forecast year in its annual pricing proposals in the 2015–19 regulatory control period.”

In making this variation, we note that clause 6.12.3 of the NER states:

- “(c) The form of the control mechanisms must be as set out in the relevant framework and approach paper.
- (c1) The formulae that give effect to the control mechanisms referred to in paragraph (c) must be as set out in the relevant framework and approach paper unless the AER considers that unforeseen circumstances justify departing from the formulae as set out in that paper.”

We consider this variation to the control mechanism formula is necessary given the material and unforeseen (novel) change in circumstances since our April 2015 final decision.<sup>74</sup> The variation will allow us to track Essential Energy's revenue relative to our April 2015 final decision through the DUoS ‘unders’ and ‘overs’ accounts. This will enable us to implement the remade final decision while maintaining the operation of the unders and overs accounts across the 2014–19 and 2019–24 regulatory control periods. This is consistent with the requirements of the NER as it would minimise administrative costs and reduce uncertainty.<sup>75</sup>

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<sup>72</sup> AER, *Stage 1 Framework and approach paper – Ausgrid, Endeavour Energy and Essential Energy, Attachment 2 Control mechanisms*, March 2013, p.43. Available at: <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19/aer-position>

<sup>73</sup> AER, *Final Decision Essential Energy distribution determination: 2015–16 to 2018–19, Attachment 14 - Control mechanism*, April 2015, p.18.

<sup>74</sup> NER, cl. 6.12.3(c)(1).

<sup>75</sup> NER, cl. 6.2.5(c)(2) and (3).

We will ensure Essential Energy earns no more than the amount set out in the remade final decision through the design of the control mechanism for standard control services for the 2019–24 regulatory control period. This is because we will not know what Essential Energy's actual revenue for the 2014–19 regulatory control period will be until after this regulatory control period expires.

A revenue cap will continue to apply to Essential Energy's standard control services in the 2019–24 regulatory control period.<sup>76</sup> At this stage, we are likely to maintain the general properties of the control mechanism from our April 2015 final decision, including the unders and overs accounts. With this in mind, we consider there are several options for enforcing the remade final decision through the control mechanism for the 2019–24 regulatory control period. Any amounts recovered above that allowed in the remade final decision will be returned to customers in the forthcoming regulatory control period and determined as part of Essential Energy's 2019-24 distribution determination.

## 5.4.2 Inflation error adjustment

In the course of its review of our decisions of the Victorian electricity distributors and ActewAGL's gas decision, the Tribunal identified an error in how inflation was estimated.<sup>77</sup> The Tribunal made note of the error in its decision and left it to the AER to determine how best to address the error.<sup>78</sup> The error affected not only the decisions under that review, but the 2015 decisions for the NSW distributors. The error had not been picked up during the review of the 2015 NSW decisions.

The error results from an incorrect geometric average calculation undertaken on the annual inflation rates; resulting in an incorrect (lower) inflation rate of 2.38 per cent instead of 2.42 per cent. Correcting the error would result in a downward revenue adjustment of approximately \$10.75 million (\$, nominal) compared to our April 2015 final decision.

On 15 December 2017, we notified Essential Energy (and other NSW and ACT distribution businesses) in writing, stating that we were considering whether it is appropriate to correct the affected determinations when remaking our decisions.<sup>79</sup> This date is well after a period in which substantial pre-lodgement engagement on the key financial parameters of Essential Energy's 30 November 2017 proposal had already taken place with its key stakeholders, including consumer groups and our officers. As a consequence of this timing, the broad consumer support for its proposal and the good faith in which Essential Energy sought early resolution of all outstanding remittal-related matters, we affirm the approach we took in our remade draft decision to use our discretion and not apply the inflation estimation error correction in our remade final decision for Essential Energy's 2014-19 regulatory control period.

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<sup>76</sup> AER, *Framework and approach Ausgrid, Endeavour Energy and Essential Energy: Regulatory control period commencing 1 July 2019*, July 2017, pp. 41 and 52–54.

<sup>77</sup> File Nos: ACT 3, 4, 5, 6, 7, 8 of 2016: <http://www.competitiontribunal.gov.au/current-matters/tribunal-documents>

<sup>78</sup> For example, see ACT, Application by ActewAGL Distribution [2017] ACompT 2, 17 October 2017, p i-iii.

<sup>79</sup> AER, *Proposed correction to an inflation calculation error impacting Essential Energy distribution determination 2014-19*, 17 December 2017. Available at: <https://www.aer.gov.au/system/files/DORIS%20-%20D17-178607%20AER%20letter%20proposed%20inflation%20correction-Essential%2015....pdf>

### 5.4.3 Minor corrections to our 2015 final decision

On 20 May 2015, we published an open letter on our website notifying our intention to correct three errors in our April 2015 final decision once any appeal to that decision is resolved.<sup>80</sup> As per the approach we took in our March 2018 remade draft decision, and as part of this remade final decision for Essential Energy, we now refer and give effect to that open letter which sets out our proposed correction for the following errors:

1. inaccurate description of metering in Appendix A to the Overview
2. inaccurate public lighting prices
3. parameter missing for control mechanism

To ensure the relevant legal documents accurately reflect our decisions, the correction set out in the open letter shall form part of our remade final decision for Essential Energy's remitted determination and supersede the errors we had identified in our April 2015 final decision.

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<sup>80</sup> AER, *AER letter to Essential Energy about correcting errors in Essential Energy distribution determination 2015–16 to 2018–19*, 20 May 2015. Available at: <https://www.aer.gov.au/system/files/Letter%20from%20AER%20to%20Essential%20Energy%20about%20correcting%20errors%20in%20distribution%20determination%20-%2020%20May%202015.pdf>