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Energex electricity distribution network - 2020 to 2025: Draft Decision

AGL Energy (AGL) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) *Queensland electricity distribution determination 2020 to 2025 draft decision* (Draft Decision) and provide comments on the Energex revised regulatory proposal (Revised Proposal) for the period 2020 to 2025.

The Energex Revised Proposal appears to be seeking a reasonable balance between the need for additional network expenditure, efficiency of the expenditure and ensuring affordability by providing significant reductions in network revenue and distribution network charges over the next period.

However, AGL notes that the key drivers of the lower proposed revenue for the 2020-25 period are:

- a lower rate of return with the nominal Weighted average cost of capital decreasing from around 6 per cent to 4.87 per cent for the 2020–25 regulatory control period; and
- a reduced tax allowance in line with the AER's recent review of the regulatory tax approach.

These elements are outside of Energex's control which means the significant reductions in projected revenue and network charges for the 2020-25 period do not necessarily indicate that the cost allowances in the Revised Proposal are prudent or cost-efficient.

Indeed, the AER Draft Decision identified significant amounts of capital expenditure in the initial Energex revenue proposal that were considered inefficient or that could not be readily justified. AGL is concerned that in its Revised Proposal, Energex has elected to include much of this omitted expenditure, albeit with additional supporting information.

AGL offers the following comments regarding the various components of the Revised Proposal.

Capital expenditure

A distribution network's capital expenditure is predominantly on long-lived assets with the costs recovered over many regulatory control periods. Under the regulated framework, these costs are paid by consumers over the entire life of the asset, irrespective of whether the asset is being fully utilised, now or in the future. The energy industry is undergoing a transformation with changing technologies and the introduction of more distributed energy resources and it is with this background that any network investment be assessed for prudency and efficiency.

Although Energex initially proposed a capital spend around 11 per cent lower than its capital expenditure over the current period, AGL notes that in its Draft Decision, the AER reduced the capital expenditure allowance by a further 10 per cent because the regulatory proposal:

- did not demonstrate the need for some of the expenditure;
- did not provide quantitative analysis in support of the forecast;
- used a more conservative approach (deterministic) to forecasting; and
- included expenditure that was unlikely to be delivered within the 2020–25 regulatory period.

The Energex Revised Proposal does not accept the AER Draft Decision and includes augmentation and replacement capital expenditure that is in line with its initial proposal. AGL, and other stakeholders, rely on the AER to rigorously assess any new supporting information to ensure that these revenue allowances are in the long-term interest of consumers.

AGL specifically queries how the Revised Proposal can justify the increase in capital expenditure on property and fleet given the AER's Draft Decision. It would seem unlikely that investment in property and fleet would be dependent on forecasts of growth of the network, demand and potential safety risks that are used to support the additional replacement and augmentation capital expenditure.

AGL also questions the revision to capitalised overheads in the Revised Proposal. The derivation of the forecast of capitalised overheads may be defendable on a formulaic basis but appears to make little sense.

In effect, Energex proposed $524 million that it believed was required as overheads for its future capital spend. The AER reduced the total capital spend in the Draft Decision but determined an increase in overheads to $535 million. The Energex Revised Proposal returns its capital spend to a level like its initial proposal but has increased its requirements for capitalised overheads to $558 million.

The general level of overheads required by Energex on any capital expenditure is itself worrying but the continued escalation of the allowance for capitalised overheads at each stage of the consultation process is more concerning.

Operating expenditure

AGL supports the reductions in projected operating expenditure made by Energex for the 2020-25 regulatory control period and the AER's acceptance of this allowance in the Draft Decision noting that it is a material improvement in Energex's efficiency against historical benchmarks.

Incentive Schemes

Energex elected not to claim the benefits of the current efficiency benefit sharing mechanism (EBSS) and capital expenditure sharing scheme (CESS) in its intital regulatory proposal but have reversed this decision in its Revised Proposal. AGL has no concerns with Energex's decision given this is part of its regulatory determination. However, this will amount to an additional $160 million in annual revenue to be paid by consumers over the next regulatory period because, put simply, the network was not required to spend $160 million of the allowances provided in the last regulatory period.

AGL understand that these schemes are supposed to provide an incentive for networks to pursue efficiency improvements and share the benefits between the business and consumers but has serious concerns with their impact and has yet to ascertain any clear benefit to consumers.

Invariably, regulated networks manage to underspend operationally or on capital over a regulatory period and accrue a material benefit into the next regulatory period. However, it is doubtful whether this total underspend has any positive impact for customers because:

- it is difficult to ascertain whether the reduction in expenditure was driven by improved cost efficiency of a network or simply changing circumstances and that investments were not required at that time; and
- any efficiencies over the period do not have a clear, discernible relationship with the level of forecast capital and operational expenditure in the next regulatory period given that the base year used in the determination of these future allowances is usually a latter year that may have little underspend.

AGL does not believe these schemes are balanced and share the benefits with consumers and may be encouraging unintended consequences such a bias towards higher operating and capital expenditures allowances. As such, AGL cannot support the continued use of the EBSS and CESS in future regulatory periods.

Tariff structure statement (TSS)

In its Draft Decision, the AER highlighted that the purpose of network tariff reform is to improve the cost reflectivity of price signals but also recognised that it was retailers that were being directly charged by the distribution networks. Consequently, the network price signal must allow retailers to make informed decisions about how to manage the financial risks of cost reflective network pricing including:

- non-price measures, such as targeted demand management initiatives;
- pass through of the network tariff structures to end-customers; or
- by providing retail products that insulate consumers from the risk of the cost reflective network tariff structures and offer end-customers simpler alternatives.

AGL agrees with the AER and therefore believes that when a network is determining its future tariff strategies it must also consider the implications of certain tariff structures on retailers as well as on consumers.

AGL believes the Energex TSS in the Revised Proposal is greatly improved compared to its initial TSS and supports:

- the introduction of demand and ToU energy tariffs for residential and small business customers;
- a narrower evening peak window of 4-9 pm for all new demand and ToU energy tariffs; and
- much of the tariff assignment policy that enables take up of cost reflective tariffs while managing customer price impacts.

Energex has stated that it anticipates an increase in the relevance of capacity-based tariffs in support of emergent technology and new customer needs.

However, many of the future challenges identified by Energex seem to reflect the importance of peak demand rather than customer capacity such as:

- air-conditioner load exacerbating the early evening peak;
- electric vehicles could potentially exacerbate the early evening peak;
- solar PV take up continuing to cause localised voltage management issues in the midday period;
- home batteries allowing solar generation to be used in any time period.

As such, AGL is uncertain regarding the future scope for capacity-based tariffs given technology change and agrees with delaying their introduction until trials can be undertaken during this regulatory period to better inform their future usage.

Cost reflective tariff structures

As mentioned above, distribution networks need to consider the implications of certain tariff structures on retailers as well as consumers. While AGL generally supports the TSS in the Revised Proposal, several details of the proposed network tariff structures are problematic for successful uptake as highlighted below:

- AGL supports the ToU Energy Tariffs and alignment of the peak consumption period with the peak period use for demand tariffs. However, AGL does not understand the need for different off-peak rates for day and night given they do not appear materially different in quantum and complicate the tariff. If there is a major benefit to this time differentiation, then AGL would expect to see this reflected in the rates accordingly.
- Similarly, the proposal that small business customers with basic accumulation meters consuming more than 20MWh per annum are re-assigned to a tariff with a fixed charge ($/day) that varies according to customer's annual consumption (i.e. between 0-20, 20-40,40-60, 60-80 or 80-100 MWh/year) is problematic. The inclining fixed charge structure may improve the correlation of fixed cost to customers' connection size, but Energex would be aware that consumption is only a rough proxy for connection cost. The network tariff may be an improvement in cost reflectivity for some customers but would be extremely difficult to administer and track because the fixed charges would vary according to a customer's consumption which can vary widely from year to year.

Complicated network structures are not attractive to customers and are usually moderated through retail products. AGL believes the above pricing structures are unlikely to be passed through to customers as they stand because of their complexity for both customers and retailers. AGL therefore advises the AER and Energex to consider whether these structures are appropriate in the final TSS.

Should you have any questions in relation to this submission, please contact Patrick Whish-Wilson on [redacted].

Yours sincerely

[redacted]

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