FINAL DECISION
Jemena distribution determination 2016 to 2020

Attachment 1 – Annual revenue requirement

May 2016

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Note

This attachment forms part of the AER's final decision on Jemena's distribution determination for 2016–20. It should be read with all other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – f-factor scheme

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for Electricity Distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia

Shortened form	Extended form
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

1 Annual revenue requirement

The annual revenue requirement (ARR) is the sum of the various building block costs for each year of the regulatory control period before smoothing. The ARRs are smoothed across the period to reduce fluctuations between years and to determine expected revenues for each year. The expected revenues are the amounts that Jemena will target for annual pricing purposes and recover from customers for the provision of standard control services for each year of the regulatory control period. This attachment sets out our final decision on Jemena's ARRs and expected revenues for the 2016–20 regulatory control period.

1.1 Final decision

We do not accept Jemena's revised proposed total revenue requirement of $1527.3 million over the 2016–20 regulatory control period. This is because we have not accepted the building block costs in Jemena's revised proposal. We determine a total revenue requirement of $1302.1 million ($ nominal) for Jemena for the 2016–20 regulatory control period, reflecting our final decision on the various building block costs. This is a reduction of $225.2 million ($ nominal) or 14.7 per cent to Jemena's revised proposal.

We approved the expected revenue for 2016 of $238.5 million in our preliminary decision for Jemena.[1] Under the transitional rules, we are required to determine the ARR for 2016 as part of this final determination process and adjust for the difference between the preliminary decision revenue and the ARR for 2016. We have now determined the ARR for 2016 of $250.3 million for Jemena. The difference is therefore $11.8 million. We have applied this difference as part of the smoothing process to establish the annual expected revenue for the remaining four years of the 2016–20 regulatory control period.

As a result of our smoothing of the ARRs, our final decision on the annual expected revenue and X factor for each regulatory year of the 2016–20 regulatory control period is set out in Table 1.1. Our final decision is to approve total expected revenues of $1302.1 million ($ nominal) for the 2016–20 regulatory control period.

Figure 1.1 shows the difference between Jemena's revised proposal and our final decision.

Table 1.1 shows our final decision on the building block costs, the ARR, annual expected revenue and X factor for each year of the 2016–20 regulatory control period.

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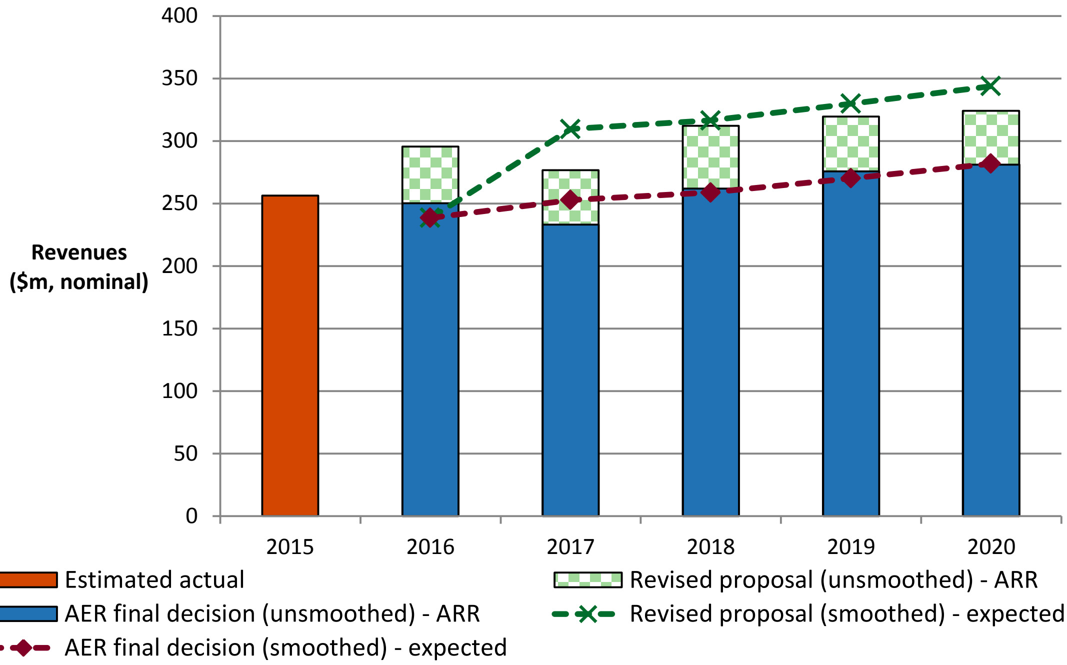
1 AER, *Preliminary decision Jemena distribution determination - Attachment 1 - Annual revenue requirement*, October 2015, p. 7.

Figure 1.1 AER's final decision on Jemena's revenues for the 2016–20 regulatory control period ($million, nominal)



Source: AER analysis.

Table 1.1 AER's final decision on Jemena's revenues for the 2016–20 regulatory control period ($million, nominal)

	2016	2017	2018	2019	2020	Total
Return on capital	75.7	81.4	90.2	96.8	103.2	447.4
Regulatory depreciation	55.5	44.9	49.3	53.8	59.3	262.9
Operating expenditure	92.5	92.8	96.1	100.3	103.2	485.0
Revenue adjustments[a]	8.9	–0.3	12.0	9.5	–0.1	30.1
Net tax allowance	17.6	14.3	14.2	15.1	15.5	76.8
Annual revenue requirement (unsmoothed)	250.3	233.2	261.9	275.6	281.1	1302.1
Annual expected revenue (smoothed)	**238.5**	**252.8**	**258.8**	**270.1**	**281.9**	**1302.1**
X factor[b]	n/a[c]	–3.60%	–0.02%	–2.02%	–2.00%	n/a
Annual change in revenue (smoothed)	n/a	6.0%	2.3%	4.4%	4.4%	n/a

Source: AER analysis.

(a) Revenue adjustments include efficiency benefit sharing scheme carry-overs, forecast DMIA, 2010 S-factor scheme close out and shared asset adjustments.

(b) The X factors from 2017 to 2020 will be revised to reflect the annual return on debt update. Under the CPI–X framework, the X factor measures the real rate of change in annual expected revenue from one year to the next. A negative X factor represents a real increase in revenue. Conversely, a positive X factor represents a real decrease in revenue.

(c) In our preliminary decision, we determined the expected revenue and associated X factor for 2016. In this final decision to update the 2016 revenue for our assessment of efficient costs, we maintained the preliminary decision expected revenue and determined X factors for the final four years of the 2016–20 regulatory control period. This is to adjust the total expected revenue requirement for the remaining four years in the 2016–20 regulatory control period for the difference between the preliminary decision revenue and our final decision on efficient costs for 2016. Expected revenue in 2016 is around 9.0 per cent lower than approved revenue in 2015 in real terms, or 6.9 per cent lower in nominal terms.

1.2 Jemena's revised proposal

Jemena's revised proposal included a total expected revenue of $1538.2 million ($ nominal) for the 2016–20 regulatory control period.

Table 1.2 shows Jemena's revised proposed building block costs, the ARR, expected revenue and X factor for each year of the 2016–20 regulatory control period.

Table 1.2 Jemena's revised proposed revenues for the 2016–20 regulatory control period ($million, nominal)

	2016	2017	2018	2019	2020	Total
Return on capital	103.3	109.7	119.5	123.6	127.4	583.5
Regulatory depreciation[a]	59.0	47.2	56.4	57.1	62.9	282.5
Operating expenditure	95.9	95.9	99.5	104.2	107.4	503.0
Revenue adjustments[b]	9.2	0.2	11.4	8.9	–0.1	29.5
Net tax allowance	28.0	23.6	25.1	25.6	26.5	128.8
Annual revenue requirement (unsmoothed)	295.4	276.6	311.9	319.4	324.0	1527.3
Annual expected revenue (smoothed)	**238.5**[c]	**309.6**	**316.4**	**329.9**	**343.8**	**1538.2**
X factor	n/a	–27.01%	–0.02%	–2.02%	–2.00%	n/a
Annual change in revenue (smoothed)	n/a	29.8%	2.2%	4.3%	4.2%	n/a

Source: Jemena, *Revised regulatory proposal*, *Attachment 05-02*, January 2016; AER analysis.

(a) Regulatory depreciation is straight-line depreciation net of the inflation indexation on the opening RAB.

(b) Revenue adjustments include efficiency benefit sharing scheme carry-overs, forecast DMIA, 2010 S-factor scheme close out and shared asset adjustments.

(c) Jemena's revised proposal conducted an adjustment for the difference between the preliminary decision revenue and its revised proposal revenue for 2016 by holding the 2016 preliminary decision revenue constant. This results in the difference being adjusted for in the expected revenue (via the X factor) for the remaining four years of the 2016–20 regulatory control period.

1.3 Assessment approach

We have not changed our assessment approach for the ARR from our preliminary decision. Section 1.3 of our preliminary decision details that approach.[2] We have reviewed our revenue path for the final decision in light of the requirement to do an adjustment for 2016 and this is discussed further in section 1.4.1.

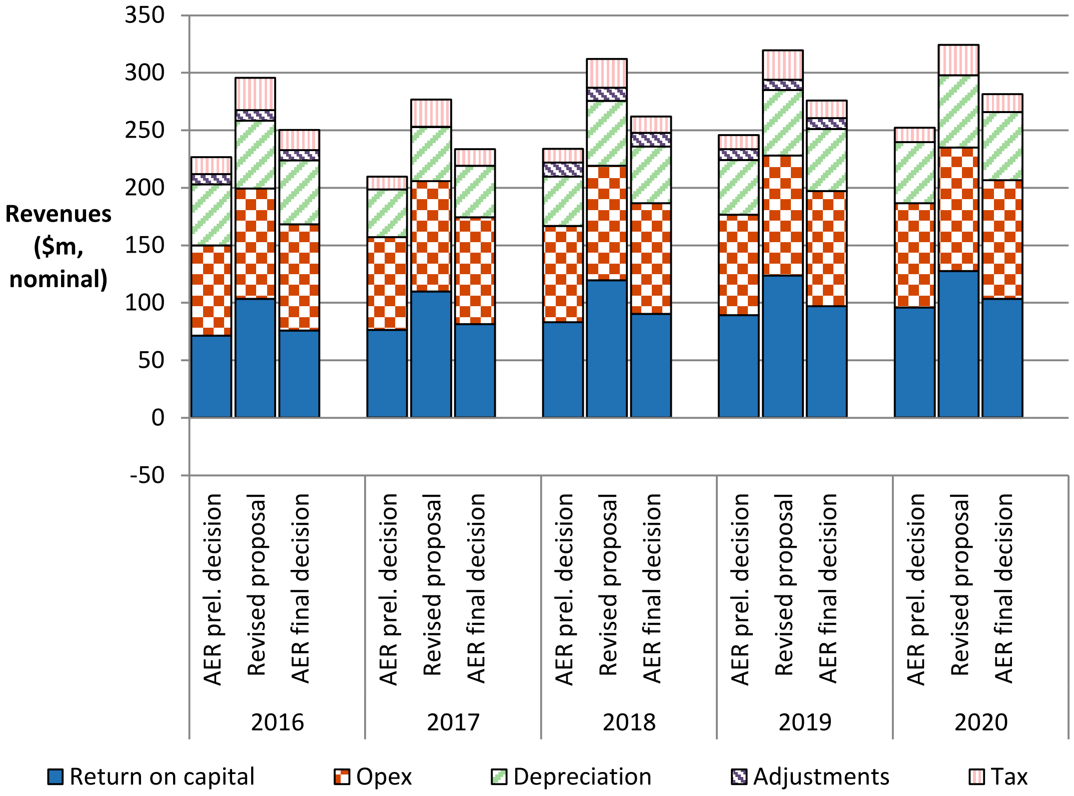
1.4 Reasons for final decision

For this final decision, we determine a total revenue requirement of $1302.1 million ($ nominal) over the 2016–20 regulatory control period for Jemena. This is $225.2 million ($ nominal) or 14.7 per cent below Jemena's revised proposal. This reflects the impact of our final decision on the various building block costs.

Figure 1.2 shows our preliminary decision and the difference between Jemena's revised proposed ARRs and our final decision.

2 AER, *Preliminary decision Jemena distribution determination - Attachment 1 - Annual revenue requirement*, October 2015, pp. 8–10.

Figure 1.2 AER's preliminary and final decisions and Jemena's revised proposed annual revenue requirements ($million, nominal)



Source: AER analysis; Jemena, *Revised regulatory proposal*, *Attachment 05-02*, January 2016.

The most significant changes to Jemena's revised proposal include:

- a reduction in the return on capital allowance of 23.3 per cent (attachments 2 and 3)
- a reduction in the regulatory depreciation allowance of 7.0 per cent (attachment 5)
- a reduction in the opex allowance of 3.6 per cent (attachment 7)
- a reduction in the cost of corporate tax allowance of 40.4 per cent (attachment 8).

1.4.1 Revenue true-up for 2016

In October 2015, as required under the transitional rules, we made our preliminary decision on Jemena's proposed revenue requirement for the 2016–20 regulatory control period.[3] We determined the expected revenue for 2016 of $238.5 million for Jemena in the preliminary decision.[4]

3 NER, cl. 11.60.3.

4 AER, *Preliminary decision Jemena distribution determination - Attachment 1 - Annual revenue requirement*, October 2015, p. 7.

For this final decision, we are required to revoke and substitute the preliminary decision for the ARRs over the 2016–20 regulatory control period. As part of this, we are to determine ARRs for each year of the 2016–20 regulatory control period and use a net present value (NPV) neutral adjustment mechanism to account for any difference between:[5]

- the expected revenue for 2016 approved in the preliminary decision, and
- the ARR for 2016 that is established through this final determination process.

Our final decision approves the 2016 ARR of $250.3 million for Jemena. To give effect to the true-up, we have set Jemena's first year expected revenue in the post-tax revenue model (PTRM) equal to our preliminary decision revenue for 2016 of $238.5 million. This is the only practical option as prices were set for 2016 based on this approved preliminary decision amount. This approach means that the difference in the revenues for 2016 between the preliminary and final decisions is accounted for in the remaining four years of the 2016–20 regulatory control period. That is, the expected revenue for 2016 established from the preliminary decision provides a base from which the expected revenues for the remaining four years of the 2016–20 regulatory control period are calculated. This is done through the determination of the X factors for each of the remaining years in that period.[6] This gives effect to the true-up requirements under the NER and ensures that the difference of $11.8 million is recovered from customers over the remaining four years of the 2016–20 regulatory control period (adjusted for the time value of money).

Jemena's revised proposal adopted this approach for the adjustment.

1.4.2 Revenue smoothing

We have taken the building block costs determined in this decision and smoothed them to determine the expected revenues for Jemena over the 2016–20 regulatory control period. In doing so and for the reasons discussed in section 1.4.1, we first set the expected revenue for the first regulatory year (2016) at $238.5 million ($ nominal). This is lower than the 2016 ARR (unsmoothed) we have now determined, which is $250.3 million ($ nominal). We then applied a profile of X factors to determine the expected revenue in subsequent years.

We consider that our profile of X factors is reasonable in the circumstances. Revenues determined for this final decision are higher than expected in the preliminary decision due to various changes to the building blocks. Accordingly, expected revenues (smoothed) will increase in the remaining years of the 2016–20 regulatory control period, rather than decrease as anticipated in the preliminary decision. We have mitigated the revenue increase for 2017 somewhat by spreading the increases over

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5 NER, cll. 11.60.4(d)(1) and (e).

6 The X factors represent the rate of change in the real revenue path over the 2016–20 regulatory control period under the CPI–X framework. They must equalise (in net present value terms) the total expected revenues to be earned by the service provider with the total revenue requirement for that period.

the remaining four years of the regulatory control period. We have limited the difference between smoothed and unsmoothed revenues in the last year of the 2016–20 regulatory control period to less than one per cent. This mitigates the potential for any step changes in revenues at the end of the regulatory control period.[7]

1.4.3 Shared assets

Our final decision is to maintain our position set out in the preliminary decision on the shared asset adjustments for Jemena.

Service providers, such as Jemena, may use assets to provide both standard control services we regulate and unregulated services. These assets are called 'shared assets'.[8] Of the unregulated revenues a service provider earns from shared assets, 10 per cent will be used to reduce the service provider's prices for standard control services.[9]

Shared asset price reductions are subject to a materiality threshold. Unregulated use of shared assets is material when a service provider's unregulated revenues from shared assets in a specific regulatory year are expected to be greater than one per cent of its total expected revenue for that regulatory year.[10]

In the preliminary decision, we accepted Jemena's proposed shared asset revenue adjustments using an updated assessment of the materiality threshold based on the preliminary decision revenues.[11] Jemena's revised proposal updated the shared asset revenue adjustments based on its revised proposal revenues. Jemena submitted that its shared asset unregulated revenues will meet the shared asset threshold in each year of the 2016–20 regulatory control period. However, as noted in the preliminary decision, Jemena's revised forecast unregulated revenues must be compared to the total regulated revenues we determine, rather than the total revenue proposed by Jemena. Our final decision sets lower expected revenue than Jemena's revised proposal, so we estimate that Jemena's unregulated revenues are between 1.2 and 1.4 per cent of its total expected revenue in each regulatory year of the 2016–20 regulatory control period. We are satisfied Jemena's shared asset unregulated revenues meet the threshold for revenue adjustments in each year of the 2016–20 regulatory control period.

Our final decision is therefore to apply a shared asset revenue adjustment as shown in Table 1.3, consistent with the revised proposal from Jemena. The shared asset

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7 In the preliminary decision, the divergence in the smoothed and unsmoothed revenues was 4.4 per cent at the end of the regulatory control period. We allowed this difference to diverge more than would be usual by allowing for a more gradual path for lower revenues over the 2016–20 regulatory control period.

8 NER, cl. 6.4.4.

9 AER, *Shared asset guideline*, November 2013.

10 AER, *Shared asset guideline*, November 2013, p. 8.

11 AER, *Preliminary decision Jemena distribution determination - Attachment 1 - Annual revenue requirement*, October 2015, pp. 12–13.

revenue adjustment is a total reduction of $1.8 million ($ nominal) across the 2016–20 regulatory control period.

Table 1.3 AER's final decision on Jemena's shared asset revenue adjustment ($million, nominal)

	2016	2017	2018	2019	2020	Total
Jemena revised proposed shared asset revenue adjustment	–0.3	–0.4	–0.4	–0.4	–0.4	–1.8
AER final decision shared asset revenue adjustment	–0.3	–0.4	–0.4	–0.4	–0.4	–1.8

Source: AER analysis.

1.4.4 Indicative average distribution price impact

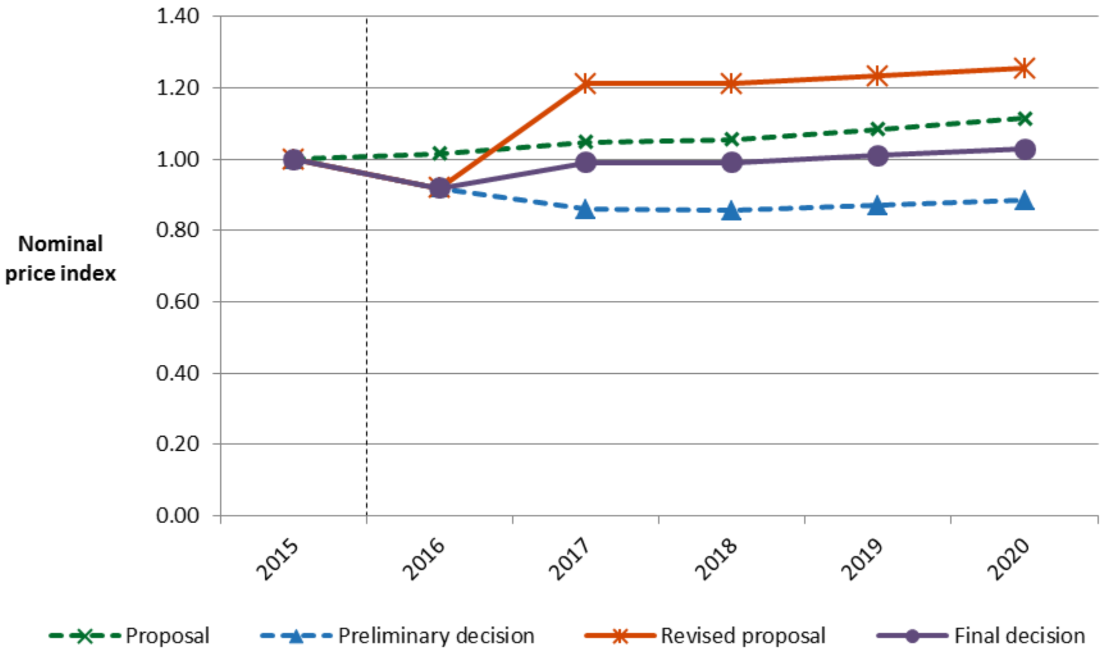
Our final decision on Jemena's expected revenues ultimately affects the prices consumers pay for electricity. There are several steps required in translating our revenue decision to a price impact.

We regulate Jemena's standard control services under a revenue cap form of control. This means our final decision on Jemena's expected revenues do not directly translate to price impacts. This is because Jemena's revenue is fixed under the revenue cap form of control, so changes in the consumption of electricity will affect the prices ultimately charged to consumers. We are not required to establish the distribution prices for Jemena as part of this determination. However, we will assess Jemena's annual pricing proposals before the commencement of each regulatory year for the 2016–20 regulatory control period. In each assessment we will administer the pricing requirements set in this distribution determination.

For this final decision, we have estimated some indicative average distribution price impacts flowing from our determination on the expected revenues for Jemena over the 2016–20 regulatory control period. In this section, our estimates only relate to standard control services (that is, the core electricity distribution charges), not alternative control services (such as metering, including advanced metering infrastructure (AMI) charges). These indicative price impacts assume that actual energy consumption across the 2016–20 regulatory control period matches Jemena's forecast energy consumption, which we have adopted for this final decision.

Figure 1.3 shows Jemena's indicative price path based on the expected revenues established in our final decision compared to its revised proposal. The indicative price path is estimated using the approved expected revenue and dividing by total forecast energy consumed (MWh) in Jemena's distribution network for each year of the 2016–20 regulatory control period. For presentational purposes, the prices are scaled so that the price index begins at 1.0 in 2015. The index provides a simple overall measure of the relative movement in expected distribution prices over the 2016–20 regulatory control period.

Figure 1.3 AER's final decision and Jemena's revised proposed indicative price paths (nominal price index)



Source: AER analysis.

Notes: The nominal price index is constructed by dividing expected revenue for standard control services by forecast energy consumption for each year of the regulatory control period submitted in Jemena's revised proposal, then scaling relative to the base year (2015).

We estimate that our final decision on Jemena's annual expected revenue will result in an increase to average distribution charges by about 0.6 per cent per annum over the 2016–20 regulatory control period in nominal terms.[12] This compares to the nominal average increase of approximately 4.6 per cent per annum proposed by Jemena over the 2016–20 regulatory control period. These high-level estimates reflect the aggregate change across the entire network and do not reflect the particular tariff components for specific end users.

Table 1.4 displays the comparison of the revenue and price impacts of Jemena's revised proposal and our final decision.

[12] This amount includes a forecast inflation rate of 2.32 per cent per annum. In real terms we estimate average distribution charges to decline by 1.7 per cent per annum, compared to an increase of 2.3 per cent proposed by Jemena.

Table 1.4 Comparison of revenue and price impacts of Jemena's revised proposal and the AER's final decision

	2015	2016	2017	2018	2019	2020
AER final decision						
Revenue ($m, nominal)	256.2	238.5	252.8	258.8	270.1	281.9
Price path (nominal index)[a]	1.00	0.92	0.99	0.99	1.01	1.03
Revenue (change %)		–6.9%	6.0%	2.3%	4.4%	4.4%
Price path (change %)		–8.0%	7.7%	0.0%	1.9%	1.9%
Jemena revised proposal						
Revenue ($m, nominal)	256.2	238.5	309.6	316.4	329.9	343.8
Price path (nominal index)[a]	1.00	0.92	1.21	1.21	1.23	1.25
Revenue (change %)		–6.9%	29.8%	2.2%	4.3%	4.2%
Price path (change %)		–8.0%	31.8%	–0.1%	1.8%	1.7%

Source: AER analysis.

(a) The nominal index is constructed by dividing expected revenue for standard control services by forecast energy consumption for each year of the regulatory control period submitted in Jemena's revised proposal, then scaling relative to the base year (2015).

1.4.5 Expected impact of decision on electricity bills

The annual electricity bill for customers in Jemena's distribution area will reflect the combined cost of all the electricity supply chain components—wholesale energy generation, transmission, distribution, metering, and retail costs. This decision primarily relates to the distribution charges for standard control services, which represent approximately 37 per cent, on average, of the annual electricity bill for these customers.[13] The decision also covers charges for metering services that were previously regulated under a separate 'Order in Council'.

In this section, we estimate the expected bill impact by varying the distribution charges in accordance with our decision, while holding all other components—including the metering component—constant. This differs from section 2.3 of the overview to this final decision, which presents estimates that show the combined impact of our changes to distribution and metering charges. This approach isolates the effect of our decision on the core distribution charges, and does not imply that other components will remain unchanged across the regulatory control period. This section is directly comparable with the estimated bill impacts in our preliminary decision (which did not include metering services) and section 1.4.4 above.

[13] Oakley Greenwood, *Causes of residential electricity bill changes in the Jemena service area*, 1995 to 2014, December 2014.

Based on this approach, we expect that our final decision will result in annual electricity bills that are below 2015 levels from 2016 to 2018, but above 2015 levels in 2019 and 2020. Estimated 2016 bills have already decreased by 3.0 per cent, reflecting our preliminary decision. Across the rest of the regulatory control period, we expect small increases of 2.7 per cent or less each year. The expected annual electricity bill in 2020 is approximately 1.1 per cent above the 2015 level.

We expect that a typical resident in Jemena's distribution area with an annual electricity bill of $1771 ($ nominal) in 2015 will face:

- a decrease of $53 ($ nominal) or 3.0 per cent in 2016
- an increase of $46 ($ nominal) or 2.7 per cent in 2017
- an increase of less than $1 ($ nominal) in 2018
- increases of $13 and $12 ($ nominal) or 0.7 per cent in 2019 and 2020 respectively.

By comparison, had we accepted Jemena's revised proposal, the expected annual electricity bill in 2020 would be approximately $170 ($ nominal) or 9.4 per cent above the 2015 level.

Our estimate of the potential impact our final decision will have for Jemena's residential customers is based on the typical annual electricity usage of around 4700 kWh per annum for a residential customer in Victoria.[14] Therefore, customers with different usage will experience different changes in their bills. We also note that there are other factors, such as transmission network costs, metering, wholesale and retail costs, which affect electricity bills.

Similarly, an average small business customer on Jemena's network that uses approximately 12 MWh of electricity per annum,[15] with an annual electricity bill of $3771 ($ nominal) in 2015 will face:

- a decrease of $112 ($ nominal) or 3.0 per cent in 2016
- an increase of $99 ($ nominal) or 2.7 per cent in 2017
- no change in nominal terms in 2018
- increases of $27 and $26 ($ nominal) or 0.7 per cent in 2019 and 2020 respectively.

By comparison, had we accepted Jemena's revised proposal, the expected annual electricity bill in 2020 would be approximately $360 ($ nominal) or 9.4 per cent above the 2015 level.

14 Based on ESC, *Energy Retailers Comparative Performance Report - Pricing 2013–14 -Supplementary Report on Electricity Flexible Prices*, October 2014, p. 3.

15 Based on ESC, *Energy Retailers Comparative Performance Report - Pricing 2014–15*, January 2016, p. XIII.

Table 1.5 shows the estimated annual average impact of our final decision for the 2016–20 regulatory control period and Jemena's revised proposal on the average residential and small business customers' annual electricity bills. As explained above, these bill impact estimates are indicative only, and individual customers' actual bills will depend on their usage patterns and the structure of their tariffs.

Table 1.5 Estimated impact of Jemena's revised proposal and the AER's final decision on annual electricity bills for the 2016–20 regulatory control period ($ nominal)

	2015	2016	2017	2018	2019	2020
AER final decision						
Residential annual bill	1771[a]	1718	1764	1765	1777	1790
Annual change[c]		–53 (–3.0%)	46 (2.7%)	0 (0.0%)	13 (0.7%)	12 (0.7%)
Small business annual bill	3771[b]	3659	3758	3758	3785	3811
Annual change[c]		–112 (–3.0%)	99 (2.7%)	0 (0.0%)	27 (0.7%)	26 (0.7%)
Jemena revised proposal						
Residential annual bill	1771[a]	1718	1910	1909	1924	1938
Annual change[c]		–53 (–3.0%)	192 (11.2%)	–1 (0.0%)	14 (0.8%)	14 (0.7%)
Small business annual bill	3771[b]	3659	4068	4066	4097	4127
Annual change[c]		–112 (–3.0%)	409 (11.2%)	–2 (0.0%)	31 (0.8%)	30 (0.7%)

Source: AER analysis; ESC, *Victorian Energy Retailers Comparative Performance Report - Pricing 2014–15,* January 2016, p. XIII; ESC, *Energy Retailers Comparative Performance Report - Pricing 2013-14 - Supplementary Report on Electricity Flexible Prices*, December 2014, p. 3

(a) Based on average standing offers at June 2015 on Switch On comparison tool (postcode 3047) using annual bill for typical consumption of 4690 kWh per year.

(b) Based on average standing offers at June 2015 on Switch On comparison tool (postcode 3047) using annual bill for typical small business consumption of 12020 kWh per year.

(c) Annual change amounts and percentages are indicative. They are derived by varying the distribution component of 2015 bill amounts in proportion to yearly expected revenue divided by forecast demand. Actual bill impacts will vary depending on electricity consumption and tariff class.