



PRELIMINARY DECISION
Powercor distribution
determination
2016 to 2020

Attachment 1 – Annual revenue
requirement

October 2015

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Note

This attachment forms part of the AER's preliminary decision on Powercor's revenue proposal 2016–20. It should be read with all other parts of the preliminary decision.

The preliminary 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 mechanism

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
repex	replacement expenditure

Shortened form	Extended form
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 ARR is smoothed across the period to reduce fluctuations between years and to determine expected revenues for each year. The expected revenues are the amounts that Powercor 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 preliminary decision on Powercor's ARR and expected revenues for the 2016–20 regulatory control period.

1.1 Preliminary decision

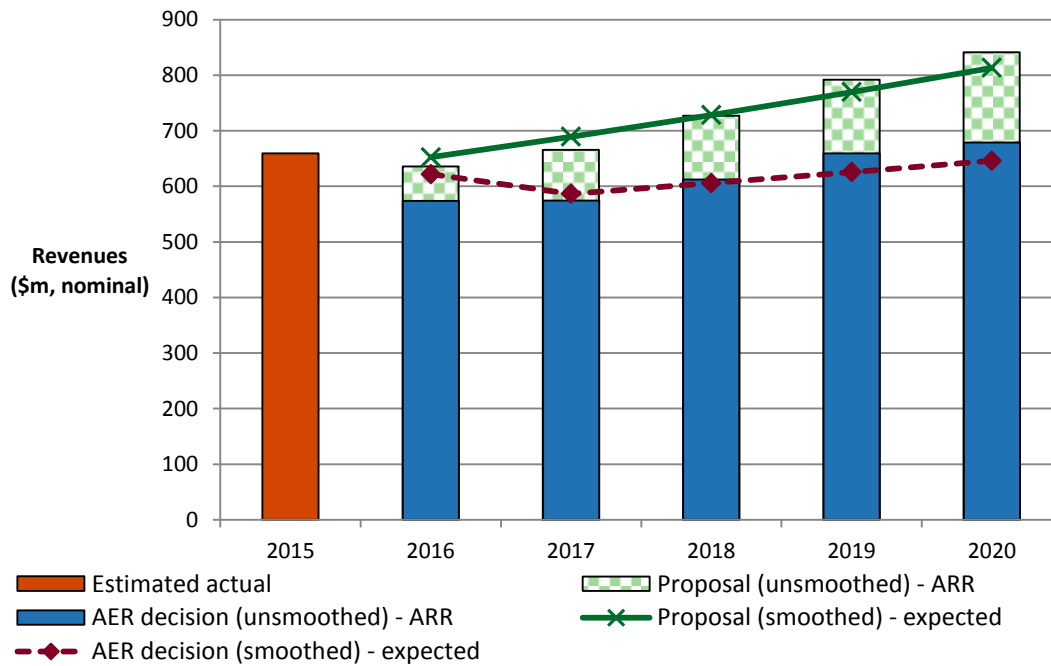
We do not accept Powercor's proposed total revenue requirement of \$3662.2 million (\$ nominal) over the 2016–20 regulatory control period. This is because we have not accepted the building block costs in Powercor's proposal. We determine a total revenue requirement of \$3098.0 million (\$ nominal) for Powercor for the 2016–20 regulatory control period, reflecting our preliminary decision on the various building block costs. This is a reduction of \$564.2 million (\$ nominal) or 15.4 per cent to Powercor's proposal.

As a result of our smoothing of the ARRs, our preliminary 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 preliminary decision is to approve total expected revenues (smoothed) of \$3085.8 million (\$ nominal) for the 2016–20 regulatory control period.

Figure 1.1 shows the difference between Powercor's proposal and our preliminary decision.

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

Figure 1.1 AER's preliminary decision on Powercor's revenue for the 2016–20 regulatory control period (\$million, nominal)



Source: Powercor, *Regulatory proposal*, April 2015, Attachment PAL 2016-20 PTRM. AER analysis.

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

	2016	2017	2018	2019	2020	Total
Return on capital	201.2	215.7	230.8	246.3	261.1	1155.1
Regulatory depreciation	102.3	89.6	96.6	105.8	108.9	503.2
Operating expenditure ^a	228.6	238.5	250.6	262.6	275.6	1255.9
Revenue adjustments ^b	4.2	-2.7	3.3	11.5	0.7	16.9
Net tax allowance	37.6	33.2	30.7	33.0	32.6	167.0
Annual revenue requirement (unsmoothed)	573.8	574.2	612.0	659.2	678.8	3098.0
Annual expected revenue (smoothed)	621.8	586.6	605.8	625.6	646.0	3085.8
X factor ^c	7.96%	7.96%	-0.75%	-0.75%	-0.75%	n/a

Source: AER analysis.

- (a) Operating expenditure includes debt raising costs.
- (b) Revenue adjustments include efficiency benefit sharing scheme carry-overs, 2010 S-factor scheme close out and demand management innovation allowance (DMIA).
- (c) The X factor 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.

1.2 Powercor's proposal

Powercor proposed a total revenue requirement of \$3662.2 million (\$ nominal) for the 2016–20 regulatory control period. Table 1.2 shows Powercor's proposed building block costs, the ARR, expected revenue and X factor for each year of the 2016–20 regulatory control period.

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

	2016	2017	2018	2019	2020	Total
Return on capital	242.0	266.0	290.8	316.1	340.6	1455.5
Regulatory depreciation	87.7	84.0	97.1	110.5	124.2	503.5
Operating expenditure ^a	254.0	269.2	289.2	306.7	325.0	1444.1
Revenue Adjustments ^b	1.9	-1.2	4.4	9.1	0.0	14.2
Net tax allowance	50.1	47.8	45.9	49.6	51.5	244.8
Annual revenue requirement (unsmoothed)	635.7	665.8	727.4	792.0	841.3	3662.2
Annual expected revenue (smoothed)	652.2	689.2	728.4	769.7	813.4	3652.2
X factor	3.55%	-3.00%	-3.00%	-3.00%	-3.00%	n/a

Source: Powercor, *Regulatory proposal*, April 2015, p. 260, table 13.9.

(a) Operating expenditure includes proposed forecast DMIA and debt raising costs.

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

1.3 AER's assessment approach

We are required to determine the ARR for Powercor for each year of the 2016–20 regulatory control period.¹

In this determination we first calculate ARRs for each year of the 2016–20 regulatory control period. To do this we consider the various costs facing the service provider and the trade-offs and interactions between these costs, service quality and across years. This reflects the AER's holistic assessment of the service provider's proposal.

The ARR for each year is the sum of the building block costs. These building block costs are set out in section 1.3.1. The AER's post-tax revenue model (PTRM) brings together these building block costs and calculates the resulting ARRs.

We understand the trade-offs that occur between building block costs and test the sensitivity of these costs to their various driver elements. These trade-offs are

¹ NER, cl. 6.3.2(a)(1).

discussed in the interrelationships section of the various attachments to this preliminary decision and are reflected in the calculations made in the PTRM developed by the AER.² Such understanding allows the AER to exercise judgement in determining the final inputs into the PTRM and the ARR that result from this modelling.

Having determined the total revenue requirement for the 2016–20 regulatory control period, the ARRs for each regulatory year are smoothed across the 2016–20 regulatory control period. This is to reduce revenue variations between years and to come up with the expected revenue for each year. This is done through the determination of the X factors.³ The X factor must equalise (in net present value terms) the total expected revenues to be earned by the service provider with the total revenue requirement for the 2016–20 regulatory control period.⁴ The X factor must usually minimise, as far as reasonably possible, the variance between the expected revenue and ARR for the last regulatory year of the period.⁵

For this preliminary decision, the expected revenue in the last year of the regulatory control period is not required to be as close as reasonably possible to the ARR for that year, due to the transitional provisions.⁶ Typically, we would target a divergence of less than 3 per cent between the expected revenue and ARR for the last year of the regulatory control period, if this can promote smoother price changes over the regulatory control period. However, due to the expected true-up for 2016 over the remaining years of the 2016–20 regulatory control period for the substitute decision,⁷ we have provided a gradual decrease in smoothed revenues over the first two regulatory years. We have also allowed the divergence in the final year revenues to exceed 3 per cent in this preliminary decision. This helps minimise the prospect of a significant price decrease followed by significant price increases over the 2016–20 regulatory control period. We will review the smoothing for the substitute decision if necessary.

The building block costs (and the elements that drive those costs) used to determine the unsmoothed ARR are set out below.

² There are trade-offs that are not modelled in the PTRM but are reflected in the inputs to the PTRM. For example, service quality is not explicitly modelled in the PTRM, but the trade-offs between service quality and price are reflected in the forecast capex and opex inputs to the model. Other trade-offs are obvious from the calculations in the PTRM. For example, while someone may expect a lower regulatory asset base to also lower revenues, the PTRM shows that this will not occur if the reduction in the regulatory asset base is due solely to an increase in the depreciation rate. In such circumstances, revenues increase as the increased depreciation allowance more than offsets the reduction in the return on capital caused by the lower regulatory asset base.

³ NER, cl. 6.5.9(a).

⁴ NER, cl. 6.5.9(3)(i). The X factors represent the real revenue path over the 2016–20 regulatory control period under the CPI–X framework.

⁵ NER, cl. 6.5.9(b)(2).

⁶ NER, cl. 11.60.3(b).

⁷ NER, cl. 11.60.4(d)(1).

1.3.1 The building block costs

The efficient costs to be recovered by a service provider can be thought of as being made up of various building block costs. Our preliminary decision assesses each of the building block costs and the elements that drive these costs. The building block costs are approved reflecting trade-offs and interactions between the cost elements, service quality and across years. Table 1.3 shows the building block costs that form the ARR for each year and where discussion on the elements that drive these costs can be found within this preliminary decision.

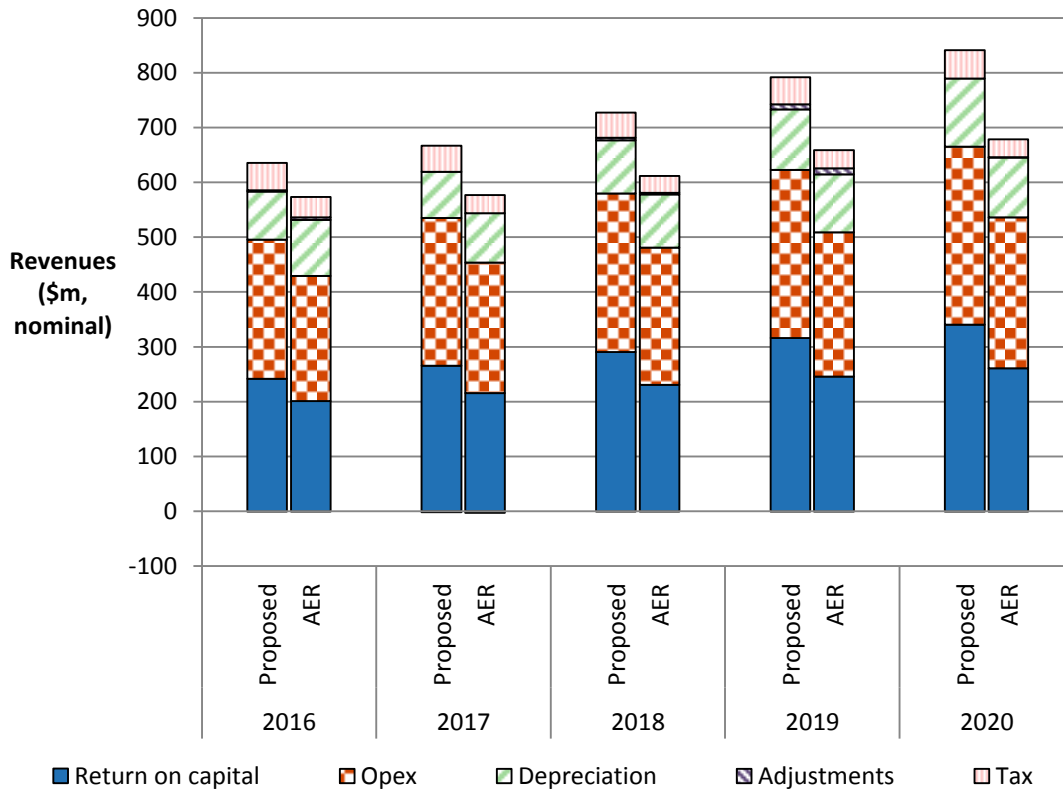
Table 1.3 Building block costs

Building block costs	Attachments where elements are discussed
Return on capital	Regulatory asset base (attachment 2)
	Capex (attachment 6)
	Rate of return (attachment 3)
Regulatory depreciation (return of capital)	Regulatory asset base (attachment 2)
	Capex (attachment 6)
	Rate of return (attachment 3)
Operating expenditure (opex)	Opex (attachment 7)
Efficiency benefits/penalties	Efficiency benefit sharing scheme (attachment 9)
Estimated cost of corporate tax	Corporate income tax (attachment 8)
	Value of imputation credits (attachment 4)
Adjustment for shared assets	Annual revenue requirement (attachment 1)
Demand management innovation allowance	Demand management incentive scheme (attachment 12)

1.4 Reasons for preliminary decision

For this preliminary decision, we determine a total revenue requirement of \$3098.0 million (\$ nominal) for Powercor over the 2016–20 regulatory control period. This is \$564.2 million (\$ nominal) or 15.4 per cent below Powercor's proposal. This reflects the impact of our preliminary decision on the various building block costs. Figure 1.2 shows the difference between Powercor's proposed ARRs and our preliminary decision.

Figure 1.2 AER's preliminary decision and Powercor's proposed annual revenue requirement (\$million, nominal)



Source: Powercor, *Regulatory proposal*, April 2015, p. 260, table 13.9.
AER analysis.

Note: Revenue adjustments include efficiency benefit sharing scheme carry-overs, 2010 S-factor scheme close out and DMIA.

Opex includes debt raising costs.

The most significant changes to Powercor's proposal include:

- a reduction in the return on capital allowance of 20.6 per cent (attachments 2 and 3)
- a reduction in the capex allowance of 20.8 per cent (attachment 6)
- a reduction in the opex allowance of 13.0 per cent (attachment 7)
- a reduction in the cost of corporate income tax allowance of 31.8 per cent (attachment 8).

1.4.1 Revenue smoothing

We have taken into account the building block costs determined in this decision when smoothing the expected revenues for Powercor over the 2016–20 regulatory control period. We consider that our profile of X factors is reasonable given the requirements

of the transitional rules.⁸ Due to the expected true-up for 2016 in the substitute decision,⁹ we have provided a gradual decrease in expected revenues over the first two regulatory years. We have also allowed the difference between smoothed and unsmoothed revenues in the last year of the 2016–20 regulatory control period to diverge more than would be usual. This approach smooths the revenues by allowing for a more gradual path for lower revenues over the 2016–20 regulatory control period.

In the present circumstances, based on the X factors we have determined for Powercor, the difference between the expected revenue and ARR for 2020 is around 4.8 per cent. While we consider this divergence is larger than usual, it avoids the situation where cost changes for the substitute decision and the consequent true-up could result in a large price decrease in 2016 followed by significant price increases for the remaining four years of the regulatory control period. We will review this smoothing for the final decision if necessary.

1.4.2 Shared assets

Service providers, such as Powercor, may use assets to provide both the standard control services we regulate and other unregulated services. These assets are called 'shared assets'.¹⁰ 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.¹¹

Shared asset revenue 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 1 per cent of its total expected revenue for that regulatory year.¹²

Powercor submitted that its shared asset unregulated revenues are forecast to be between 0.4 and 0.5 per cent of its total expected revenue in each regulatory year of the 2016–20 regulatory control period.¹³ We consider Powercor's forecasts are reasonable, based on Powercor's reporting of historical shared assets revenue and our assessment of this revenue source for other service providers.¹⁴ However, Powercor's forecast unregulated revenues must be compared to the regulated revenues we determine, rather than those proposed by Powercor. On that basis, we consider Powercor's unregulated revenues are between 0.5 and 0.6 per cent of its total expected revenue in each regulatory year of the 2016–20 regulatory control period.

⁸ NER, cl. 11.60.3(b).

⁹ NER, cl. 11.60.4(d)(1).

¹⁰ NER, cl. 6.4.4.

¹¹ AER, *Shared asset guideline*, November 2013.

¹² AER, *Shared asset guideline*, November 2013, p. 8.

¹³ Powercor, *Regulatory proposal*, April 2015, p. 258, table 13.7.

¹⁴ This includes consideration of this issue for the other Victorian electricity distribution networks, as well as work undertaken during the development of our shared asset guideline in 2013.

Hence, the materiality threshold is not met in any year of the 2016–20 regulatory control period and we do not apply a shared asset revenue adjustment.

We note unregulated revenues from shared assets may in future become material.¹⁵ We will monitor Powercor's shared asset unregulated revenues and, if necessary, determine our own forecasts for future regulatory control periods.

1.4.3 Indicative average distribution price impact

Our preliminary decision on Powercor'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.

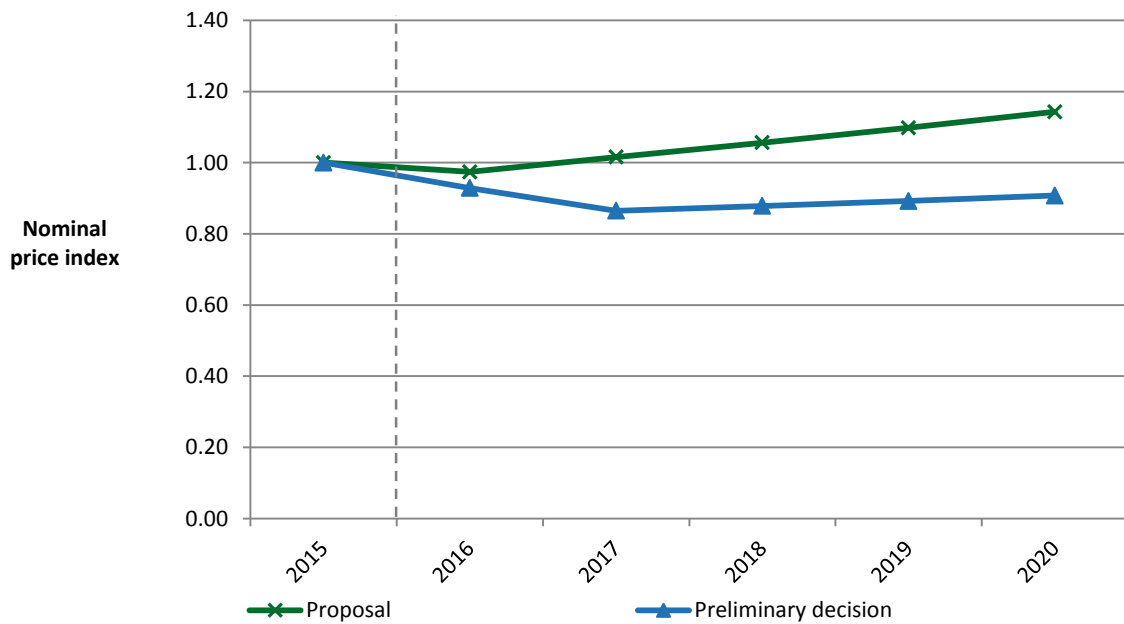
We regulate Powercor's standard control services under a revenue cap form of control. This means our preliminary decision on Powercor's expected revenues do not directly translate to price impacts. This is because Powercor's revenue is fixed under the revenue cap form of control, so changes in the consumption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

For this preliminary decision, we have estimated some indicative average distribution price impacts flowing from our determination on the expected revenues for Powercor 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 Powercor's forecast energy consumption, which we have adopted for this preliminary decision.

Figure 1.3 shows Powercor's indicative price path based on the expected revenues established in our preliminary decision compared to its proposed revenue requirement. The indicative price path is estimated using the approved expected revenue dividing by forecast energy consumption for each year of the 2016–20 regulatory control period. For presentational purposes, the prices are scaled so that the price index begins at 1.00 in 2015. The index provides a simple overall measure of the relative movement in expected distribution prices over the 2016–20 regulatory control period.

¹⁵ We will reassess the materiality of the forecast shared asset unregulated revenues for our final decision.

Figure 1.3 AER's preliminary decision and Powercor's proposed indicative price path (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, then scaling relative to the base year (2015).

We estimate that our preliminary decision on Powercor's annual expected revenue will result in a decrease to average distribution charges by about 1.9 per cent per annum over the 2016–20 regulatory control period in nominal terms.¹⁶ This compares to the nominal average increase of approximately 2.7 per cent per annum proposed by Powercor 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 Powercor's proposal and our preliminary decision.

¹⁶ This amount includes a forecast inflation rate of 2.50 per cent per annum. In real terms we estimate average distribution charges to decline by 4.3 per cent per annum, compared to an increase of 0.2 per cent proposed by Powercor.

Table 1.4 Comparison of revenue and price impacts of Powercor's proposal and the AER's preliminary decision

	2015	2016	2017	2018	2019	2020
AER preliminary decision						
Revenue (\$m, nominal)	659.0	621.8	586.6	605.8	625.6	646.0
Price path (nominal index) ^a	1.00	0.93	0.86	0.88	0.89	0.91
Revenue (change %)		-5.7%	-5.7%	3.3%	3.3%	3.3%
Price path (change %)		-7.1%	-6.9%	1.6%	1.6%	1.7%
Powercor proposal						
Revenue (\$m, nominal)	659.0	652.2	689.2	728.4	769.7	813.4
Price path (nominal index) ^a	1.00	0.97	1.02	1.06	1.10	1.14
Revenue (change %)		-1.0%	5.7%	5.7%	5.7%	5.7%
Price path (change %)		-2.6%	4.3%	4.0%	4.0%	4.1%

Source: AER analysis.

(a) 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, then scaling relative to the base year (2015).

Distribution charges represent approximately 25 per cent on average of Powercor's typical customer's annual electricity bill.¹⁷ We expect that our preliminary decision, holding all other components of the bill (including metering components) constant, will reduce the average annual electricity bills for residential customers in Powercor's network. This is because we estimate that our preliminary decision will result in lower distribution charges on average over the 2016–20 regulatory control period compared to Powercor's proposal as discussed above. We estimate that based on the distribution charges from our preliminary decision passing through to customers, we would expect the average annual electricity bill for residential customers to reduce by \$32 (1.8 per cent) and \$29 (1.6 per cent) in 2016 and 2017, respectively (\$ nominal). This would be followed by increases of about \$6 or 0.4 per cent per annum from 2018 to 2020. By comparison, had we accepted Powercor's proposal, the average annual electricity bill for residential customers would increase by approximately \$13 or 0.7 per cent (\$ nominal) per annum over the 2016–20 regulatory control period.

Our estimate of the potential impact our preliminary decision will have for Powercor's residential customers is based on the typical annual electricity usage of around 4700 kWh per annum for a residential customer in Victoria.¹⁸ Therefore, customers

¹⁷ Powercor, *Regulatory proposal*, April 2015, p. 21.

¹⁸ Based on ESC, *Energy Retailers Comparative Performance Report - Pricing 2013-14 -Supplementary Report on Electricity Flexible Prices*, December 2014, p. 3.

with different usage will experience different changes in their bills. We also note that there are other factors, such as metering costs, transmission network costs, wholesale and retail costs, which affect electricity bills.

Similarly, for an average small business customer in Victoria that uses approximately 12000 kWh of electricity per annum,¹⁹ our preliminary decision for Powercor is expected to lead to lower average annual electricity bills. We estimate that based on the distribution charges from our preliminary decision passing through to customers, we would expect the average annual electricity bill for small business customers to reduce by \$71 (1.8 per cent) and \$64 (1.6 per cent) in 2016 and 2017, respectively (\$ nominal). This would be followed by increases of about \$14 or 0.4 per cent per annum from 2018 to 2020. By comparison, had we accepted Powercor's proposal, the average annual electricity bill for small business customers would increase by approximately \$29 or 0.7 per cent (\$ nominal) per annum over the 2016–20 regulatory control period.

Table 1.5 shows the estimated annual average impact of our preliminary decision for the 2016–20 regulatory control period and Powercor's proposal on the average residential and small business customers' annual electricity bills.

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

	2015	2016	2017	2018	2019	2020
AER preliminary decision						
Residential annual bill	1816 ^a	1784	1755	1761	1767	1774
Annual change ^c		-32 (-1.8%)	-29 (-1.6%)	6 (0.4%)	6 (0.4%)	7 (0.4%)
Small business annual bill	3998 ^b	3927	3863	3877	3891	3906
Annual change ^c		-71 (-1.8%)	-64 (-1.6%)	14 (0.4%)	14 (0.4%)	15 (0.4%)
Powercor proposal						
Residential annual bill	1816 ^a	1804	1823	1842	1861	1881
Annual change ^c		-12 (-0.6%)	19 (1.1%)	18 (1.0%)	19 (1.0%)	20 (1.1%)
Small business annual bill	3998 ^b	3972	4014	4054	4096	4141
Annual change ^c		-26 (-0.6%)	42 (1.1%)	40 (1.0%)	42 (1.0%)	45 (1.1%)

Source: AER analysis; ESC, *Victorian Energy Retailers Comparative Performance Report - Pricing 2013-14*, October 2014.

(a) Based on average of standing offers at June 2015 on Switch On comparison tool (postcode 3550) using annual bill for typical consumption of 4690 kWh per year.

¹⁹ Based on ESC, *Energy Retailers Comparative Performance Report - Pricing 2013-14*, October 2014, p. 15.

- (b) Based on average of standing offers at June 2015 on Switch On comparison tool (postcode 3550) 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.