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Consumer Challenge Panel

CCP Sub-Panel No. 9

1/02/2018

AER Board
Mr Adam Petersen, Co-ord Director – TransGrid/ElectraNet/Murraylink Reset
Australian Energy Regulator
By email: adam.petersen@aer.gov.au Cc: ccp@aer.gov.au

Dear Paula,

Re: AER Draft Decision and ElectraNet Revised Revenue Proposal for 2018-23

Please find attached our submission in relation to the above transmission network determination

Kind Regards,

Eric Groom
Chairperson, Sub-Panel 9

Consumer
Challenge
Panel

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel Sub-Panel 9

Response to Draft Decision and Revised Proposal for Revenue Reset for ElectraNet for 2018-2023

Sub-Panel 9

Eric Groom

Bev Hughson

Andrew Nance

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1. Executive Summary

CCP9 has considered the AER Draft Decision and the Revised Proposal of ElectraNet in light of the objective of the CCP which is to:

- advise the AER on whether the network businesses' proposals are in the long term interests of consumers; and,
- advise the AER on the effectiveness of network businesses' engagement activities with their customers and how this is reflected in the development of their proposals.

In this section of our advice to the AER we summarise the issues of interest to CCP9 and our recommendations are as follows:

Consumer Engagement

CCP9 has been impressed with the ongoing commitment of ElectraNet to applying best practice customer engagement principles and processes throughout its two years of consumer engagement. It has been a journey that both informs and is informed by its consumer base and in particular, consumer representatives. As a result, ElectraNet has delivered a proposal that meets its criteria of 'no surprises' and 'capable of being accepted' and has done through in a period of unprecedented turbulence and uncertainty in the SA energy market.

CCP9 has attended two consumer advisory panel meetings since the AER's Draft Decision and has considered TransGrid's response to the issues raised by the AER, CCP9 and consumers. While the material is more limited, CCP9 concludes that ElectraNet has continued its efforts to maintain and enhance its successful and leading customer engagement program. The success of this program has been based upon early engagement, management commitment, open communication and a genuine ambition to hear and respond to the voice of the consumer as part of its regulated revenue proposal.

ElectraNet has achieved this outcome within an environment of unprecedented operational and policy changes and considerable uncertainties. CCP9 considers ElectraNet's ability to maintain the confidence of consumers and regulators in the face of these challenges reflects the quality of its engagement to date. CCP9 was pleased to see ElectraNet awarded the Consumer Engagement Award from Energy Consumers Australia (ECA) in recognition of ElectraNet's leadership and innovation in this area.

However, these operational and policy challenges will continue and will require ElectraNet to maintain its commitment to its consumer engagement and to adapt its successful program to meet these new challenges. ElectraNet has started this journey of 'looking back and looking forward' in its January 2018 CAP meeting. CCP9 considers that ElectraNet will face challenges arising around engaging consumers through the RIT-T processes and associated large-scale contingent projects. Transmission tariff design may also emerge as an issue, as there is growing pressure on both ElectraNet and SAPN to design and implement cost reflective network tariffs. A further challenge to ElectraNet will be to maintain the engagement momentum – consumer representatives are typically 'multi-tasking' and facing their own time and financial pressures. This latter aspect is a challenge not only for ElectraNet, but also for the AER and lead organisations such as the ECA.

Recommendations:

a) The AER take account of the extensive customer engagement program that has been undertaken by ElectraNet over the last two years.
b) ElectraNet establish a formal, principle based, process for consumer engagement during RIT-T reviews, consistent with but going well beyond the current regulatory requirements for consultation and noting that this engagement must be tailored to some extent for individual projects.
c) ElectraNet clarify if it intends to progress engaging with relevant customers in relation to the develop of more efficient and transparent pricing as set out in its 2016 Network Vision statement.
d) ElectraNet review the appropriate response consistent with its values for openness and transparency in response to the issues raised about data sharing by SACOSS.
e) ElectraNet work with its colleagues and the CAP to consider ways in which the industry can assist in addressing the issue of resourcing for consumer representatives to ensure their capacity to provide an ongoing commitment to the engagement process.

REVENUES

CC9 recommends accepting ElectraNet's revised revenue proposal subject to updating for interest rates and inflation and to consideration of options for including some aspects of the contingent projects in the ex-ante forecast. The individual components of the revenue forecast are discussed in this section.

Total revenue allowance

ElectraNet has accepted all the components of the AER's Draft Decision subject to applying updated values for relevant components of the Draft Decision.

ElectraNet's revised revenue is lower than its original revenue proposal largely reflecting ElectraNet's acceptance of the AER's Draft Decision update of the weighted average cost of capital (WACC) including inflation estimates and the AER's decision on the value of imputation credits (gamma). ElectraNet has set out a summary of its response to each of the elements in the AER's Draft Decision in detail in Table 1 of its revised revenue proposal (pp 9-10).

CCP9 remains concerned, however, about the potential impact of the contingent projects (totalling some $640m) will have on the revenue forecasts over the longer term as the RAB expands. Modelling of these long-term revenue (and price) impacts across several regulatory periods would be a useful addition to the AER's Final Decision.

Recommendations:

f) The AER accept ElectraNet's total revenue forecast, subject to updating relevant parameters such as interest rates and to consideration of CCP's proposal to include at least one pending and reasonably certain contingent project in the ex-ante capex allowance.

Capital Expenditure and RAB

CCP9 does not agree with the AER's Draft Decision on capex and seeks further investigation by the AER of the capital expenditure program, particularly in the context of the proposal to include the capital expenditure for the Eyre Peninsula project in both the ex-ante allowance and as a contingent project. CCP9 supports the decision by the AER to require a RIT-T for all the proposed contingent projects. If projects are likely to proceed within the next year, the costs should be included in the ex-ante forecast.

In its Draft Decision, the AER approved ElectraNet's ex-ante capex proposal in total. In its revised proposal, ElectraNet has made few changes to the total proposed capex. Based on this total capex proposal, the regulatory asset base (RAB) grows at a slower rate than in the past and even declines in the final year. While this outcome is welcome, CCP9 has a number of concerns. In the first instance, assessment of the overall prudency and efficiency of the total capex is difficult because of the multiple interactions between projects and we expect the AER to 'unpick' these effects in the final decision.

Secondly, there are significant risks to the revenue and RAB growth forecasts arising from a number of large contingent projects, amounting to an additional capex of some $ 650m (around a quarter of the existing RAB value) over the regulatory period **if** all projects proceed. AEMO's inaugural Integrated System Plan (published December 2017) suggests that there is a stronger likelihood that the triggers for the additional Eyre Peninsula contingent project and the SA Electricity Transformation contingent project will occur in this regulatory period.

ElectraNet has also proposed a modification to the trigger for the Main Grid System Strength (MGSS) contingent project to remove the RIT-T requirement. This is based on AEMO's assessment of a Network Support and Control Ancillary Services (NSCAS) gap in the SA region from March 2018. CCP9 does not support a change in the trigger for the MGSS project, but in the circumstances would prefer that the AER include the full MGSS costs in the ex-ante forecast. In principle, CCP9 places high value on the RIT-T process as it ensures high levels of transparency, appropriate consultation, and consideration of other options including non-network supply. Any alternative process would need to ensure the same requirements continue in some form.

Recommendations:

g) The AER reconsider the inclusion of $80m in the ex-ante allowance for the Eyre Peninsula line replacement project and include this expenditure in the scope of the Eyre Peninsula Contingent Project.

h) The AER consider if and to what extent the costs of the MGSS contingent project should be included in the Final Decision given the timetable for the MGSS.

i) The AER continue to include the successful completion of a RIT-T as a mandatory contingent project trigger (as per the Draft Decision) and not accept ElectraNet's proposed changes.

Operating Expenditure

ElectraNet's revised operating expenditure (opex) is below the AER's Draft Decision and CCP9 recommends that the AER accept ElectraNet's revised revenue proposal subject to updating a number

of the trend modelling parameters in the light of recent benchmarking research. However, we are strongly in favour of the AER reviewing the continued decline in total and partial factor productivity and to indicate in its final decision, the impact of its component decisions on the future trend in ElectraNet's productivity measures.

ElectraNet's revised operating expenditure (opex) proposal is some $21m below the AER's Draft Decision. This revised operating expenditure is also below the opex in the final year of the current 2013-18 regulatory period, although it is noted that the 2013-18 period saw significant growth in opex. CCP9 notes that ElectraNet has consulted extensively on its proposal and revised proposal and we recommend that the AER accept ElectraNet's revised opex forecast, including the step change proposed for new regulatory obligations. CCP9 has also requested that, for the sake of consistency, the AER calculate the new operating allowance using the revised rate of change measures that are set out in the 2017 benchmarking report by Economic Insights (EI). While this will result in a small increase in the opex proposed by ElectraNet, the outcome will still be below the AER's assessment of efficient operating costs.

CCP9 also highlights the 'productivity paradox'. That is, the observed measures of productivity by EI, across the transmission industry and for ElectraNet, still show a decline in total, opex and capex productivity measures, as do the AER's partial productivity measures. Major factors in this decline include cost pressures from high levels of historical capex and the resulting RAB growth while at the same time there is declining or stagnant output and reliability. Many excuses have been made for declining productivity. However, 10 years on, can consumers still tolerate this outcome while being asked to fund further investment? We recognise this is not an issue the AER can resolve other than to focus on prudency and efficiency of expenditure in what is otherwise a mature market. However, CCP9 recommends that the AER's final decision(s) should provide, ex-ante, an estimate of productivity outcomes of its decisions on capex and opex in addition to revenue and pricing outcomes.

Recommendations:

j) The AER accept ElectraNet's proposed opex, subject to the update of the rate of change measures (price and productivity) arising from the November 2017 Economic Insight's report updating productivity trends from 2006 to 2016.

k) The AER accept ElectraNet's proposed allocation of new regulatory costs between existing expenditure forecast and step changes, given the particular circumstances of these new regulatory requirements and ElectraNet's overall restraint on the base opex forecast.

l) In assessing future contingent projects under the RIT-T process (or agreed alternative), the AER make a parallel assessment on the changes in opex, including the likelihood of reduced maintenance costs and GSL payments.

m) The AER undertake further investigation of the partial and total productivity trends as measured in the EI study, to consider if the incentives are driving the expected cost reductions.

n) In its final decision, the AER indicate how the proposed expenditures (including the contingent projects) will impact not only on revenues and prices but also on productivity outcomes.

Rate of Return, Inflation and Tax

CCP9 recommends that the AER accept ElectraNet's proposed WACC in its revised proposal, subject to updating the outcome for changes in interest rates and expected inflation using its current approach to estimating these values. We also acknowledge ElectraNet's decision to accept the AER's WACC, inflation and gamma estimates despite its reservation on some components.

CCP9 has noted that the overall approach to the WACC under the Rate of Return Guideline appears to have produced estimates that are on the high side as evidenced by considering the collective evidence from the investor market including RAB multiples, brokers' and credit rating agencies' reports, and investor behaviour in the buying and selling utility stock. However, CCP9's preference is that the AER's current decisions are in line with the 2013 Rate of Return Guideline, which has been tested through Tribunal and Federal Court decisions. Any changes to the AER's approach should be the outcome of the AER's year-long project to review the 2013 Rate of Return Guideline (and 2014 updates). CCP9 values consistency and predictability in regulatory decision-making and we require a high standard of evidence to change the AER's approach to the estimation of WACC, inflation and tax.

Recommendations

o) CCP9 accepts the proposed WACC of 5.7% (nominal, vanilla) and recommends that in its final decision the AER updates the proposed WACC for changes in interest rates and expected inflation (using the AER's current estimation process for expected inflation), but does not suggest any other change to the AER's Draft Decision on WACC.

Incentive Schemes

CCP9 recommends that the AER accept ElectraNet's proposed assessment of the three incentive schemes (EBSS, CESS and STPIS). The AER's Draft Decision made some important modifications to ElectraNet's original proposal and CCP9 supports these modifications. ElectraNet has also adopted these modifications in its revised proposal.

The discussion also includes some comments on the effectiveness of the three schemes in driving the types of productivity outcomes and performance gains that consumers expect over time. CCP9 also comment on whether the three incentive measures achieve the balanced outcomes consumers seek in terms of the trade-offs between opex, capex and reliability performance; reliabililty outcomes are lagged measures and the impact of network 'short-cuts' may not impact on reliability in the same regulatory period. Moreover, CCP9 highlights that costs which are based on benchmarks alone (e.g. debt costs) and do not use the revealed cost approach at the revenue reset should not be included in the EBSS or CESS.

Recommendation:

p) The AER should accept the three incentive schemes as modified by ElectraNet in its revised proposal

More detailed consideration of each of these issues is set out in CCP9's advice below.

2. Background

- This advice was prepared in accordance with the Schedule of Work agreed upon between sub-panel CCP9 working on the ElectraNet, Murraylink and TransGrid resets and Adam Petersen and Andrew Ley, Co-ordination Directors for the resets.
- The NSPs commenced the process of preparation of their access arrangement proposal and the related consumer engagement early in 2016. During 2016 and 2017 the NSPs undertook a range of consumer engagement activities and processes.
- CCP9 was established in September 2016.
- CCP9 held regular meetings with the Co-ordination Directors since October 2016.
- Introductory contact was made with ElectraNet in October 2016.
- CCP9 sub-panel has been invited to attend all of ElectraNet's Consumer Advisory Panel (CAP) and has done so on 6 occasions between October 2016 and January 2018. The proceedings and almost all papers presented at the meeting are available on ElectraNet's web-site and provided directly to CCP9 members in a timely fashion.
- CCP9 has had additional meetings with ElectraNet's senior staff and independent customer engagement expert on a number of occasions.
- CCP9 presented at two public forums organised by the AER; on the 7 June 2017 following the publication of ElectraNet's preliminary Regulatory Revenue Proposal and the AER's Issues Paper; and on 6 November 2017 following the publication of the AER's Draft Decision. Consumer representatives, direct customers (or prospective customers) of ElectraNet, the SA electricity distributor (SAPN) and representatives from the SA Government attended the forums.
- CCP9 provided a detailed submission to the AER on ElectraNet's Regulatory Revenue Proposal and the AER's Issues paper on 12 July 2017 proposal and Issues
- Meetings have been held with most of the AER specialist teams involved in the reset. These meetings have provided an opportunity for the sub-panel to better understand some of the technical issues involved as well as for the Panel and AER officers to exchange views on issues associated with ElectraNet proposals in the context of the rapidly evolving context of the South Australian electricity system since the September 2016 system black out event.

CCP9 greatly appreciates the ongoing advice and support from the AER's Co-ordination directors and AER staff. CCP9 also appreciates the opportunities to meet with ElectraNet's staff and its independent consultant and to participate in ElectraNet's CAP processes. This has greatly facilitated our ability to learn from, and to assess ElectraNet's customer engagement process and the regulatory revenue proposal.

3. Consumer Engagement

3.1 Summary

CCP9 considers that ElectraNet has continued on its journey of establishing a successful and leading customer engagement program based upon early engagement, management commitment, open communication and a genuine ambition to hear the voice of the consumer as part of its regulated revenue proposal. ElectraNet has achieved this outcome within an environment of unprecedented operational and policy changes and uncertainties. CCP9 considers ElectraNet's ability to maintain the confidence of consumers and regulators through these challenges reflects the quality of its engagement to date. CCP9 was pleased to see ElectraNet awarded the Consumer Engagement Award from Energy Consumers Australia (ECA) in recognition of ElectraNet's leadership and innovation in this area.

However, these operational and policy challenges will continue and will require ElectraNet to maintain its commitment to its consumer engagement and to adapt its successful program to meet these new challenges. ElectraNet has started this journey of 'looking back and looking forward' in its January 2018 CAP meeting. CCP9 considers that ElectraNet will face challenges arising around consumer engagement through the RIT-T processes associated with the multiple contingent projects. A further challenge to ElectraNet will be maintaining the engagement momentum – consumer representatives are typically 'multi-tasking' and facing their own time and financial pressures. This latter aspect is a challenge not only for ElectraNet, but also for the AER and lead organisations such as the ECA.

3.2 The changing industry environment

Any assessment of consumer engagement in the regulatory processes should start first with recognition of the environmental pressures facing the industry and consumers. The energy industry is facing unprecedented rate of change in the market, in technology and in energy policy. Consumer representatives are facing increasing calls on their time and resources from the growing call for consumer engagement across a range of industries and from their own consumer base who are looking for advocates to address the issues of living costs – especially energy costs.

ElectraNet's revenue proposal and the AER's decision has been developed within this environmental context and complicated further by the fact that SA is at the forefront of the debate about future energy policy. It is a credit to ElectraNet that they have persisted, and indeed enhanced, the consumer engagement program that commenced in 2015 including a program of outreach to communities in regional and rural areas to address local concerns with energy affordability and reliability of supply. The benefits of this approach were seen as early as September 2016 in the community and government response to the System Black event during which there was a complete disruption to supply to SA customers.

ElectraNet's customer engagement program has been recently recognised by receiving the inaugural award from Energy Consumers Australia (ECA). As discussed below, a key aspect of this recognition

and Award was ElectraNet's responsiveness to the technological, market and policy changes it has been facing.

3.3 Response to the Regulatory Revenue Proposal (March – July 2017)

In CCP9's response to ElectraNet's initial revenue proposal (July 2017), CCP9 highlighted ElectraNet's commitment to a structured approach to customer engagement including a number of innovations such as the 'no surprises' policy and the establishment of the Consumer Advisory Panel (CAP). The program progressed through a series of regular meetings with the CAP, commencing with confirming the purpose, functions and modis operandi of the CAP, and later covering industry developments and specific aspects of the revenue proposal. The program also benefited from implementing a separate stream of 'deep dives' where CAP members with particular interests and knowledge could explore more complex issues. This approach, although not without its own challenges, goes someway to addressing the vexed issue of consumer representatives having varied interest, limited time and resources, and very different levels of industry knowledge.

ElectraNet also appointed an independent and very experienced facilitator to assist in the ongoing development and design of the program and to provide independent feedback to the business. Importantly, ElectraNet welcomed both the AER and the CCP to be observers and participants in the process. The AER was also able to play a valuable role in clarifying more complex technical and regulatory issues for consumers; in turn the AER learnt more about the business and consumer concerns.[1] CCP9 considers that this was a significant factor in resolving issues between the business, the AER and consumers early in the process rather than at the end of the process. CCP9's experience is that when important issues are left unresolved until late in the process, it becomes very much harder to resolve them in a mutually constructive manner.

This early engagement produced a number of publications for public comment covering the vision, strategies and priorities of the business and its consumers, culminating in the publication of a Preliminary Revenue Proposal for public discussion. The CAP was engaged in the development of all these publications. On the basis of this program, CCP9 recommended to the AER, that the AER favourably consider most of the elements of ElectraNet's revenue proposal. Engagement in the future around the proposed contingent projects and RIT-T process remained a question mark in CCP9's mind, as was the level of co-ordination between the various industry parties, particularly ElectraNet and SA Power Networks (SAPN).

The feedback CCP9 received from participants in the CAP process was also generally very positive and the CAP members appreciated the openness and transparency of the discussions and the opportunity to meaningfully collaborate with ElectraNet, particularly during the deep-dive sessions. While the CCP9 could only attend one of these deep-dive meetings, the feedback from those that did attend was very positive. ElectraNet's Revenue Proposal and Revised Revenue Proposal clearly benefited from this exchange of views.

Feedback from consumer representatives in their submissions and in subsequent conversations were also generally very positive although there was some concern about the time demands and the complexity of some of the issues. There were also questions about what issues were best left to the

[1] For example, in addition to attending the full CAP meetings, the AER met with the CAP deep dive teams for a series of technical workshops during 2016. See for instance, ElectraNet, *Customer Engagement Outcomes Report,* 28 March 2017, p 11.

regulator and the business and what issues consumers could meaningfully respond to. It was put to CCP9 that consumer representatives are also accountable to their own constituencies and need to be able to demonstrate to their constituencies how their participation in the CAP has contributed to addressing their concerns about affordability, reliability and continuity of supply. However it was that these comments should not detract from the overall positive response. There was also a concern expressed by SACOSS whether early engagement and 'no surprises' philosophy corresponded to a 'fast track' approach that did not allow time for adequate scrutiny of the proposals.

3.4 The AER's Draft Decision

The AER's Draft Decision supported the observations by CCP9 regarding the benefits of an early start to the process, a well designed and sustainable structure, appointment of an independent facilitator, support for the program from the Board, CEO and senior management and the quality, clarity and accessibility of the ElectraNet's communications with its consumer base and other stakeholders. The AER concluded:[2]

> *In recent years we have seen a number of businesses raise the bar on consumer engagement in developing regulatory proposals*
>
> *…*
>
> *ElectraNet's consumer engagement for this revenue proposal has led the way and establishes one of the best practices we have seen from network service providers.*

The AER also agreed with CCP9's recommendations in terms of a focus on outcomes that representatives can take back to their constituents, and consider options to address their concerns with the time and resources required to fully participate. While the AER agreed with these recommendations from CCP9, the AER also stated that:[3]

> *We agree with these recommendations, however they do not take away from our view that ElectraNet's consumer engagement is of a high standard.*

CCP9 was pleased to see the AER acknowledge the concerns of SACOSS around the resourcing issues although, perhaps not surprisingly, there was no specific solution forthcoming. The AER also noted SACOSS's assessment of the risk of implementing a 'fast track' process will mean an inadequate consultation process with limited opportunities for dialogue or deliberative processes. The AER responded to this concern by suggesting that early engagement is a complement to the formal process not a substitute. The AER states:[4]

> *We consider that the early engagement process complements and enhances the revenue determination process. It cannot act as a substitute to the formal decision making process required of us under the rules. Our role and responsibilities under the NER remain and we adhered to this process in undertaking a rigorous assessment of ElectraNet's revenue proposal.*

[2] AER, *Draft Decision – Overview (Amended)*, 3 November 2017, p 34.
[3] Ibid, p 35
[4] Ibid, p 36.

CCP9 appreciates the AER clarifying this latter issue. 'Fast track' means different things to different people and in our mind certainly does not replace the formal obligations for the AER to conduct a careful review of a proposal. However, there is room within this formal requirement for recognition in the process of the outcomes from an effective an open consumer engagement program.

The Victorian Essential Services Commission for instance, has established a process where the allowed return on equity is moved up or down depending on, inter alia, the quality of the customer engagement as assessed by the business and by the Commission.[5] In the UK, OfGem recognises the quality of the customer engagement as part of its approval process. While these approaches may not fit within the AER's regulatory framework, they provide examples of regulators exploring suitable approaches that reflect the growing importance placed on effective consumer engagement.

3.5 ElectraNet's revised revenue proposal

In the period between the original Revenue Proposal and the Revised Revenue Proposal, ElectraNet continued to work with its CAP, regulators and governments on the electricity supply issues for SA as well as work with AEMO to strengthen the networks and prepare for the impact of the National Energy Guarantee program. In October 2017, ElectraNet advised stakeholders (including the CAP and the AER) about the expected implications of these developments in the Revised Proposal.

More generally, and following consultation in November 2017 with its CAP, ElectraNet adopted all other aspect of the AER's Draft Decision in its Revised Revenue Proposal. ElectraNet also conducted a session with its CAP in January 2018. This session included updates of all the developments in the energy markets and early discussions around the way forward. A CCP9 member attended each of these sessions and was satisfied that ElectraNet continued with its open discussion with its stakeholders on its plans. While ElectraNet did not agree with all aspects of the AER's Draft Decision, the discussion provided a balanced assessment of the main issues. ElectraNet's Revised Revenue Proposal also responded to requests from CCP9 and others to provide more information on the pricing impacts of contingent projects.[6]

In separate discussions, ElectraNet clarified with CCP9 that it had broadened its consumer consultation to include meetings with stakeholders in regional areas, particularly Port Lincoln. This engagement was part of ElectraNet refining its capital expenditure program and as input into the RIT-T process for reinforcing the transmission supply to the Eyre Peninsula.

3.6 CCP9's Assessment

As noted above, CCP9 was generally satisfied that over the course of the two recent CAP meetings, ElectraNet demonstrated its ongoing commitment to high quality consumer engagement in its response to the AER's Draft Decision and its engagement program beyond the revenue reset process. We understand that consumer representatives have not sought further 'deep-dive' sessions, which suggests that these have achieved their objectives in the original revenue proposal. However, CCP9 does consider that there will be issues arising out of the NEG and the AEMO industry wide processes

[5] See Essential Services Commission, *2018 Water price review guidance paper*, November 2016, Attachment 5. The water business and the Commission establish a new incentive, the PREMO score rating, for a price submission. The PREMO score influences the allowed return on equity. https://www.esc.vic.gov.au/document/water/36646-2018-water-price-review-guidance-paper-november-2016/

[6] See for example, ElectraNet, *Revised Revenue Proposal*, December 2017, p 29.

and that this mechanism may be extremely useful in ElectraNet developing its responses to issues as they emerge over the next year.

Clearly, other major challenges remain and such as maintaining the momentum of engagement once the AER publishes its final decision and establishing a framework for engagement during the tariff setting process and during the various RIT-T projects. Each of these will require complex trade offs and decisions about allocation of costs between different consumers. Moreover, the contingent projects in particular, have the potential to have a very significant impact on the RAB and reverse all the pricing savings that are included in the revised revenue proposal. It is therefore, fortunate that ElectraNet has established such a positive base with its customers to work from.

For example, CCP9 is aware that in the past a number of larger regional consumers have had concerns about the transmission tariff structures. CCP9 is also aware that ElectraNet published its latest proposed pricing methodology for the regulatory period 2018-23 in March 2017 as part of its initial Revenue Proposal,[7] and that the AER approved the pricing methodology as part of its Draft Decision.[8] ElectraNet advises CCP9 that transmission network tariffs were discussed with consumers during the early stages of its regulatory process leading to the following "insights": [9]

- Most customers are unaware of, or confused by, transmission pricing structures;
- Direct customers are generally against ElectraNet using peak demand as a base for determining charges
- The key finding with respect t pricing structures was that consumers are seeking stability in their arrangements.

ElectraNet's 2016 Network Vision report included transmission pricing arrangements as one of its priorities: "Explore more efficient and transparent pricing arrangements to promote clarity and stability".[10]

While ElectraNet has advised CCP9 that it is not planning any specific engagement on transmission pricing in the context of the current process, it maintains its commitment to achieve the priority outcome.[11] CCP9 welcomes this commitment to pursue pricing structure issues in the future. While we recognise that some tariff negotiations with large customers will be confidential and transmission tariffs are notoriously complex and arcane, CCP9 believes there is value in greater transparency and consultation particularly given around the allocation of costs for contingent projects. Importantly, since the initial studies with customers, there has been a growing stress on more implementing cost reflective tariffs at the network level to encourage efficient use of and investment in the networks. Achieving economic efficiency, in the face of consumer resistance to demand style tariffs will be a challenge for ElectraNet and one that its experienced CAP members may assist in, in the future.

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[7] ElectraNet, *Proposed Pricing Methodology*, March 2017. This document was included as an attachment in ElectraNet's initial Revenue Proposal but was not on the list of attachments to the Revised Revenue Proposal.
[8] AER, *Draft Decision*, Attachment 12, p 12-6.
[9] ElectraNet, *Customer Insights Report*, September 2016, p. 17
[10] ElectraNet, *Network Vision*, September 2016, p 14.
[11] Email from Simon Appleby, Senior Manager Regulation and Land Management, ElectraNet, dated 1 February 2018. Note, transmission pricing requirements under the NER differ from distribution pricing requirements, e.g the transmission companies are not required to publish a Tariff Structure Statement or obtain AER approval of the specific tariffs. Transmission networks do, however require approval of their pricing methodology by the AER as part of the regulatory determination.

CCP9 is also aware and appreciates that ElectraNet has held several community meetings in regional areas in the development of its preliminary revenue proposal and more recently, in relation to contingent project options. in addition to one-on-one meetings with relevant existing or potential businesses. CCP9 would welcome ElectraNet providing additional information to the CAP on how it plans to engage with all affected stakeholders in the various RIT-T projects (and noting the engagement may well differ from one project to another). As we noted in the pricing discussion above, the CAP has valuable experience that contribute to this process.

CCP9 have a number of additional concerns beyond the questions of sustaining momentum, and the tariffs and RIT-T consultation processes. In particular, we have carefully considered the response from SACOSS. While SACOSS commented reasonably favourably on most aspects of the customer engagement process, SACOSS has raised important issues around access to information and responsiveness to some critiques of ElectraNet's strategy around the Eyre Peninsula and the AER's Draft Decision on the same issue.[12]

CCP9 understands that SACOSS has sought additional information that would assist them to assess this project as it has significant implications for consumers in South Australia. We further understand that this information has not been provided in time for their response to the Revised Revenue Proposal. CCP9 is not party to the data requests and therefore cannot comment on the nature of these requests. However, it would appear that SACOSS has a legitimate inquiry about a significant expenditure proposal (Eyre Peninsula) and complaint that neither the AER nor ElectraNet has responded to these requests. This situation raises the question in our mind about whether effective consumer engagement should extend to providing this type of additional detailed data over and above what is available on the AER's web-site or on the ElectraNet web-site. CCP9 is interested in hearing views on this issue but in the meantime consider some response to SACOSS is warranted as part of the move to more responsive and open discussions with consumers.

CCP9's concluding comments reflect the sentiments expressed by the ECA in selecting ElectraNet as the winner of the inaugural Consumer Engagement Award in November 2017. The Award recognises consumer engagement is more than a process, it is about an outlook across the business that real engagement is critical for the successful transformation of a business to adapt to change and to align its strategy with the interests, preferences and needs of its customers. As Rosemary Sinclair, CEO of the ECA, said at the Award night: [13]

> *Our view is that engagement, real engagement is critical for the successfully transformation of the grid and the energy sector*
>
> *…*
>
> *It is about making the transition from old infrastructure and assets mindset to a platform and services mindset.*

As noted above, ElectraNet has faced unprecedented changes in its operating and policy environment over the last two years. Throughout this period ElectraNet has retained its commitment

[12] SACOSS, Submission on ElectraNet's revised proposal, January 2018.
[13] Rosemary Sinclair, remarks at the ENA Awards Dinner, 29 November 2017. http://energyconsumersaustralia.com.au/news/ena-awards-dinner-rosemary-sinclair-remarks/

to quality consumer engagement processes. To quote again from the ECA Awards presentation to ElectraNet: "the dialogue and good will generated through the process allowed the network and its customers and its stakeholders to deal with the unexpected".[14] CCP9 agrees.

Finally, in making the recommendations below, CCP9 is aware that ElectraNet has already commenced discussing the next steps with its CAP and these areas might be matters already in progress.

Recommendations

a) The AER take account of the extensive customer engagement program that has been undertaken by ElectraNet over the last two years.
b) ElectraNet establish a formal, principle based, process for consumer engagement during RIT-T reviews, consistent with but going well beyond the current regulatory requirements for consultation and noting that this engagement must be tailored to some extent for individual projects.
c) ElectraNet clarify its customer engagement processes around the development of its transmission tariffs.
d) ElectraNet review the appropriate response consistent with its values for openness and transparency in response to the issues raised about data sharing by SACOSS.
e) ElectraNet work with its colleagues and the CAP to consider ways in which the industry can assist in addressing the issue of resourcing for consumer representatives to ensure their capacity to provide an ongoing commitment to the engagement process.

4. Revenues and Tariffs

4.1 Summary of total revenue

ElectraNet has accepted all the components of the AER's Draft Decision subject to applying updated values for relevant components of the Draft Decision.

ElectraNet's revised revenue is lower than its original revenue proposal largely reflecting ElectraNet's acceptance of the AER's Draft Decision update of the weighted average cost of capital (WACC) including inflation estimates and the AER's decision on the value of imputation credits (gamma). ElectraNet has set out a summary of its response to each of the elements in the AER's Draft Decision in detail in Table 1 of its revised revenue proposal (pp 9-10). CCP9 remains concerned, however, about the potential impact of the contingent projects (totalling some $640m) will have on the revenue forecasts over the longer term as the RAB expands. Modelling of these long-term revenue (and price) impacts across several regulatory periods would be a useful addition to the AER's Final Decision.

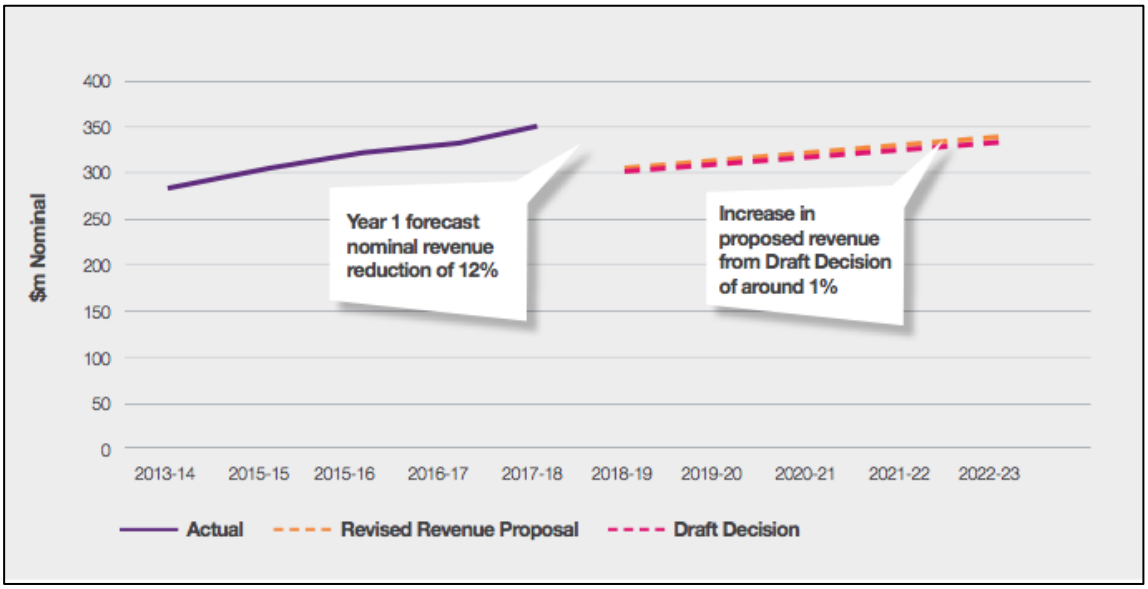
Explanation and Assessment

Overall, the revenue in Year 1 ($2018-19) is 12% lower in nominal terms than the final year of the current regulatory period. ElectraNet states that for a residential customer, the impact of this revenue reduction on their annual electricity bill in 2018-19 is a saving of around $20 ($nominal), all other things being equal.[15]

[14] Ibid.
[15] ElectraNet, *Revised revenue proposal*, December 2017, p 19.

Figure 4.1 illustrates the forecast revenue path for the regulatory period in nominal terms. In real dollar terms this represents a stable revenue outlook with revenues forecast to increase at the inflation rate.[16]

Figure 4.1: Revised revenue path – smoothed ($nominal)



Source: ElectraNet, Revised revenue proposal, December 2017, Figure 3, p 20.

As indicated in the following sections, the reduction in the first year of the regulatory period reflects a reduction in operating expenditure and the WACC. An additional and more indirect driver of this lower opening revenue forecast arises from the significant reduction in ElectraNet's actual capital expenditure in 2013-18 compared to the AER's allowance for 2013-18 (estimated by ElectraNet to be around 39%[17]). The reduction in capital expenditure in 2013-18 will reduce the opening RAB for the 2019-23 regulatory period, and thereby contributes to the overall reduction in revenue.

[16] Ibid, p 20.
[17] Ibid, p 6.

While a revenue price path based on CPI increases is modest, CCP9 highlights that the actual outcome for revenue and prices will depend to some extent on the direction of the cost of debt which is updated each year, and on the extent to which the nominated contingent projects proceed in the 2018-23 regulatory period. As discussed in section 4.2, ElectraNet included an estimate of the impacts on revenues of the two most prospective projects, namely Eyre Peninsula and the Main Grid System Strength (MGSS) project. However, the contingent projects proposal highlights that even for these projects there is a possibility of much greater expenditures during the 2018-23 period.

The section below on capital expenditure highlights the risks for the revenue forecast arising from the contingent projects that have been submitted by ElectraNet. While the AER has accepted the proposal on the contingent projects (subject to revision of trigger events fro one proposal), the importance of careful assessment of the prudency and efficiency of these expenditures is essential to protecting the long-term interests of consumers. As discussed below, CCP9 is of the mind that the AER should consider, at least for the projects that are now more probable and required in the near future, as becoming part of the ex-ante forecast of capex rather than remain as contingent projects. In turn this will provide greater transparency and a more realistic assessment of the overall revenue and risks to this revenue from these projects

Recommendation

f) The AER accept ElectraNet's revised total revenue proposal subject to updates for interest rates and other relevant variables

4.2 Capital Expenditure and RAB

4.2.1 Summary

In its Draft Decision, the AER approved ElectraNet's capex proposal. In its revised proposal, ElectraNet has made few changes to the total proposed capex. Based on this total capex proposal, the regulatory asset base (RAB) grows at a slower rate than in the past and even declines in the final year. While this outcome is welcome, CCP9 has a number of concerns. In the first instance, assessment of the overall prudency and efficiency of the total capex is difficult because of the multiple interactions between projects and we expect the AER to 'unpick' these effects in the Final Decision.

Secondly, there are significant risks to the revenue and RAB growth forecasts arising from a number of large contingent projects amounting to an additional cape of $ 650m (around a quarter of the existing RAB value) over the regulatory period (if all projects proceeded). AEMO's inaugural Integrated System Plan (published December 2017) suggests that there is a stronger likelihood that the triggers for the additional Eyre Peninsula contingent project and the SA Electricity Transformation contingent project will be called.

ElectraNet has also proposed a modification to the trigger for the Main Grid System Strength (MGSS) contingent project to remove the RIT-T requirement. This is based on AEMO's assessment of a Network Support and Control Ancillary Services (NSCAS) gap in the SA region from March 2018. CCP9 does not support a change in the trigger for the MGSS project, but in the circumstances would prefer that the AER include the full MGSS costs in the ex-ante forecast. In principle, CCP9 places high value on the RIT-T process as it ensures high levels of transparency, appropriate consultation, and consideration of other options including non-network supply. Any alternative process would need to ensure the same requirements continue in some form.

4.2.2 AER's Draft Decision

(Attachment 6 – Capital Expenditure, October 2016)

The AER was satisfied that ElectraNet's investment risk tool analysis used to inform the economic assessment of asset replacement and refurbishment decisions is consistent with good industry practice and generally reflects reasonable inputs and assumptions (page 6-3).

Table 6.1 Draft decision on ElectraNet's forecast capex ($2017–18, millions)

	2018–19	2019–20	2020–21	2021–22	2022–23	Total
ElectraNet's proposal	96.6	99.8	108.5	100.2	53.2	458.4
ElectraNet's proposal (CPI adjusted)[a]	96.8	99.9	108.7	100.4	53.3	459.1
AER draft decision	96.8	99.9	108.7	100.4	53.3	459.1

Source: ElectraNet, *Forecast Capital Expenditure Model*, March 2017; AER analysis.

Note: [a] We have used our estimate of forecast inflation of 2.5 per cent, as determined in Attachment 3 of this draft decision, to express ElectraNet's forecast capex in real 2017–18 dollars.

The Draft Decision also set out minor changes to the proposed trigger events for Contingent Projects. This included a requirement for the successful completion of a RIT-T " … which will add to the rigour of the contingent project assessment process" (page 6-70).

4.2.3 ElectraNet's Revised Proposal

ElectraNet has written to the AER and its stakeholders (including to the CAP and the CCP) on 6 October 2017 to provide an update on the impact of various inquiries and reviews on expenditure. In particular, these changes were likely to result in increased Operating Expenditure.

ElectraNet's revised proposal did not include significant changes in relation to the total forecast capex allowance. ElectraNet has proposed further changes to the Contingent Project triggers to include the completion of RIT-T or an "… alternative applicable decision-making framework" (page 28):

> *… in the expectation that an alternative path for the approval of transmission investments in the NEM may be developed in the near future, we therefore propose that the relevant triggers for this contingent project be amended as follows to provide for this possibility, while preserving the role of the AER in determining that such a process has been successfully completed.*

The revised proposal included indicative impacts on revenues of the two "… most prospective contingent projects", namely Eyre Peninsula and the Main Grid System Strength (MGSS) project (page 29). ElectraNet put this additional expenditure in context by reminding readers of the expected initial reduction in 2018-19 of $20 in the transmission component of the average residential electricity bill for a typical consumer of 5,000 kWh per annum:

> *A full rebuild of the Eyre Peninsula line … would represent an additional capital cost of $220 million in the coming period and be partly offset by operational expenditure savings through avoided generation support payments. In net terms, this project would be expected to add less than $3 per annum to the transmission component of the average residential bill.*

[for MGSS] an indicative cost of $80 million … would be expected to add approximately $3 per annum to the transmission component of the average residential bill.

In relation to the MGSS, ElectraNet has stated that as a result of new rules,[18] and that AEMO formally declared a Network Support and Control Ancillary Services (NSCAS) gap in the SA region on 13 October 2017, they are required to use reasonable endeavours to address the shortfall by 30 March 2018. Consequently, ElectraNet proposed that this relatively rapid timeframe and requirement under the rules meant that a RIT-T was not appropriate and propose an amended trigger for the contingent project to be (page 27):

3. *Determination by the AER that the proposed investment satisfies the RIT-T (or equivalent economic evaluation).*

4.2.4 CCP9's Assessment

CCP9 notes that the AER did not agree with our view that the Eyre Peninsula Repex program (approx. $80m) should be incorporated in the Eyre Peninsula RIT-T process. Further, we note that SACOSS has expressed strong views on the justification of this expenditure in the original and revised proposals from ElectraNet. CCP9 is concerned that SACOSS's requests for further information have not been met and that the overall investment program for Eyre Peninsula's Transmission Network will be split between the ex-ante revenue and a contingent project being advanced under a RIT-T.

There are multiple interactions with other aspects of the SA network such as interactions with the network support payments to the Pt Lincoln generators under the ex-ante opex allowance and the interactions with the SA Electricity Transformation RIT-T and AEMO's Integrated System Plan. In addition, there is the potential for distribution investment by SA Power Networks (SAPN) following the findings of ESCOSA's review into reliability in the region. As a result, it has become a very difficult context for consumers to assess the efficacy and efficiency of transmission investment in its entirety. CCP9 expects this to be addressed in the AER's Final Determination.

In relation to contingent projects, CCP9 recommended in its submission to the original revenue proposal that the AER should include the probable impact of contingent projects on revenues and prices in the draft decision (noting that ElectraNet had provided residential customer $ per annum estimates for two projects in the proposal: Eyre Peninsula and SA Electricity Transformation of $4 and $8 respectively). The AER responded that "There is significant uncertainty surrounding the scope, timing and cost of ElectraNet's contingent projects, such that providing a reasonable estimate of possible revenue and price impacts is difficult" (page 6-28) and, with reference to ElectraNet's residential $pa estimates: "In our view, it is not possible for us to provide a more meaningful assessment of the probable impact of contingent projects on revenues and prices …" (page 6-74).

As mentioned above, ElectraNet's revised proposal included residential customer $ per annum estimates for Eyre Peninsula and MGSS of approximately $3 pa each.

CCP9 understands that there is difficulty in estimating the magnitude and timing of expenditure and hence the impact on prices and revenues during the regulatory period. However, the intent of our

[18] AEMC, Rule Determination: National Electricity Amendment (Managing power system fault levels) Rule 2017, 19 September 2017, available at: http://aemc.gov.au/Rule-Changes/Managing-power-system-fault-levels#

original comments was not to provide a precise forecast but to allow consumers to understand the magnitude of the potential expenditures above what the ex-ante forecasts allow for. To this end, the CCP9 presentation at the 6 November pre-determination conference included a series of charts that illustrated the Draft Decision Regulatory Asset Base plus two plausible RAB scenarios. These are reproduced below.

The first chart, Figure 4.2, illustrates the Draft Decision RAB in nominal $ that shows a RAB that falls in the final year of the coming regulatory period:

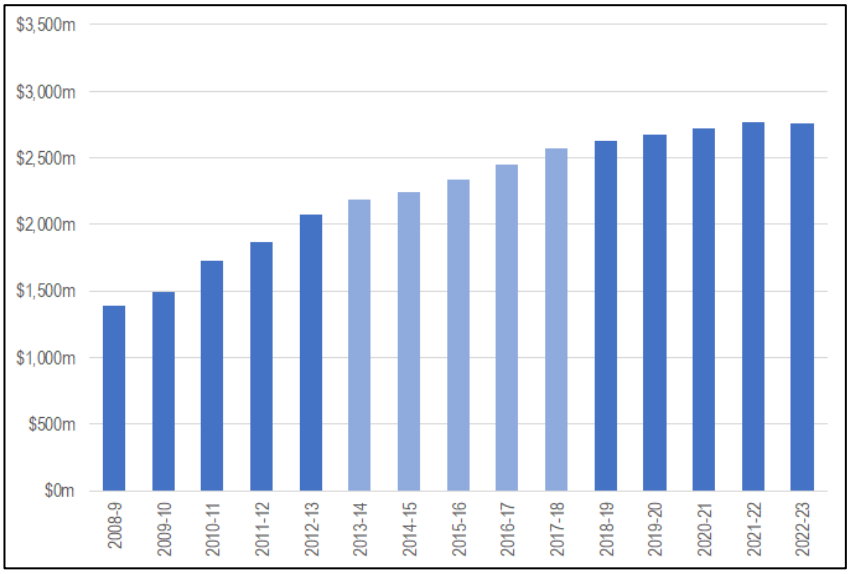


Figure 4.2 ElectraNet historic and forecast RAB (nominal $) Source: AER Draft Decision 2018-23

The second chart, Figure 4.3, illustrates the addition of $250 in new net capital expenditure added in stages over the period (the orange tips). For example, this might include the MGSS and Eyre Peninsula contingent projects and indicates a return to near trend growth of the RAB.

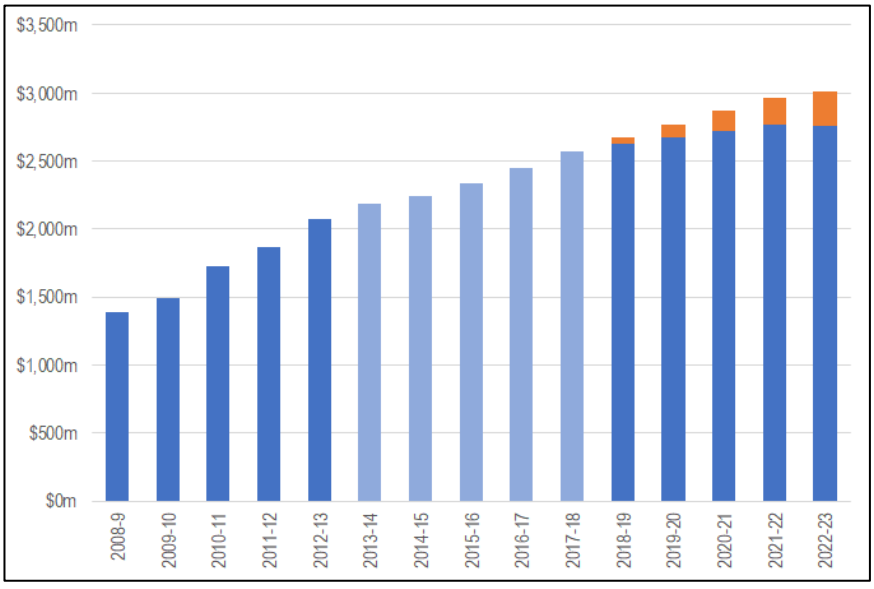


Figure 4.3 ElectraNet historic and forecast RAB (nominal $) with additional $250m in net capex added in stages Source: AER Draft Decision 2018-23, CCP9 analysis

The third chart, Figure 4.4, illustrates the addition of $400 million in new net capital expenditure added in stages over the period (the orange tips). For example, this might include some of the SA Electricity Transformation as well as the MGSS and Eyre Peninsula contingent projects. This indicates a clear growth in RAB at or above trend. The full list of contingent projects would add $650million, an unprecedented (albeit unlikely) outcome that would increase the RAB by around a quarter.

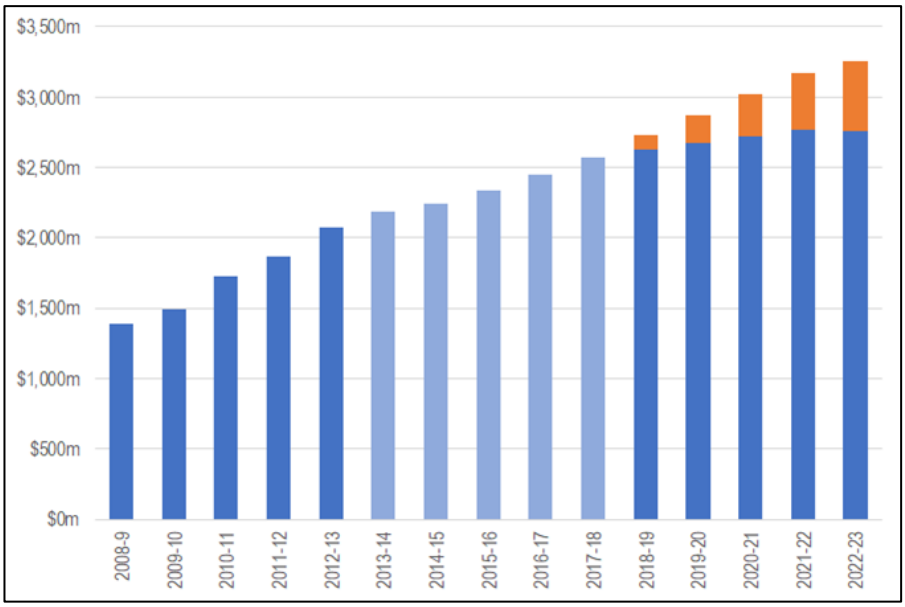
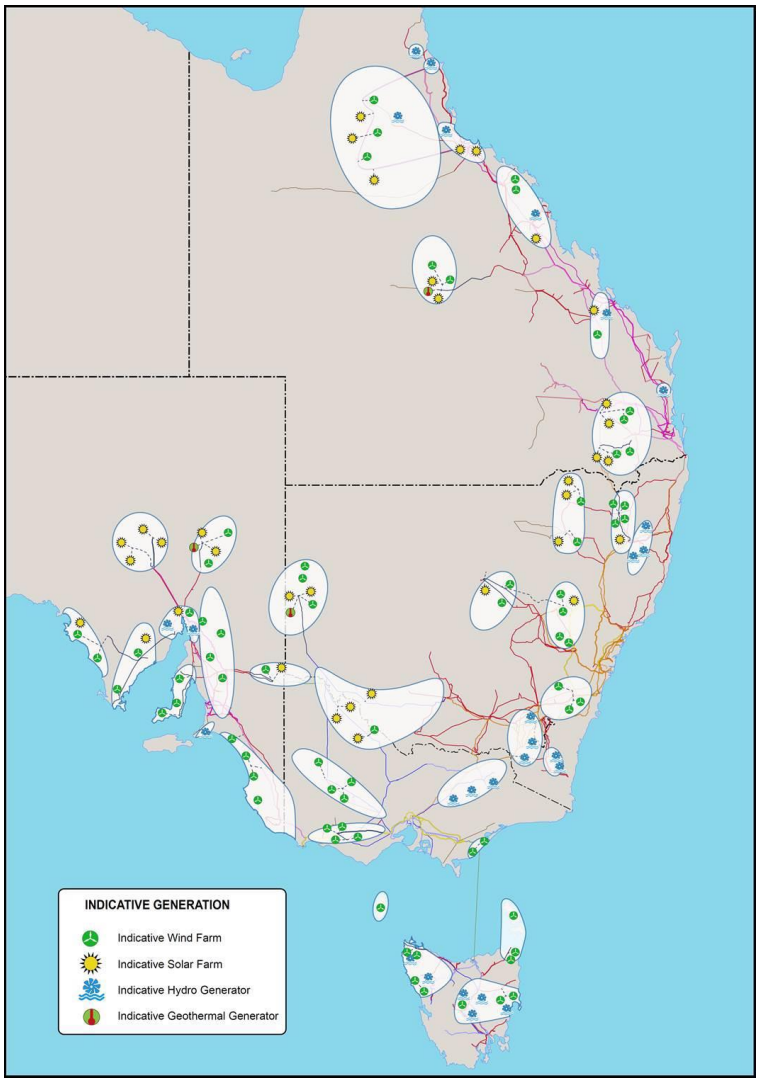


Figure 4.4. ElectraNet historic and forecast RAB (nominal $) with additional $400m in net capex added in stages Source: AER Draft Decision 2018-23, CCP9 analysis

Further in relation to contingent projects, we also note that AEMO released a consultation paper on an inaugural Integrated System Plan (ISP) on 18 December 2017[19]. AEMO's preliminary analysis of renewable resources has identified potential locations for **Renewable Energy Zones (**REZs) including several in South Australia. However, AEMO also stated that that further analysis is required (page 5,6):

- Eyre Peninsula in South Australia, where ElectraNet is undertaking a RIT-T.
- The intersection of South Australia, Victoria and New South Wales state boundaries, currently being assessed in ElectraNet's South Australia Energy Transformation RIT-T.
- Northern South Australia is said to also appear to be a prospective REZ but does not currently have related transmission development projects underway.

[19] Available from www.aemo.com.au/Media-Centre/Preparation-of-Inagural-Integrated-System-Plan



AEMO Figure 1 Range of Potential REZs

As can be seen from AEMO's Figure 1, there is very little of South Australia adjacent to the transmission network that is not a 'potential REZ'. AEMO also states that (page 7):

> *After consultation, the ISP will provide a staged transmission investment development plan for the power system, starting with least-regret upgrades, while considering the need to manage potential risks of unexpected, low probability situations which might create an urgent need for additional capacity (such as unexpected withdrawal of capacity from the NEM).*

We therefore expect that Eyre Peninsula and SA Electricity Transformation RIT-T projects will trigger significant capital investment and, noting that some investment under the MGSS is virtually certain, that significant growth in ElectraNet's RAB will occur as a result. This not necessarily bad news for consumers as long as the resultant generation and system security investments put downward pressure on wholesale prices. However, the risk profile of these two stakeholders (owners vs consumers) is very different. Once in the RAB, a return on investment is all but guaranteed for the owners. For consumers, the 'return on investment' remains contingent on a range of factors including effective competition in the wholesale and retail markets and effective implementation of the National Energy Guarantee (NEG).

In our view, it is important that consumers are informed of, and understand, this is likely growth in the RAB and allocation of risk.

In conclusion, the MGSS contingent project appears to be likely to reach some conclusion by March 2018 and therefore, to the maximum extent possible, we recommend that the AER reflect this in the Final Determination in April 2018.

Further, ElectraNet's proposal to include an 'alternative applicable decision-making framework' in the trigger for contingent projects appears reasonable in the context of AEMO's ISP. However, CCP9 is of the view that the RIT-T is the current evaluation process and that any alternate framework to replace this would need to be codified in the Rules. This appears to be consistent with the related recommendations of the Finkel Review[20]:

Recommendation 5.2

By mid-2019, the Australian Energy Market Operator, in consultation with transmission network service providers and consistent with the integrated grid plan, should develop a list of potential priority projects in each region that governments could support if the market is unable to deliver the investment required to enable the development of renewable energy zones.

The Australian Energy Market Commission should develop a rigorous framework to evaluate the priority projects, including guidance for governments on the combination of circumstances that would warrant a government intervention to facilitate specific transmission investments.

Recommendation 5.5

By mid-2020, the COAG Energy Council should commission a further review of the Regulatory Investment Test for Transmission to ensure the suite of reforms implemented following the 2017 COAG Energy Council review have been effective in addressing stakeholder concerns.

A review of the Regulatory Investment Test for Distribution should be conducted at the same time.

If an alternate investment test appears and a rule change occurs then this would be the time to accommodate the changes, not pre-emptively as proposed by ElectraNet. The RIT-T process is not perfect but a review of application guidelines has been announced by the AER to be completed by September 2018 and we see no reason to undermine the process[21].

In the event of a rule change, it would be important that some of the key elements of the RIT-T are retained (or enhanced) including consultation requirements and mandated investigation of non-network alternatives. The same would apply if the AER were to alter the trigger event specifically for the MGSS project (although CCP9 does not recommend this option as stated above).

We consider that the AER should continue to include the successful completion of a RIT-T as a mandatory contingent project trigger (as per the Draft Decision) and not accept ElectraNet's proposed changes.

[20] Independent Review into the Future Security of the National Electricity Market – Blueprint for the Future – June 2017

[21] Further information on the review is available at www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-the-application-guidelines-for-the-regulatory-investment-tests-for-transmission-and-distribution

Recommendations:

g) The AER reconsider the inclusion of $80m in the ex-ante allowance for the Eyre Peninsula line replacement project and include this expenditure in the scope of the Eyre Peninsula Contingent Project.
h) The AER consider if and to what extent the costs of the MGSS contingent project should be included in the Final Decision given the timetable for the MGSS.
i) The AER continue to include the successful completion of a RIT-T as a mandatory contingent project trigger (as per the Draft Decision) and not accept ElectraNet's proposed changes.

4.3 Operating Expenditure

4.3.1 Summary

ElectraNet's revised operating expenditure (opex) proposal is some $21m below the AER's Draft Decision. This revised operating expenditure is also below the opex in the final year of the current 2013-18 regulatory period, although it is noted that the 2013-18 period saw significant growth in opex. CCP9 notes that ElectraNet has consulted extensively on its proposal and revised proposal and we recommend that the AER accept ElectraNet's revised opex forecast, including the step change proposed for new regulatory obligations. CCP9 has also requested that, for the sake of consistency, the AER calculate the new operating allowance using the revised rate of change measures that are set out in the 2017 benchmarking report by Economic Insights (EI). While this will result in a small increase in the opex proposed by ElectraNet, the outcome will still be below the AER's assessment of efficient operating costs.

CCP9 also highlights the 'productivity paradox'. That is, the observed measures of productivity by EI, across the transmission industry and for ElectraNet still show a decline in total, opex and capex productivity measures, as do the AER's partial productivity measures. Major factors in this decline continue to be the cost pressures of historical capex spend and RAB growth while there is declining or stagnant output and reliability outcomes. Many excuses have been made for declining productivity but 10 years on, can consumers still tolerate this outcome while being asked to fund further investment. This is not an issue the AER can resolve other than focus on prudency and efficiency of expenditure in what is otherwise a mature market. However, CCP9 recommends that the AER's final decision(s) should provide, ex-ante, an estimate of productivity outcomes of its decisions on capex and opex in addition to revenue and pricing outcomes.

4.3.2 Approach to assessing efficient operating expenditure (opex)

The AER applies a 'base – trend– step' change approach to determining with the network's proposed operating expenditure (opex) satisfies the opex objectives set out in the NER or NER and if not, what alternative estimate should replace the network's proposal. In undertaking this review, the AER's focus is on the overall proposal rather than individual projects although it may consider these individual projects in coming to its decision.

The key elements of the AER's review of the network's opex proposal have been set out in the AER's 2013 Forecast Expenditure Guideline[22] (Expenditure Guideline) and include the following assessment stages:

- Assessment of the revealed opex in the base year (the last year in which there is audited data) to test whether it is 'materially inefficient'.
- Trend the base opex forward to provide an estimate of the final year(s) opex in the current regulatory period and then forecast trend opex for each year of the new regulatory period. The trend opex estimates include assessment of:
    - Input price growth: labour and non-labour price growth
    - Output growth: energy delivered, ratcheted maximum demand, weighted entry and exit connections and circuit line length[23]
    - Productivity growth
- Step changes, which are the components of the opex estimate that are not adequately compensated for in the base year opex or in the rate of change.
- Category specific costs, which are costs that are forecast independently from base opex and are not subject to an EBSS. The AER has typically included forecasts for debt raising costs, demand management incentive allowance (DMIA) and guaranteed service level (GSL) payments.

The AER has applied the approach set out in its 2013 Forecast Expenditure Guideline to the overall assessment of ElectraNet's initial opex proposal. In its revised proposal, ElectraNet has adopted the same approach to forecasting its expected opex.

4.3.3 AER's Draft Decision

The AER has accepted ElectraNet's total opex forecast of $440.1m ($2017-18) over the regulatory control period. The AER states that it is satisfied this forecast reasonably reflects the opex criteria. In real dollar terms, ElectraNet's proposed opex is slightly below the estimated total opex for the 2013-18 regulatory period. The AER's decision to accept the ElectraNet's initial proposal was consistent with CCP9's recommendations.[24]

However, while the AER has accepted the total opex in ElectraNet's proposal, there are a number of relatively minor differences in the components of this total opex. In the first instance, the AER's alternative estimate of efficient opex, based on the AER's standard 'base-step-trend' approach, totals $474.4m ($2017-18) which is some 7% ($34m) **above** Electranet's proposed opex. The AER's forecast of efficient opex differs from ElectraNet's forecast for the following reasons:

- Base year estimate ($2015-16): the AER did not remove $18.5m associated with 'non-recurrent expenditure' that was removed by ElectraNet.
- Change in opex between the base year and 2017-18: the AER estimated an increase of $26.9m compared to $3.5m increase proposed by ElectraNet.
- An estimate of output growth and productivity growth that was not included by ElectraNet.

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[22] AER, *Expenditure forecast assessment guideline for electricity transmission*, November 2013.

[23] These output specifications are specific to the transmission businesses. They have been modified after the Draft Determination in November 2017 following detailed assessment by the AER's advisors, Economic Insights.

[24] See, Consumer Challenge Panel Sub-Panel 9, *Response to proposals from ElectraNet for a revenue reset for the 2018-23 regulatory period*, 12 June 2017, p iv.

- Included network support costs as a category specific forecast rather than a base year cost
- The forecast of debt raising costs was higher than ElectraNet's forecast.

Base Year:

The AER has assessed the base year (excluding movements in provisions and network support costs) as efficient having had regard to the results of its benchmarking studies and the fact that ElectraNet was subject to an efficiency benefit sharing scheme (EBSS) in the 2013-19 period.

Rate of change:

The AER forecasts an average annual rate of change of 0.66%/pa, slightly higher than ElectraNet's 0.61%/pa. This is because the AER includes forecast growth in price, output and productivity. ElectraNet's forecast only includes forecast price growth.

Growth in price: In the draft determination, the AER has estimated growth in price using a weighting of labour and non-labour costs (62:38) from earlier studies of the relativity of these costs. ElectraNet's estimate is slightly different (67:33) because it has used its own costs. The AER prefers to apply a benchmark cost allocation as it considers using a benchmark will provide a better incentive for the businesses to reveal its efficient costs. However, CCP9 notes that following the most recent benchmarking study by its consultants, Economic Insights,[25] it is likely that the AER will amend the benchmark in its final decision to a ratio for labour and non-labour of 70.4:29.6,[26] a figure that is closer to ElectraNet's own cost breakdown as set out in their initial proposal.

Forecast output growth: The AER has applied a forecast output growth of 0.23%/pa while ElectraNet has forecast 0% change, assuming that none of the contingent projects were triggered over the course of the regulatory period.

Forecast productivity growth: ElectraNet proposed a productivity growth of 0%. The AER's Draft Decision includes a productivity growth factor of 0.2%/pa based on observed trends in transmission businesses productivity over 2006 to 2015. However, CCP9 notes that the 2017 benchmarking study using revised output specifications shows a decline in the transmission industry productivity over the 2006 – 2016 period. It is likely that the AER will amend the productivity factor in its final decision to 0%/pa on the basis of this updated study.

Step changes:

Electranet did not propose any step changes and the AER accepted proposal in its draft determination.

Category specific forecasts:

Debt raising costs: The AER has accepted ElectraNet's proposed debt raising costs of $0.8m ($2017-18) although the AER also notes that its own estimated was for a debt raising costs of $6.3m ($2017-18).

Network support costs: The AER is required to pass through a network's actual network support costs, but ex-ante, the AER can only estimate these costs. The AER's forecast of the network support

[25] See Economic Insights, *Economic Benchmarking Results for the AER's 2017 TNSP Benchmarking Report*, 6 November 2017.
[26] Ibid, p 6.

costs is made on the basis of the costs for this service in the base year. The total estimated cost was $41.9m ($2017-18).

Revenue reset costs: The AER did not accept ElectraNet's proposed revenue reset costs ($1.0m). The AER's argument is that the base opex, escalated by the rate of change is sufficient for these costs.

New regulatory obligations: Both the AER and ElectraNet agreed that if new regulatory obligations regarding network security were imposed on the network (as expected), then the overall opex would need to be adjusted accordingly.

4.3.4 ElectraNet's revised proposal

ElectaNet has revised its initial proposal to align with the AER's draft decision. In particular, ElectraNet's revised revenue proposal includes the following adjustments:[27]

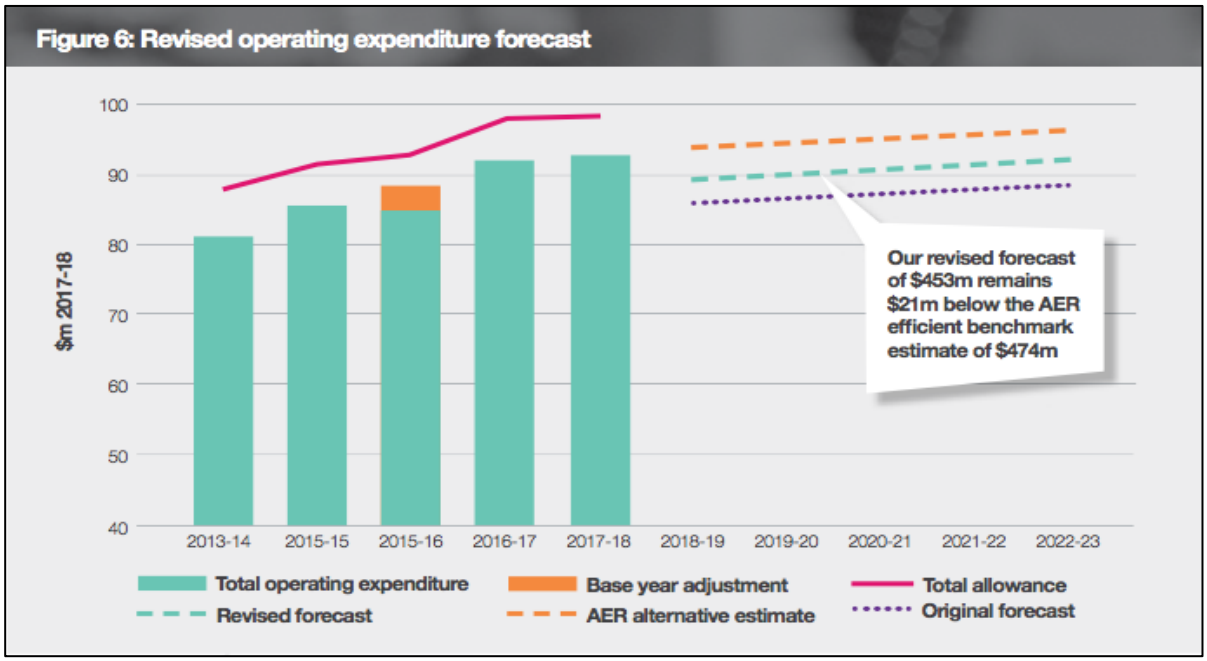
- Included an allowance for new requirements as agreed with the AER. Notably around half the estimated costs have been absorbed up-front by the business. The remaining costs amount to a step change of some $2.5m/pa ($2017-18).[28]
- Updated the labour cost escalation using more recent data but maintaining the same methodology.[29]
- Updated the estimate of network support costs estimate to reflect the AER's draft decision.
- Updated the debt raising costs to reflect the AER's benchmark allowance of $6.3m.

The revisions to the initial proposal add some $13m ($2017-18) to ElectraNet's original forecast of total opex over five years. However, as ElectraNet states, the revised proposal is still below the AER's efficient benchmark estimate (that did not include the step change for new regulations). It is also significantly lower, in real dollar terms, than the AER's opex allowance for the current regulatory period.

ElectraNet indicates that the revised opex forecast "delivers ongoing savings for customers of 9% compared to our trend allowance".[30] Figure 4.5 below from ElectraNet's revised revenue proposal illustrates these outcomes. ElectraNet also states that the revised operating costs are still consistent with an overall reduction in the transmission component of the average residential electricity bill of some $20 in the first year of the forecast.[31]

[27] ElectraNet, Revised revenue proposal, December 2017, p 33.
[28] Ibid, Table 7, p 35.
[29] Ibid, Table 8, p 36.
[30] Ibid.
[31] Ibid, p 38. In practice, transmission costs to a residential customers are 'bundled' into the distribution network charge and there may not be a 1 to 1 relationship between the average price impact and actual impact on residential prices.

Figure 4.5: ElectraNet's revised opex forecast for 2018-23 ($2017-18).



Source: ElectraNet, *Revised revenue proposal*, December 2017, Figure 6, p 37.

4.3.5 CCP9's Assessment

CCP9 recommends that the AER accept ElectraNet's revised opex proposal subject to the AER updating the price growth and productivity growth factors in the base-step-trend analysis.

As the AER highlighted in the draft determination, ElectraNet's base year and forecast operating costs are reasonable and meet the opex criteria in the NER. CCP9 would also highlight the following matters to the AER:

- In October 2017, ElectraNet advised both the AER and their stakeholders of the nature of these new obligations that have been imposed on ElectraNet as part of the system security reforms. This is consistent with ElectraNet's "no surprises" approach in the development of its regulatory revenue proposal and revised proposal.
- ElectraNet has ensured transparency as it has clearly itemised these seven new obligations (Tables 6 & 7, pp 34 & 35) and set out the details of the obligations, the benefits to customers, resource requirements and costs.
- In addition, ElectraNet has indicated what component of these costs it is absorbing in the business and the costs it is including in the step change forecast, thus providing greater transparency on the costs associated with the step change.

CCP9 considers the outcomes reflect a continuation of the effective "no surprises" approach to engagement with stakeholders and the regulator. Moreover, given the many challenges ElectraNet has faced over the last 12 – 18 months, and the swathe of new obligations on the business, it is to ElectraNet's credit that it has submitted a realistic assessment of the 'new' costs and the balance between costs that can be absorbed within the existing business costs and costs that represent a step change.

CCP9 does note the submission from the SA Government, which suggests that ElectraNet should absorb all of these new obligation costs through the rate of change escalation.[32] In most circumstances, CCP9 would agree with this proposal. However, our view is that ElectraNet has adopted a reasonable allocation of these costs in the current circumstances, and given the overall discipline evidenced in the base opex forecast the step change request is not unreasonable (subject to the AER's assessment of the efficiency of the total cost estimate).

CCP9's recommendation to support the revised revenue proposal includes a caveat that the opex should be adjusted by the updated benchmark analysis prepared for the AER by Economic Insights (EI) in November 2017. The updated 2017 benchmarking modelling included a number of changes to the output measures and the weights given to these measures in the productivity modelling. Using the updated measures and additional data, the EI modelling indicated a continued decline in industry productivity over the 2006-2016 period. EI also provide an updated assessment of the average weighting of labour and non-labour costs used in the forecast of rate of price change.

As a result of the EI 2017 analysis, CCP9 recommends that a number of changes should be made to the AER's forecast of efficient opex in its final decision. The recommended changes include:

- Update the weighting for labour and non-labour in the price growth formula to 70.4:29.6
- Update the productivity growth factor to 0% (from the current +0.2%), based on EI's updated assessment of industry productivity trends
- Adopt the revised output variables and output weights from EI's 2017 review.[33]

The effect of these changes will be a small increase in the allowed operating costs for ElectraNet. However, from a broader policy perspective, it is important that the AER adopt the updated analysis by EI. This is because EI's analysis includes an updated and improved data set, revision of the output measures and weightings and a more detailed assessment of the drivers of change in productivity.

The productivity paradox

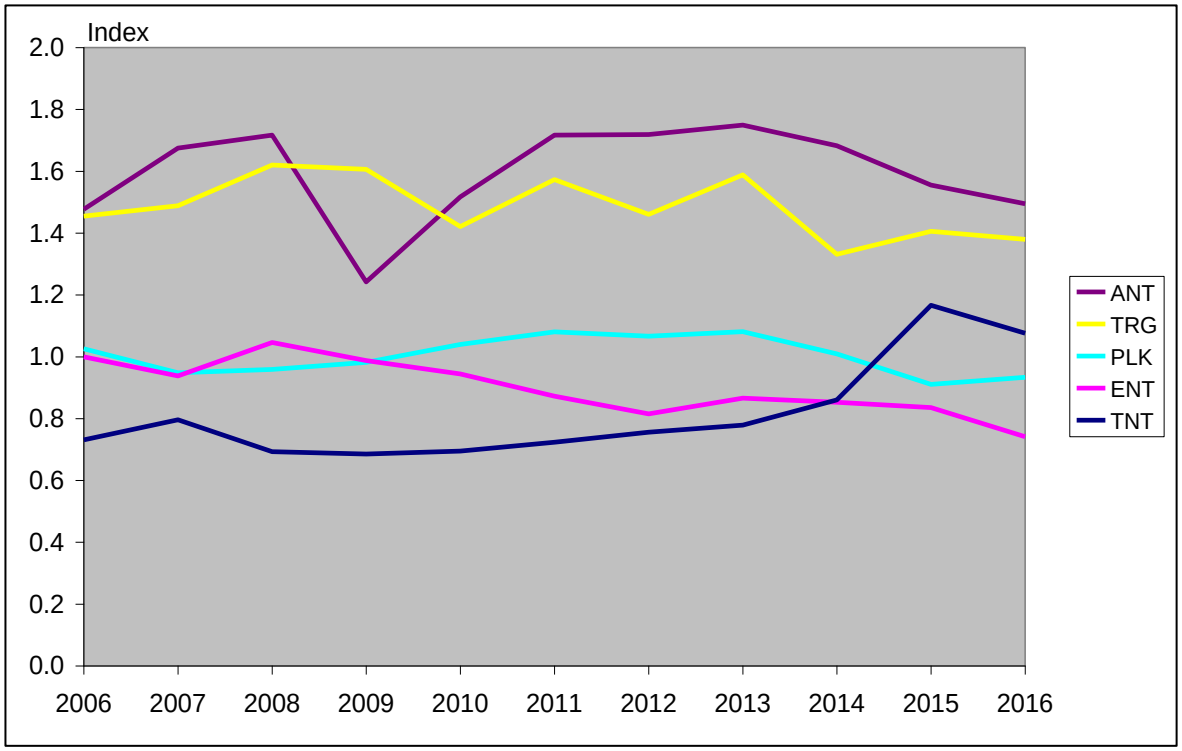
While CCP9 has recommended that the AER approve ElectraNet's revised opex proposal, including accepting that the base year opex is 'efficient' and the productivity growth rate set at 0%, it is of concern that the recent empirical measures of productivity by EI suggest that ElectraNet's productivity and the productivity of the transmission industry as a whole, has continued to decline.

Figure 4.6 illustrates the trends in multilateral opex productivity for each of the transmission companies operating in the NEM where "1" is the midpoint. ElectraNet's index score has declined to 0.742 relative to the 2006 base index of 1.0.[34] This represented an average annual decline in its opex productivity measure of 2.8% per year from 2006 to 2016.[35] EI's analysis does indicate, however, that the rate of opex productivity decline reduced between 2012 and 2015, while the drop in the

[32] Government of South Australia, Submission on ElectraNet's revised proposal, 8 January, 2018, p 2.
[33] Economic Insights, *Economic Benchmarking Results for the AER's 2017 Benchmarking Report*, 6 November 2017, p 6.
[34] Ibid, Table 5.4, p 34.
[35] Ibid.

2016 result was affected by the sizeable reduction in output associated with outages in supply that were not driven directly by ElectraNet's performance.[36]

Figure 4.6: TNSP multilateral opex partial productivity index 2006 – 2016.



Source: *Economic Insights, TNSP economic benchmarking results for the AER,* November 2017, Fig 3.2, p 21. ElectraNet is represented in the pink line (ENT).

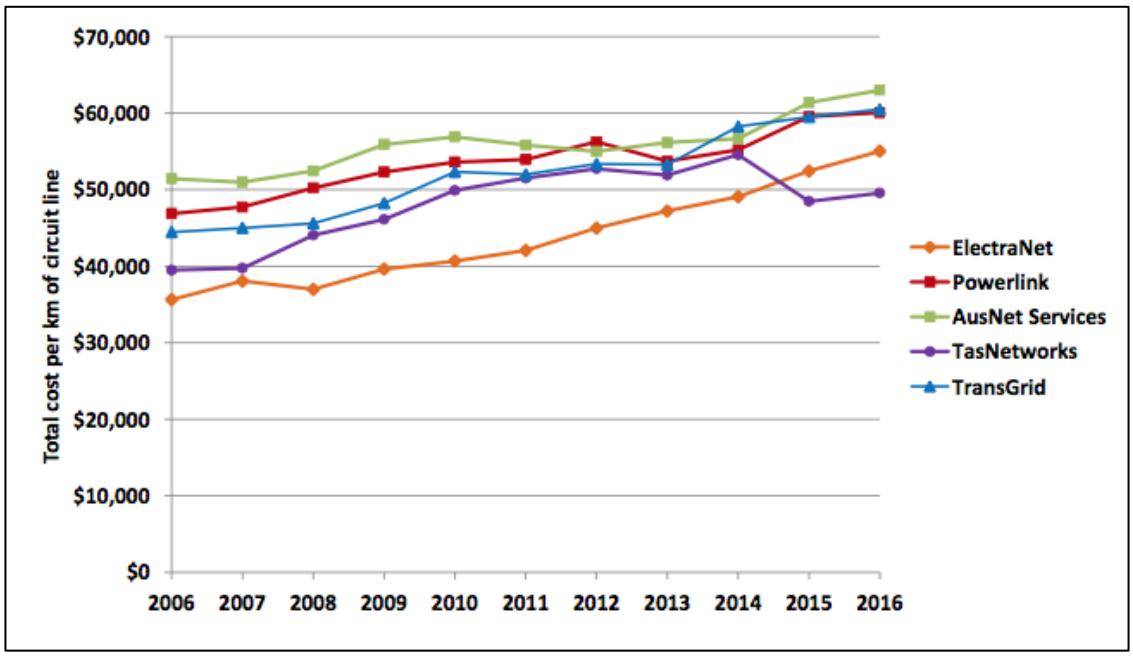
As ElectraNet's multilateral capex productivity also declined by an average of 2.46% per year,[37] the decline in opex productivity cannot readily be explained by a capex/opex substitution. The EI data suggests, perhaps not surprisingly, that the decline in Envestra's multilateral opex productivity is driven by relatively small increases in inputs (over 2006-2016), while outputs such as energy and maximum demand have declined.[38] In simpler terms, ElectraNet is facing the trade-offs between low or negative growth in volumes and demand and an increasingly complex set of new service obligations.

CCP9 is aware of the limitations of EI's transmission benchmarking despite improvements made in 2017. However, the results are consistent with the AER's 2017 assessment of partial performance indicators for ElectraNet. These measures suggest that there has been a decline in productivity. The major drivers of this observed productivity decline in recent years has been the decline in energy volumes and maximum demand, although growth in transmission circuit length was perhaps a factor

[36] See Ibid for details and ibid, Figure 5.8 p 58. The 'total energy not supplied' increased by 8.3% between 2015-16 due to the major supply interruptions. (EI uses total energy not supplied as a measure of transmission reliability. It has a negative impact on productivity, ie as energy not supplied increases, productivity declines, subject to a total cap).
[37] Ibid, Table 5.4, p 34.
[38] See for instance, Ibid, Figure 5.6 and 5.7.

as well.[39] Figure 4.7 from the AER's 2017 benchmarking report, illustrates this point using the partial productivity indicator of 'total cost ($2016) per km of transmission circuit length'. Notably, while all transmission businesses saw increases in costs per km, ElectraNet remains one of the lowest total cost per km of circuit length.

Figure 4.7: Total cost per km of transmission circuit length ($2016) 2006 to 2016

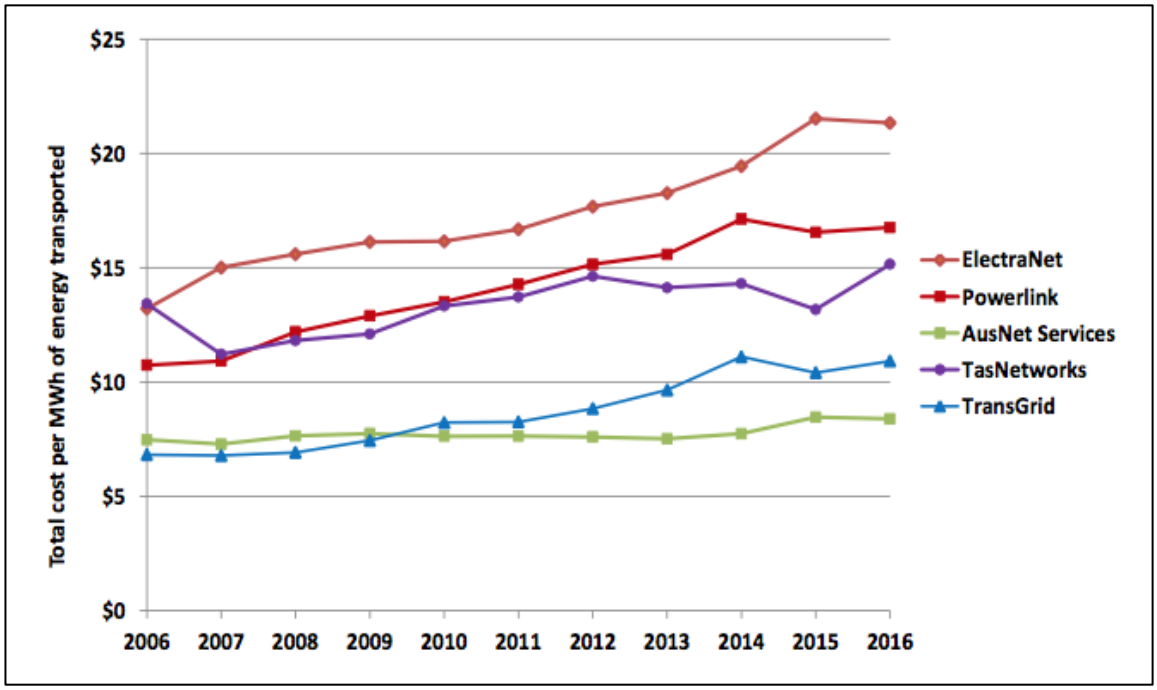


AER, *2017 Transmission network service provider benchmarking report*, November 2017, Figure C.7, p 51. Note: the chart is based on total costs, which include both opex and capital costs.

Other partial performance figures in the report, however, indicate that the decline in energy usage in SA has had a marked impact on the costs per MWh of energy transported (and therefore average prices). Figure 4.8 illustrates this and thereby highlights the challenges facing ElectraNet and the importance of ElectraNet's recent actions to limit growth in expenditures in real terms.

[39] See AER, 2017 transmission network service provider benchmarking report, November 2017, pp 49 to 52. The AER's analysis in this section is based on 'total cost' not just opex.

Figure 4.8: Total cost per MWh of energy transported ($2016) 2006 to 2016



AER, *2017 Transmission network service provider benchmarking report*, November 2017, Figure C.9, p 53. Note: the chart is based on total costs which includes both opex and capital costs.

A similar outcome is observed for the partial productivity index of 'total cost per MW of energy demand', a measure of cost to meet peak demand.

As noted, CCP9 recognises that ElectraNet has made significant efforts to reduce its overall opex in real terms, despite the difficult conditions it faces. Therefore, although the EI report demonstrates an ongoing decline in opex productivity (and capex productivity), CCP9 considers that in the current circumstances, ElectraNet's opex proposal should be accepted by the AER.

However, CCP9 continues to recommend that the AER investigate the factors that contribute to the decline across the whole electricity transmission industry in both opex and capex productivity, and to consider whether the current regulatory incentives are sufficient to drive the improvements in productivity in a monopoly business in the future. Electricity customers have funded very significant investment growth in network capacity and IT over the last decade and in principal, consumers should now be in a position to benefit from reduced unit operating costs and improved reliability. Of course, policy makers should also be aware that of the consequences of their decisions on network reliability on the operating costs of the businesses and the impact on the overall RAB and over the life of these additional assets. To whit, CCP9 is not convinced that claims about "X will only cost $x per year", fully demonstrate the life cycle costs.

Recommendations:

j) The AER accept ElectraNet's proposed opex, subject to the update of the rate of change measures (price and productivity) arising from the November 2017 Economic Insight's report updating productivity trends from 2006 to 2016.

k) The AER accept ElectraNet's proposed allocation of new regulatory costs between existing expenditure forecast and step changes, given the particular circumstances of these new regulatory requirements and ElectraNet's overall restraint on the base opex forecast.
l) In assessing future contingent projects under the RIT-T process (or agreed alternative), the AER make a parallel assessment on the changes in opex, including the likelihood of reduced maintenance costs and GSL payments.
m) The AER undertake further investigation of the partial and total productivity trends as measured in the EI study, to consider if the incentives are driving the expected cost reductions.
n) In its final decision, the AER indicate how the proposed expenditures (including the contingent projects) will impact not only on revenues and prices but also on productivity outcomes.

4.4 Rate of Return, Inflation and Tax

4.4.1 Summary

CCP9 recommends that the AER accept ElectraNet's proposed WACC in its revised proposal, subject to updating the outcome for changes in interest rates and expected inflation using its current approach to estimating these values. We also acknowledge ElectraNet's decision to accept the AER's WACC, inflation and gamma estimates despite its reservation on some components.

CCP9 has noted that the overall approach to the WACC under the Rate of Return Guideline appears to have produced estimates that are on the high side as evidenced by considering the collective evidence from the investor market including RAB multiples, brokers' and credit rating agencies' reports, and investor behaviour in the buying and selling utility stock. However, CCP9's preference is that the AER's current decisions are in line with the 2013 Rate of Return Guideline, which has been tested through Tribunal and Federal Court decisions. Any changes to the AER's approach should be the outcome of the AER's year-long project to review the 2013 Rate of Return Guideline (and 2014 updates). CCP9 values consistency and predictability in regulatory decision-making and we require a high standard of evidence to change the AER's approach to the estimation of WACC, inflation and tax.

4.4.2 AER'S Draft Decision

The AER Draft Decision proposed a WACC of 5.7% (nominal vanilla), consistent with the AER's Rate of Return Guideline, and slightly lower than the 6.02% WACC proposed by ElectraNet. The ElectraNet proposal had accepted the approach and parameter values in the Rate of Return Guideline which has also been applied by the AER in its draft decision. The difference reflects an updating of the market-based parameters to the place-holder averaging period for the Draft Decision of the 20 business days to 31 July 2017. These parameters will be up-dated in the final decision to an averaging period closer to the date of the final decision.

The return on equity (ROE) of 7.2% is based on current yields on 10-year Commonwealth Government bonds, a market risk premium (MRP) of 6.5%, and a beta of 0.7. Consistent with its Rate of Return Guideline and ElectraNet's proposal, the AER adopted the transition to the trailing average in estimating the return on debt at 4.78%. The return on debt will be up-dated annually during the regulatory control period.

The estimate for inflation expectations in the draft decision is 2.5%. This is based on the AER's established methodology which uses the compound average inflation rate over 10 years based on the latest available forecasts of inflation from the RBA and the mid-point of the RBA inflation target range for the remaining years. In 2017 the AER reviewed its approach to the inflation and in its position paper finalising that review maintained this approach. The estimate of inflation expectations is higher than ElectraNet's proposal of 1.97%, which was based on the difference between the yields on 10-year nominal bonds and indexed bonds issued by the Commonwealth Government.

While the AER determines a nominal vanilla WACC, its pricing models (the PTRM and RFM) are designed to provide a revenue stream consistent with a real rate of return on the indexed RAB. Hence, the inflation assumption has an important impact of the allowed revenue. A higher assumed inflation rate results in a lower real WACC and lower revenues and prices for a given nominal WACC.

Finally, the AER used a gamma (value of imputation credits) of 0.4, consistent with the 2014 update to the Rate of Return Guideline, in estimating the allowance for tax expense, compared to ElectraNet's proposed gamma of 0.25.

4.4.3 ElectraNet's Revised Revenue Proposal

In preparing its Revised Proposal ElectraNet accepted the AER draft decision in regard to the WACC and its components, the estimation of inflation expectations, and the value of gamma used in estimating tax expense.

The only two parameters on which there had been a difference between ElectraNet's original proposal and the AER Draft Decision were the rate of inflation and the gamma. In each case Electranet has accepted the AER's draft decision but noted that:

- it considers a market based estimate provides a more representative and appropriate estimate of inflation
- greater weight should be placed on tax statistics in estimating gamma

4.4.4 CCP9's Assessment

CCP9 supports the application of the AER's Rate of Return Guideline and, as a consequence of this, the proposed WACC of 5.7%. In doing so, it notes that:

- *It considers that AER's current approach and values for key parameters have resulted in WACCs that have systematically erred on the high side, but that this is best considered through the current review of the Rate of Return Guideline*
- *It supports the CCP16 submission to the Rate of Return Guideline*

Why we have accepted the AER's proposed WACC of 5.7%

While we consider that AER's approach resulted in WACC's that have erred on the high side we support the application of the Rate of Return Guideline as the AER has done in the draft determination. The AER developed the Rate of Return Guideline through an extensive process of consultation and research. While the Guideline is non-binding, it created a reasonable expectation that the AER would apply the Guideline unless there was strong persuasive new evidence or a substantial change in circumstances such that a change in approach and parameters was necessary

to achieve the ARORO and NEO. That is, in layman's terms, there is a high burden of proof on those requesting a variation in approach or parameters from those in the Rate of Return Guideline

We find it disappointing that some NSPs have been selective in their approach and not respected the role of the Rate of Return Guideline in promoting certainty and consistency of regulation, consistent with best practice principles of regulation and NSPs' past requests for greater certainty. While it may be useful for them to select individual components of the WACC to criticise, the important consideration is the overall outcome and whether the overall WACC is consistent with the NEO and the efficient financing of a regulated network. Hence, we wish to recognise and support Electranet's decision to accept the AER Draft Decision on the WACC, inflation expectations, and the value of gamma, which we consider properly implements the Rate of Return Guideline.

In our submissions to the AER on the TNSPs proposals, we argued that:

1. Market evidence, such as market value to RAB ratios, suggests that the allowed rates of return have exceeded the expected rates of return required by investors.
2. Indicators of investment climate and uncertainty/risk do not support an increase in the MRP, which is the risk premium for investing in equities compared to risk-free investments.

However, we accept that these issues are best considered in the review of the Rate of Return Guideline and that while there is evidence that could support a lower WACC it does not meet the burden of proof required to support a change in approach at a revenue reset covered by the current Rate of Return Guideline.

Why we consider that the proposed WACC errs on the high-side

As the CCP16 submission to the Review of the Rate of Return Guideline argues:

Market evidence on the attractiveness of the sector for investors suggests that the current approach, as implemented by the AER has more than met the requirements under the NEO and ARORO to provide the utility with the opportunity to earn a fair return. In particular:

- Acquisition values do not support the view that the allowed ROR is less than fair for investors – indeed they are more likely to be consistent with the allowed return exceeding investor expectations;
- Commentaries from brokers and rating agencies provide a positive assessment of the regulatory regime for investment; and
- Existing investors do not appear to be seeking, on balance, to reduce their exposure to the sector[40].

The winning bidders in the most recent electricity network transactions, the long-term leases of the TransGrid network (2015), the Ausgrid network (2016) and the Endeavour network (2017), paid 1.6, 1.4 and 1.58, respectively, times the RAB. These multiples are significantly above the RAB multiples commonly seen internationally. The multiples are also above the RAB multiple of 1.15 paid for the Sydney Desalination Plant.

Acquisition or market values need to be treated with caution. A premium is not proof of an overly generous regulatory regime, but it provides some information on the relativity of allowed returns

[40] See for example, CCP16, Submission on the rate of return issues paper, December 2017, p 18.

and investor expectations. A very conservative interpretation of the RAB multiples in the acquisitions of TransGrid, Ausgrid and Endeavour is that they provide strong evidence that the combined allowances for the cost of capital and tax under the AER's current framework and recent decisions are not too low and probably exceed investors' expectations for the required return on investment. This is discussed further in various CCP submissions.[41]

Brokers and rating agencies appear to regard the regulatory regime and the rates of return offered as positive features of the investment environment.

For example, in its report on Hastings Infrastructure Fund after the purchase of TransGrid, Credit Suisse commented that TransGrid was "*governed by a generous regulatory regime which still by design errs on the side of over-incentivising*."[42]

In its presentation for investors Jemena noted that both Moody's and Standard and Poor's referenced the maturity and strength of the regulatory regimes in providing the underpinning for the regulated businesses cash flows.

If the ROR offered were less than fair, one would expect to see investors seeking to reduce their exposure to the sector. This could occur though an increase in gearing as the investor converts equity into debt or a reluctance to invest. In regard to gearing, the Frontier Economics study on beta did not suggest any significant change in gearing was occurring:

> *We note that the average leverage is reduced by the inclusion of AGL and Alinta – both of which had maintained low leverage in order to preserve borrowing capacity to enable them to acquire assets during a time of industry consolidation. But for these two firms, the mean leverage is again very close to the 60% gearing assumption adopted by the AER.* [43]

Recommendation:

o) CCP9 accepts the proposed WACC of 5.7% (nominal, vanilla) and recommends that in its final decision the AER updates the proposed WACC for changes in interest rates but does not otherwise change it.

4.5 Incentive Schemes

4.5.1 Summary

CCP9 recommends that the AER accept ElectraNet's proposed assessment of the three incentive schemes (EBSS, CESS and STPIS). The AER's Draft Decision made some important modifications to ElectraNet's original proposal and CCP9 supports these modifications. ElectraNet has also adopted these modifications in its revised proposal.

The discussion also includes some comments on the three and the effectiveness of the schemes in driving the types of productivity and performance gains consumers would expect over time. There is

[41] See CCP submissions on Profitability Measures, the Review of the Rate of Return Guideline, and the Transgrid and Murraylink Revenue Proposals for 2018-19 to 2022-23.
[42] Credit Suisse, *Spark Infrastructure Group, Equity Research,* 25 November 2015 at p1
[43] Jemena Electricity Networks (Vic) Ltd 2016-20 Electricity Distribution Price Review Regulatory Proposal Revocation and substitution submission, Attachment 6-6 Frontier Economics - Estimating the equity beta for the benchmark efficient entity at p10

also a further discussion on whether the three measures achieve the balanced outcomes consumers seek in terms of the trade-offs between opex, capex and reliability performance. Moreover, CCP9 highlights that costs which are based on benchmarks alone and do not use the revealed cost approach at the revenue reset should not be included in the EBSS or CESS.

4.5.2 AER's Draft Decision

The AER has three standard incentive mechanisms: the Efficiency Benefit Sharing Scheme (EBSS) and the Capital Expenditure Sharing Scheme (CESS) which are designed to provide stronger and more neutral incentives for efficiency in opex and capex; and the Service Target Performance Incentive Scheme (STPIS) that seeks to balance the TNSP's incentives to reduce costs or improve services. The AER's Draft Decision proposes to:

1. *Approve EBSS carryover amounts of -$2.2 million from the 2013-18 regulatory period.* This is a larger negative adjustment than that calculated by ElectraNet (-$1.9 miillion) due to the exclusion of opex for the defined benefit superannuation scheme.
2. *Continue the application of the EBSS.*
3. *Apply the CESS for the 2018-23 period.* This will be the first time that the CESS, which covers all capex except priority projects approved under the STPIS, has been applied to ElectraNet.
4. *Apply the STPIS for the 2018-23 period* covering unplanned outages, market impacts, and network capability projects.

In applying the STPIS the AER:

1. Accepted the service component measures but set different floors and caps based on a review of the statistical analysis provided by ElectraNet.
2. Revised the target for dispatch intervals affected down from 4911 to 4100 based on the exclusion of certain force majeure events from the historic performance data.
3. Accepted the proposed network capability improvement projects.

4.5.3 ElectraNet's Revised Proposal

In its revised proposal ElectraNet has:

1. Accepted the application of the EBSS and updated the calculation of the carryover to -$3.5 million.
2. Accepted the application of the CESS.
3. Accepted the application of the STPIS with the parameters proposed in the draft decision.

4.5.4 CCP9's Assessment

CCP 9 considers that incentives to improve efficiency are in the long-term interest of consumers as long as it is not at the expense of service quality and supports the application of the EBSS, CESS, and STPIS as proposed in the AER's draft decision.

Incentive mechanisms and the long-term interest of consumers

The set of performance incentives are in the long-term interest of consumers if they are successful in promoting larger efficiency improvements.

In the absence of the EBSS and CESS, the TNSPs' incentives to pursue efficiency improvements diminish through the regulatory period. As a result, reductions in costs that could be achieved in the last years of a regulatory period may be foregone or deferred to the subsequent period. Under the

revealed costs approach, where costs in the last year of one regulatory period form the basis for assumed costs for the first year of the next, this results in higher prices for consumers.

The EBSS and CESS are intended to:

1. Equalise the incentives to improve efficiency across each year of the regulatory period
2. Equalise the incentives to improve efficiency through reductions in opex and capex.
3. Provide a fair sharing of efficiency benefits between the TNSPs and consumers

Equalising the incentives over the regulatory period provides a stronger incentive for the TNSP to reduce costs in the latter years of the regulatory period. If the TNSP responds to this these incentives the costs at the end of the period will provide a base for future prices. This should provide a benefit that more than offsets the increment to prices in the next regulatory period under the EBSS or CESS to provide the incentive to the TNSP.

Equalising the incentives between Opex and Capex removes a potential distortion in the TNSP's that could lead a utility to inefficiently substitute opex for capex or vice versa. Again this should result in lower revealed costs that provide the basis for future prices.

One concern is that in strengthening incentives to reduce costs it also strengthens the incentives to reduce costs through reductions in service standards not just efficiency improvements. The concern is that there may be cases where the increased costs (or loss of value) for consumers may exceed the reduction in costs for the TNSP. The STPIS provides a mechanism for protecting against this and is an important component of the incentive framework from the consumers' perspective. However, it is subject to the constraints on measuring service performance, the time-lag between action (or inaction) and outcomes and the limitations on the revenue at risk.

A second concern is that use of EBSS and CESS targets to strengthen incentives should not reduce the need to set a stretch target for the assumed efficiency gains that requires continuous improvements in the operational and capital efficiency. As noted in the discussion of opex, we are concerned that the current approach to estimating the trend efficiency improvement assumes the continuation of past relatively poor efficiency performance of the sector rather than mimicking the incentives for continuous improvement for businesses operating in competitive markets.

Finally, it is important to note the differences in incentives for costs not set using the revealed preference approach and covered by the EBSS and CESS. Under the current approach some costs – most notably debt costs and tax expense – are set using a benchmark without reference to actual costs incurred. Debt costs are based on the yield for benchmark corporate bonds. These may vary from actual costs incurred but there is no adjustment or reset at any point to actual costs incurred (in contrast to most opex and capex). Tax expense is based on an estimate of taxable income based on the allowed revenue requirement and the statutory tax rate. The forecast tax expense may vary from tax paid – indeed the forecast allowance appears to systematically exceed actual tax paid – but there is no adjustment or reset at any point to actual costs incurred (in contrast to most opex and capex). This means that for debt and tax costs the utility retains 100% of the benefit of any reduction in these costs and that the consumers do not benefit. This has two important implications:

1. **The incentives for the utility to minimise debt costs or tax costs are more than 3 times as strong as the incentive to achieve opex and capex efficiencies.** Unfortunately, this means that if

there were limited management resources, it would be rational for the TNSP to prioritise minimising tax, to the detriment of other taxpayers and without benefit to consumers or economic benefit through more efficient resource usage, and minimising debt costs.

2. **Costs which are based on benchmarks alone and do not use the revealed cost approach at the revenue reset should not be included in the EBSS or CESS.** The utility already retains 100% of any reduction in these costs. Inclusion in the EBSS would 'double count' these benefits to the detriment of consumers who would have to fund the incentive payments with no benefit through a reduction in the cost base for the determination of future prices.

A similar concern may also relate to the estimation of network support costs, which is part of the opex 'other category' allowance and therefore similar to the debt allowance. Network support costs vary significantly from year to year and the AER's Draft Decision is based on a projection of costs from the base year review. We would welcome the AER's advice on this matter too.

4.5.5 EBSS carryover calculation

We note that the calculation of the EBSS carryover is governed by the rules applying to the EBSS and that Electranet has accepted the adjustments to the calculation made by the AER in its Draft Decision. On that basis, we accept the calculated carryover amount of -$3.5m in Electranet's revised proposal. This is the amount calculated by AER adjusted for opex related to NCiPAP.

4.5.6 STPIS

We note that the calculation of the service and market impact components of the STPIS are governed by the rules applying to the STPIS. The AER is required to review the parameters and proposed under the service component and calculation of the benchmarks for the service and market components, but there are constraints on the scope for AER to reject/modify these. AER has undertaken a careful analysis of the statistical basis for the benchmarks and Electranet has accepted the variations proposed. Electranet has accepted the adjustments to the calculation made by the AER in its draft decision. On that basis we accept the STPIS as proposed in the draft decision.

Recommendation:

o) The AER should accept the three incentive schemes as modified by ElectraNet in its revised proposal.

5. Conclusion

CCP9 considers that the consumer engagement conducted by ElectraNet has been at a consistently high-level both before and during the regulatory approval process. We recognise that ElectraNet has maintained its approach throughout a turbulent two years during which there have been changes in operations and policies – and much still remains uncertain. In this environment it was even more important, and more challenging, that ElectraNet continue to engage its customers in its regulatory process and in the market conditions overall. This has recently been reflected in the ECA's inaugural award to ElectraNet for its customer engagement excellence. Going forward, new challenges will arise particularly around maintaining momentum and addressing customer engagement in the context of the proposed contingent projects and associated RIT-T. CCP9 considers ElectraNet's commitment to date will stand it in good stead to address these issues.

In terms of ElectraNet's revised revenue proposal, CCP9 has supported almost all these revisions with respect to opex, WACC and the incentive schemes. CCP9 has also accepted most of the proposed capex, although we have raised some caveats about the treatment of contingent projects, suggesting that the capex for at least one project might be included in the ex-ante forecast rather than as a contingent project.

Overall, the revised proposal includes a significant reduction in revenue (and prices) in the first year with increases limited to CPI beyond that. This provides some prospect that network cost rises to SA customers will be constrained or even reversed. Notably, the rate of growth in RAB is reduced and declines in the last year. This is another important step towards reducing pressures on consumer prices over the longer term.

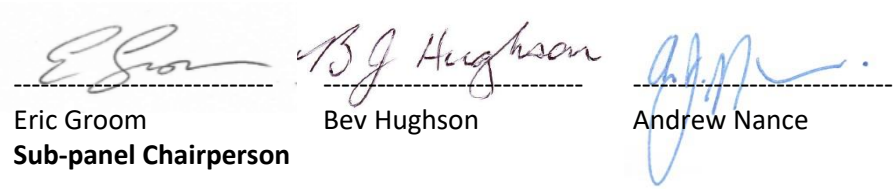
CCP9 has raised a number of more general issues, which, while relevant to ElectraNet, concern the regulatory processes more generally. They are:

- The continued decline in total, capital and opex productivity despite the expenditures in previous regulatory period – the reasons for this decline and whether the regulatory arrangements such as the incentive schemes, should be amended to address this issue.
- The treatment of contingent projects and RIT-Ts in terms of consumer engagement and transparency. In addition, with so many changes "in the wings" and new obligations under the NEG et al, it is difficult for consumers (and regulators?) to assess if and where the overlaps are occurring. There is a clear risk of double counting, particularly in the capex allowances.
- We have noted the limitations of the incentive schemes in delivering the productivity and continued improvement performance that would be seen – would be necessary – in even a "workably competitive market" (the reference benchmark used by the Courts). CCP9 considers there should be further investigation to this.

To conclude, CCP9 would like thank the AER staff for their ongoing advice. CCP9 would also like to acknowledge ElectraNet's achievements in maintaining an effective and innovative customer engagement program in the face of many challenges and we are grateful for their openness to CCP9. We would also thank the members of ElectraNet's Consumer Advisory Panel for the work they have put into in ensuring that ElectraNet achieves its ambition of a 'no surprises' proposal, that is 'capable of acceptance' by the regulator. CCP9 believes that working in collaboration with consumers is the way forward for all networks - perhaps the only way forward - in a market facing economic, environmental, regulatory and technological change.

CCP9 commends to the AER the issues raised in this advice and the recommendations made.

Signed



Eric Groom	Bev Hughson	Andrew Nance
Sub-panel Chairperson		