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13 September 2018

Re: NSW electricity distribution determinations: 2019-24

AGL Energy (AGL) welcomes this opportunity to provide comments on the regulatory proposals of Ausgrid, Endeavour Energy, Essential Energy (NSW networks) for the period 2019 to 2024 and to provide our position on many of the questions raised by the Australian Energy Regulator (AER) in its *Issue Paper: NSW electricity distribution determinations* (Issues Paper).

AGL is one of Australia's leading integrated energy companies with over 3.6 million electricity and gas accounts in New South Wales, Victoria, Queensland and South Australia as well as being the owner, operator and developer of a diverse power generation portfolio including base, peaking and intermediate generation plants, spread across traditional thermal generation and renewable sources.

In the Australian energy market, all network charges are passed through to customers through their retail electricity prices so any increase (or reduction) in network charges has no direct commercial impact on retailers. However, as an energy retailer with over 820 thousand electricity customer accounts in NSW, AGL is highly interested in the price outcomes of the NSW networks' regulatory proposals and whether they are effectively addressing affordability.

First, AGL would highlight that the suggested moderation of the impact of network charges as a component of the retail bill has been greatly over-stated in the regulatory proposals. It is true that recent increases in retail prices has resulted in the network share of a typical residential customer's bill dropping. However, this is misleading as:

- it is predominantly a result of wholesale energy prices increasing the total bill rather than reflecting any decrease in network charges; and
- they have calculated the network cost being considerably less than 40 per cent of the bill based on standing offer retail prices. The ACCC[1] have estimated that more than half of NSW residential customers are on market contracts with discounts of 20 per cent or more. This suggests the network's share of the total bill remains at almost 50 percent.

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[1] ACCC (2018), *Restoring electricity affordability and Australia's competitive advantage Retail Electricity Pricing Inquiry—Final Report*

From a competitive price point of view, network costs cannot be varied or discounted by retailers and must be paid. The network component therefore remains the largest element of most residential customers' bill and its price path is highly material to energy affordability.

Secondly, and most concerning to AGL is the network businesses' proposals are generally seeking higher distribution revenues than approved for the 2014–19 regulatory control period, with associated average annual network price increases, however small.

Given the decrease in the regulated rate of return is driving a substantial decrease in annual revenue in the next period, AGL believes the networks regulatory proposals should be able to provide real decreases in network prices. However, rather than aiming to reduce network revenues, the proposals appear to have increased operating requirements and spending on asset renewal, replacement, and non-network capital expenditure to substitute for the diminished rates of return and maintain annual revenues at current levels.

AGL believes the AER needs to specifically examine:

- the increased capital expenditure on replacement and non-network capital and that capitalised overheads are not simply an allocation to avoid higher operating expenditure; as well as
- any inefficiencies in operating expenditure forecasts to ensure the network allowances incorporate productivity improvements, input cost reductions and an environment of low wage growth.

Finally, AGL believes that the current rate of reform by the NSW networks towards cost-reflective network pricing has been slow, although this does vary across the network proposals. AGL encourages the AER to pursue greater network price reform on this regulatory period

Further comments on these and other issues are attached. If you wish any further information, please contact me or Patrick Whish-Wilson on (02) 9921 2207.

Yours sincerely

Elizabeth Molyneux
GM of Energy Markets Regulation

Attachment 1: AGL Comments on the NSW Network Proposals

Regulated Asset Base (RAB)

It is publicly recognised that the size of the RAB for the NSW networks remains excessive and a major impediment to correcting the high cost of delivered energy.

However, the regulatory proposals result in increases in the real value of RABs over the forecast period. This is untenable when the capital investment is not linked with growth or utilisation. AGL appreciates that this concern has been highlighted by Essential which recognises that its cost of refurbishing and replacing old assets is greater than depreciation and is placing ongoing upward pressure on network charges.

AGL notes that the Issues Paper confirms that the regulatory framework is appropriate and that the RAB continuing to increase is expected due to the large capital expenditures in recent years outweighing depreciation which is calculated over long asset lives.

AGL would question the treatment of assets that have been replaced before their allocated asset life and therefore the percentage of the RAB that is making a rate of return despite the assets not being in use.

Capital expenditure

The networks have all proposed principles for their capital expenditure that are highly laudable such as:

- deliver a lower RAB per customer;
- keep capex to a minimum by only replacing aging assets where there is no alternative that is more efficient; replace only what needs to be replaced, augment just enough and invest on a no regrets basis considering emerging technologies.
- investing in research and new technology to improve asset monitoring, analysis, and risk management;
- automation of manual processes to reduce operational costs and drive efficiencies.
- new technology, innovation and partnering with other companies and our customers will solve the problem rather than building more infrastructure.

However, the capital expenditures in the network proposals have failed to drive a lower RAB and lower network prices.

Replacement capital expenditure

AGL is concerned that the networks have continued to propose significant replacement capital expenditure for the next regulatory period with it being the largest capital component in the network proposals.

The networks justify these expenditures based on the need to replace assets:

- in poor condition
- that pose a safety risk; or
- have reached their end of useful life.

AGL relies on the AER to review the networks' asset replacement programs for efficiency and avoid any advanced asset replacement in the long-term interest of consumers.

Non-network capital expenditure

The networks have also proposed significant increases in non-network capex such as information and communications technology (ICT), fleet, property, and plant.

AGL does support capital expenditure spent on improving the quality of supply in the distribution network with the expansion of distributed generation and storage currently being limited by supply quality including voltage. As such, we support any ICT programs that will see significant improvements in the transformation of the networks.

AGL is also comfortable with the ICT expenditure proposed by Essential as it has quantified many of the benefits accruing from its investment including improved efficiency and lower operating and capital costs.

However, AGL is not clear that the increased expenditure on plant, property and fleet is warranted or whether the reduced capital expenditure in other areas has simply provided an opportunity for supplementary spend by the networks.

Capitalised overheads

AGL understands that the capital overheads of all three networks relate to capital program support including planning, management and supervision of capital projects and programs, as well as administrative support and safety. The proposed allowances are substantial.

AGL would expect capital overheads to:

- reduced in total in line with the networks' reduced capital expenditure programs when compared with the previous two regulatory periods; and
- reduced as a percentage of the capital program with productivity and efficiency improvements.

This has not been clearly demonstarted.

AGL expects that the networks' capital overheads are allocated from cost centres that also incur operating expenditure. We would expect the AER to ensure that the operating expenditure improvements made by the NSW networks are proven and not simply supported by changing costs allocations to capital programs.

Operating expenditure

AGL continues to support the AER's reliance on industry benchmarking for reviewing operating cost allowances.

We note that all the NSW networks' have adjusted the base operating expenditure to reflect:

- increases for forecast changes in real prices of key inputs; and
- increases driven by expected output growth.

However, only Essential has included negative adjustments to its base operating expenditure and forecast productivity improvements over the period to negate these increases and propose lower operating expenditure in the next regulatory period.

AGL strongly supports the inclusion of productivity improvements in the network businesses' proposals. Assuming zero productivity over the next five years period would be unacceptable for a competitive firm and is therefore unacceptable for these regulated businesses given:

- they have previously demonstrated that significant efficiency improvements are achievable when driven by the regulator; and
- the AER's incentive regulation framework is one where the networks will be unduly rewarded for basic productivity improvements through incentive schemes.

Incentive schemes

The AER incentive schemes include:

- the operating expenditure efficiency benefit sharing scheme (EBSS)
- the capital expenditure sharing scheme (CESS)
- the service target performance incentive scheme (STPIS)
- the demand management incentive scheme (DMIS) and demand management innovation allowance mechanism (DMIAM).

AGL understand that the EBSS and CESS are supposed to provide a balanced incentive for networks to pursue efficiency improvements in operating and capital expenditure and to share these between the business and consumers. However, AGL is yet to observe any benefit for consumers through this approach and believe it is too opaque to work effectively for consumers.

AGL believes the benchmarking of operating expenditure allowances during the regulation determination provides ample incentive for networks to pursue improvements in efficiency in the period. The networks have an underlying incentive to improve efficiency and 'bank' any benefits if their operating allowance in the following period is based on the industry benchmarks and not solely their performance.

Similarly, we have observed many network businesses' making appropriate capital investment decisions to underspend or overspend their capital allowance depending on circumstances during regulatory periods. This occurs in the absence of any CESS.

Consequently, AGL is not a supporter of the EBSS and CESS incentive schemes.

AGL support the use of the DMIS and DMIAM currently. Encouraging improved and more efficient demand management practices to reduce long term network costs is highly desirable but we have yet to see it develop with any scale. As such, incentives to encourage development are welcomed. In the medium term, we would expect these practices to become more entrenched and for the DMIS and DMIAM to become redundant.

Network Tariffs

AGL strongly supports network tariff reform to ensure that:

- network tariffs become more cost-reflective and align with network cost drivers;
- remove the current cross subsidies that exist because of volumetric tariffs;
- network prices are more stable and consequently, their impact on retail prices is more stable; and
- time signals are provided that allow consumers to efficiently invest in new technologies.

For that reason, AGL has supported demand-based tariffs to date because they most closely align to network cost drivers but there is a spectrum of cost reflective models for network tariffs that could be

considered from subscription type pricing models (based on demand profiles) to Time of Use pricing with limited peak periods which then provides a proxy for the customers' demand profile.

AGL is pleased to see that Essential and Endeavour have proposed introducing residential demand tariffs for the next regulatory period, even with different assignment approaches, transitions and opt-out options.

We note that Ausgrid has also proposed introducing a demand tariff for residential customers but that it may or may not be utilised. Instead, Ausgrid have focussed on increasing fixed charges for small customers as a way of re-balancing its tariffs to lower non-peak volume charges to be more cost-reflective. Although higher fixed charges do provide price stability and are more cost reflective than volumetric charges, they do discriminate against small consumers of electricity that have very low demand profiles. Ausgrid has recognised this and proposed a network rebate system for residential customer consuming less than 2 MW per annum.

AGL is not supportive of this approach as:

- consumption-based pricing thresholds have proven to be highly problematic to administer; and
- Ausgrid will be providing rebates to many customers that have low consumption but high peak demand (e.g. Solar customers) so this pricing approach will be less cost-reflective than its current approach.

AGL note that Ausgrid have also proposed an inclining block tariff for larger residential users. This appears to conflict with its reasoning that increased fixed charges are needed to lower off-peak volume rates. We suggest that Ausgrid articulate its over-arching strategy for network pricing reform and then apply it consistently rather than change the approach depending on the customer group and bill impact.

AGL is also supportive of some consistency of approach by the NSW networks. This is not to say that the NSW networks must all utilise the same network tariff structures. However, if they are introducing similar pricing structures then it would be highly sensible to align other elements like:

- Peak and off-peak periods;
- Mandatory assignment rules for cost-reflective tariffs; and
- Demand charge calculation methods;

to allow improved customer education on a state-wide basis as well as moderating costs and complexity for retailers and customers.

Finally, AGL does supports the certainty that the TSS provides with network tariff structures "locked-in" for the duration of the regulatory control period. However, AGL sees no issue with a network nominating a network tariff structure that it can therefore utilise in the regulatory period although we do question why that tariff cannot be assigned indicative prices, even if it currently unavailable.