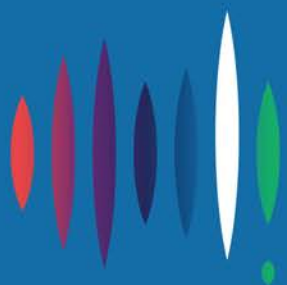


Endeavour Energy

Regulatory proposal 2019-24

Submission to the AER Issues Paper

August 2018



**ENERGY
CONSUMERS
AUSTRALIA**

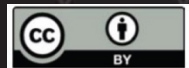
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Introduction

Energy Consumers Australia considers that the long-term interests of consumers are served when current and future consumers pay no more than they need to for the services they prefer.

Consumers are looking to Endeavour Energy to provide high quality services, at affordable prices. In return, they accept that investors should earn a fair return for their long-term investment in these regulated assets. We are looking to Endeavour Energy to adopt long-term strategies, and revenue proposals that align the interests of their shareholders with the interests of their customers.

Energy Consumers Australia is the national voice for residential and small business energy consumers. Established by the Council of Australian Governments Energy Council (the Energy Council) in 2015, our objective is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety and security of supply.

We appreciate the opportunity provided by the Australian Energy Regulator (AER) to respond to the Issues Paper. In our response, we have taken into account relevant developments including:

- the subsequent decisions of the AER in accepting the remittal proposals submitted by Essential Energy and Endeavour Energy;
- ongoing engagement with Endeavour Energy to refine its 2019-24 proposal as submitted;
- ongoing engagement with Ausgrid, in relation to both its remittal proposal for 2014-19 which has not yet been submitted and the 2019-24 proposal.

In this submission we are responding to the revenue proposal submitted by Endeavour Energy and the associated issues raised by the AER in its Issues Paper on the NSW electricity distribution determinations 2019-24.

We understand that the final outcome for consumers of Endeavour Energy's 2019-24 proposal, when combined with the return of revenue to consumers from the remaking of the 2014-9 decisions by the AER, is expected to be decreases in real terms in average annual network prices for households and small businesses.

However, in our view there remain issues with the Endeavour Energy proposal, which means that the proposal as submitted is not able to be accepted by the AER, in making its Draft Decision.

In our view capital expenditure remains too high, largely due to expenditure on the replacement of assets (\$800.5 million) and the change in approach to capital contributions (\$309 million).

Further, we expect that the application of the 2018 Rate of Return Guideline (which is currently under review) could put further downward pressure on network prices charged by Endeavour Energy.

Our framing and approach

Energy Consumers Australia considers that the long-term interests of consumers are served when current and future consumers pay no more than they need to for the services they prefer.

Central to achieving this objective is the development of effective competition in markets where competition is viable, and best practice regulation of natural monopoly services where competition is not viable. Our model of network regulation is designed to provide incentives to networks to improve their performance, while constraining their prices within an efficient cost of service envelope.

Consumers are looking to Endeavour Energy to provide high quality services, at affordable prices. In return, they accept that investors should earn a fair return for their long-term investment in these regulated assets.

The proposal from Endeavour Energy is made at a time when capital market conditions are favourable, there is availability of capital seeking to finance quality assets, and new shareholders and management teams are bringing greater discipline to these processes.

For these reasons, Energy Consumers Australia is looking to Endeavour Energy to adopt long-term strategies, and revenue proposals that align the interests of their shareholders with the interests of their customers. It is time that we move on from the adversarial processes of the past and move the consideration of these revenue proposals from the courts to the boardroom.

In this context, we consider that the AER should engage directly with the Board of Endeavour Energy. This will serve to emphasise to them directly the importance of achieving least cost network services for consumers that are consistent with their investing not one more dollar than necessary, one day earlier than necessary.

Our response

We recognise that it is the responsibility of the AER to set the maximum revenues that networks are allowed to recover from consumers through network tariffs over the five-year regulatory period, based on its assessment of efficient costs and an informed view on expected electricity demand.

Consumer views and perspectives are integral to ensuring that the decisions made by the AER are in the long-term interests of consumers.

In forming our views of this proposal, Energy Consumers Australia has had a laser like focus on affordability, which needs to be a constraint on all the expenditure decisions of these businesses.

Engagement with stakeholders

Energy Consumers Australia has engaged with Endeavour Energy throughout the process of the development of their proposal. There has been real improvement in the way in which engagement with consumers and other stakeholders has been undertaken, compared with the previous period.

We agree with the assessment of the Public Interest Advocacy Centre (PIAC) that Endeavour Energy's engagement was mixed.

While there were instances of good practice engagement, the lateness in starting and the premature ending of engagement – meaning no account was taken of feedback – limited its effectiveness.

In the case of the deep dive forums, these were well run and valuable for stakeholders, in gaining understanding of Endeavour Energy's proposal, but did not result in changes to the proposal in respect of capital expenditure.

On the other hand, the engagement on the tariff structure proposals was effective and collaborative, leading to an innovative proposal from Endeavour Energy that responded to issues raised by stakeholders.

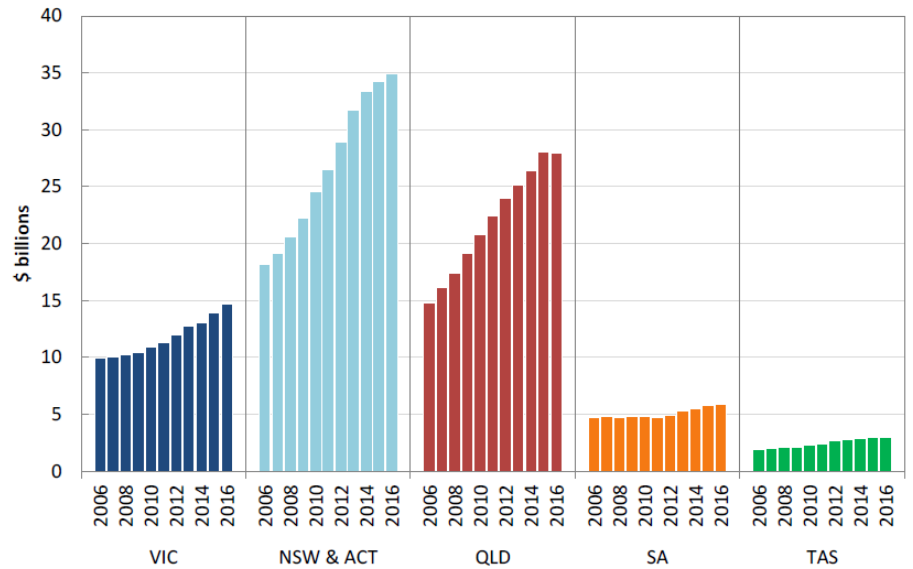
Growth in the regulated asset base

Across all three businesses in NSW we have seen significant increases in capital expenditure over the last decade that have resulted in combined regulatory asset bases that are too high as shown in Figure 1 (which is from the Australian Competition and Consumer Commission's Retail Electricity Pricing Inquiry, Preliminary Report).¹

Given the size of these regulated asset bases, we believe that the circumstances and the outcomes for consumers of already incurred capital expenditure needs to be carefully scrutinised, as consumers are yet to receive a dividend from the increased capacity and improvements in reliability that this investment was intended to deliver.

¹ ACCC Retail Electricity Pricing Inquiry, Preliminary Report, page 63

Figure 1: Regulatory asset bases (real \$2015-16) across the NEM



Source: AER economic benchmarking, Regulatory Information Notice responses.

The growth in Endeavour Energy’s regulatory asset base since 2004-05 is shown in Figure 3. Endeavour Energy is proposing further growth in the regulated asset base over the period 2019-24 (12%) reflecting significant capital expenditure.

Figure 2: Growth in Endeavour Energy RAB (\$million 2018-19)

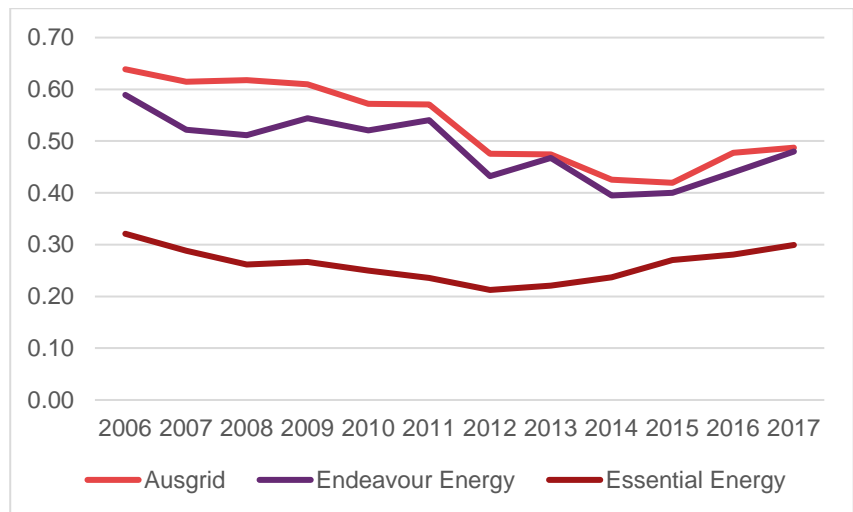


Source: AER Issues Paper, NSW electricity distribution determinations: Ausgrid, Endeavour Energy, Essential Energy, 2019 to 2024

Capacity utilisation

While the regulatory asset base has grown, capacity utilisation rates on the Endeavour Energy network fell significantly.

Figure 3: Capacity utilisation rates (RIN data)



Capacity utilisation fell from 59% in 2006, to a low of 40% in 2015 and has since recovered somewhat to be 48% in 2017 (see Figure 3).

In this context there is little, or no, detail provided by Endeavour Energy in their proposal as to how capacity utilisation might be improved in the future, to bring down unit network costs for consumers.

Without a strong focus on capacity utilisation, there remains a greater risk that consumers will be responding to distorted price signals when deciding to invest in distributed generation assets to reduce their use of the network.

This investment in distributed generation increases the costs for the customers who remain on the network, and who do not, or often cannot, make these investments. Economists could point to this outcome as a dramatic example of the loss of dynamic efficiency that can be caused by allowed revenues being too high.

Comments on key components

The key components of Endeavour Energy’s revenue proposal are summarised in Table 1. We have focussed our comments principally on capital expenditure, and to a lesser extent changes in operating expenditure. We have not commented on the application of incentive schemes to Endeavour Energy.

Table 1: Key components of the proposals

2019-24 SUMMARY	ENDEAVOUR ENERGY
Revenue (\$2018-19m) unsmoothed	\$3,891.6*
RAB June 2019 (\$m)	\$6,512
RAB June 2024 (\$m)	\$7,294
% change in RAB	12%
CAPEX	\$2,165.6
OPEX	\$1,485.5

*\$4,335 in the AER Issues Paper when the remitted decision is included

Rate of return

Endeavour Energy have adopted the approach to setting the allowed rate of return set out in the 2013 Rate of Return Guideline and subsequent determinations.

In our view, should the revised 2018 guideline be released by the end of the year and be binding on the distribution businesses as proposed by the COAG Energy Council, it should apply to the 2019-24 final determinations for Endeavour Energy. In the event that the legislation does not come into effect, we submit that the allowed rate of return should be calculated using the parameters and approaches proposed by the AER in its 2018 Final Guideline.

The current Draft Guideline, on which the AER is currently consulting, includes the following parameters:

- a benchmark gearing ratio of 60% for the allowed return on debt;
- the risk-free rate estimated based on an average of the yield on 10-year Commonwealth Government Bonds (CGS) over an averaging period of between 20 and 60 business days;
- a market risk premium of 6%;
- an equity beta of 0.6;
- an allowed return on debt determined on the basis of the revenue neutral transitional arrangements that AER recently determined for each service provider to move from an 'on-the-day' approach to a 10-year trailing average approach;
- the benchmark for estimating return on debt is the yield on debt instruments issued at a BBB+ investment grade rating; and
- a value for imputation credits (gamma) of 0.5.

Energy Consumers Australia is considering whether some of these parameter choices could be revised to apply a lower rate of return, in its forthcoming submission on the Draft Guideline.

Depreciation

According to the AER's Issues Paper regulatory depreciation is provided so investors can recover their investment over the economic life of the asset. While the AER's preferred approach is that businesses adopt a weighted average remaining life approach (WARL) to calculating straight line-depreciation, it has on occasion accepted period-by-period tracking as consistent with the National Electricity Rules (NER).

Our concern with this approach is that while it does not increase the overall investment recovered overall (in a net present value sense) it does increase the amount of network revenue recovered from today's consumers.

As Engineroom Infrastructure Consulting explained in its work on accelerated depreciation:

The difference in the United Energy decision between the WARL approach and year-by-year tracking for the 2016-2020 regulatory control period was \$106.5 million, and the year-by-year tracking approach was about 34 per cent more than the WARL approach.²

In the case of the NSW electricity distribution businesses, Ausgrid decided not to proceed with period-by-period tracking after consultation with stakeholders, while Endeavour Energy has included period-by-period tracking in its proposal. We are seeking information from Endeavour Energy on the difference in revenue in the 2019-24 period between the two approaches.

It is understood that the WARL approach to calculating regulatory depreciation is less accurate than the period-by-period tracking approach proposed by Endeavour Energy and also currently used by Ergon Energy and TransGrid. The accuracy is measured against a straight-line method using individual assets with individual economic lives.

In our view the fact that WARL is less accurate than the period-by-period tracking approach should be of little concern to the AER because the NER requirements in Clause 6.5.5(b)(1) requires that the depreciation schedules conform to a number of requirements, including:

"The schedule must depreciate using a profile that reflects the nature of the assets or category of assets over the economic life of that asset or category of assets."

² Engineroom Infrastructure Consulting, An evaluation of the role of accelerated depreciation in the regulation of electricity and gas networks, April 2017, page 14, available <https://energyconsumersaustralia.worldsecuresystems.com/grant-archive/807-research-advocacy-accelerated-depreciation>

The current methodology is NER compliant and it would be very difficult to prove that the change in methodology provides a materially better reflection of the nature of the assets or category of assets over the economic life of that asset or category of assets.

There may well be an argument for an annuity depreciation methodology to be applied as the assets continue to provide the same capability or value to customers over their lifetime. This would have the effect of reducing the depreciation allowance of assets until close to when they require replacement.

In summary, we support the AER's preferred approach continuing to be applied to Endeavour Energy in calculating straight line-depreciation.

Capital expenditure (capex)

Affordability needs to be an overarching constraint on all future network investment decisions.

In relation to proposed growth in capex we are concerned that businesses remain locked into past practices in relation to risk. While Endeavour Energy is now using probabilistic planning, and in the previous regulatory period became subject to the Service Target Performance Incentive Scheme, it appears to us that conservative failure rates and times to repair are being adopted.

The result of this approach to risk management is large proposed capital expenditure. It is noteworthy that in its Draft Rate of Return Guideline the AER states consumers may be willing to bear a higher risk to reliability in return for lower bills.³

There is also a significant missed opportunity for Endeavour Energy, as with other NSW businesses, to reduce future network capex through rewarding consumers for flexibility in their energy use – through demand response and network price signals.

Endeavour Energy has proposed capex of \$2,158.1 million (\$2018-19m) in the 2019-24 period, which is made up of:

- growth expenditure of \$726.1 million (34%);
- replacement expenditure of \$861.9 million (38%)
- non-network expenditure of \$170.1 million (8%);
- capitalised overheads of \$400 million (18%).

Growth capex

The growth capex proposed by Endeavour Energy is made up of \$417 million for increases in electricity demand from customers and around \$309 million due to the change in the approach to capital contributions.

This excludes a further \$61.2 million which is proposed as a contingent project for augmentation to support growing demand in the Western Sydney Airport area.

³ AER Draft Rate of Return Guideline: Explanatory Statement, 10 July 2018, page 28
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We consider that it is appropriate that the possible augmentation of the network to support growing demand in the Western Sydney Airport area is treated as a contingent project, and not be included in the allowed revenue.

We would welcome further engagement with consumers on this project if the need should eventuate.

Figure 4: Demand forecasts, Endeavour Energy

	2019-20	2020-21	2021-22	2022-23	2023-24
Maximum demand (MW) 50% PoE	3,949	4,039	4,129	4,205	4,278
Energy delivered (GWh)	16,621	16,730	16,831	16,954	17,228
Customer numbers (000's)	1,044	1,064	1,084	1,105	1,126

⁹ The highest amount of energy being collectively consumed across our network
¹⁰ Figure is based on a 50 percent probability of exceedance (POE) which is what is used for network planning purposes.

Endeavour Energy’s demand forecasts show that by the end of the next revenue period, expected demand for the Endeavour Energy network will be about 4,300MW which is about 600MW below the demand forecast for 2014 provided by Endeavour Energy in 2008.

This compares with maximum demand over 2016-17 of 4,107MW, so the actual growth in the next regulatory period is quite low. In our view this means there has been a 10 year plus deferral of demand growth expectations. Although the growth capex proposed for the 2019-24 period is only half replacement capex, it is still \$417 million after some considerable spending of around \$1.9 billion in the 2006 to 2017 period. With this level of further growth capex expenditure, we would expect that capacity utilisation on the Endeavour Energy network could become lower.

We are seeking further information from Endeavour Energy on where savings might be made in their proposed growth capex.

In particular, we note that the Capex Listing spreadsheet shows that there are 3 programs and 34 major projects in the growth capex category. The largest 13 projects/programs account for 75% of the proposed \$417 million expenditure. Of these only one program – the “HV development works” at \$32.8 million over the period is committed (12 major projects are not yet committed).

Of the uncommitted major projects, 6 are forecast to spend \$48 million in 2019/20, and all are assumed to have 100% probability of proceeding. A change in the likelihood that these projects could be needed could allow some deferral of expenditure to later years, or a subsequent regulatory period.

We are also exploring with Endeavour Energy whether changes in the capital contribution policy could be considered.

Replacement capex

There were more stringent planning standards in place in the previous period than will apply in 2019-14 and expected growth in demand is low in the period 2019-24.

In this context we are seeking information from Endeavour Energy on whether there are opportunities to better manage the asset replacement program, with rapid response plans and safety mitigation plans to manage overall reliability.

For example, the loading on the 166 zone substations at peak demand time only exceeds the N-1 rating of the station in 27 substations in 2024. That means that even with the rare event of a transformer failure all of the time in most of the stations will not lead to customer interruption and in a small number of stations for a very small exposure period there may be rare times when customers are interrupted while load is transferred to an adjacent zone substation. This offers options to delay replacement capex for transformers which is forecast to be \$107 million in the proposal. There is a lack of evidence of attention to these types of risk management techniques in the proposal as a way of ensuring consumers pay no more than necessary.

Non-network costs

Endeavour Energy's proposed expenditure on non-network costs which include information and communications technology (ICT), property, fleet and plant is relatively moderate.

Capitalised overheads

Endeavour Energy's proposed expenditure on capitalised overheads of 18% is high by comparison with businesses in other jurisdictions and are therefore unlikely to be considered efficient. We consider that there should be a trend of reducing capitalised overheads as a percentage of capex over the period to recognize productivity improvements.

Operating expenditure (opex)

In relation to opex, it is only now that we are seeing more efficient performance in these NSW businesses that will benefit consumers in the next five years. It is difficult for consumers to accept that these businesses should not be subject to a productivity dividend, at a time when costs of living are rising and wages growth is flat.

The issue of how output growth and productivity forecasts should be treated by the AER has been raised in the context of both the Evoenergy and NSW electricity distribution determinations, and in particular by the Consumer Challenge Panel 10 (CCP 10) in its submissions on the AER's framework and approach.

Energy Consumers Australia's view is that the approach for forecasting output growth and productivity growth should be set in advance as it is for the rate of return, rather than on a case by case basis.

In relation to the consideration of Endeavour Energy's proposal, Energy Consumers Australia supports the view of CCP10 that the AER should consider reviewing its approach to considering efficiency and trend productivity.

Concluding comments

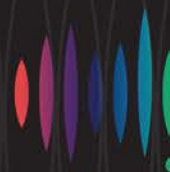
Energy Consumers Australia has appreciated the opportunity to comment on the Endeavour Energy revenue proposal for 2019-24 and address the issues raised in the AER's Issues Paper. We have separately provided submissions for Ausgrid and Essential Energy, and a combined submission on the proposed Tariff Structure Statements of the NSW businesses.

If you have any questions in relation to our comments in this submission, or require further detail, please contact Lynne Gallagher on 9220 5500 or by email lynne.gallagher@energyconsumersaustralia.com.au.

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