Essential Energy
Regulatory proposal 2019-24

Submission to the AER Issues Paper

August 2018

ENERGY CONSUMERS AUSTRALIA

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Introduction

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Consumers are looking to Essential 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 Essential Energy to adopt long-term strategies, and revenue proposals that align the interests of their shareholder 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 Essential Energy and the associated issues raised by the AER in its Issues Paper on the NSW electricity distribution determinations 2019-24.

In our view the Essential Energy proposal is able to be accepted by the AER, in making its Draft Determination.

If the AER accepts the Essential Energy proposal, the final outcome for consumers of these 2019-24 proposals, combined with the return of revenue to consumers from the remaking of the 2014-19 decisions by the AER, is a small increase (1.43% on average per annum) in prices in real terms. In this context, we expect that the application of the 2018 Rate of Return Guideline (which is currently under review) will put further downward pressure on network prices charged by Essential 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.

The Essential Energy proposal is able to be accepted by the AER, in making its Draft Determination

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 Essential 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 Essential Energy is made at a time when capital market conditions are favourable, there is availability of capital seeking to finance quality assets, and the shareholder and management teams are bringing greater discipline to these processes.

For these reasons, Energy Consumers Australia is looking to Essential Energy to adopt long-term strategies, and revenue proposals that align the interests of their shareholder 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 Essential Energy. This will serve to emphasise to them directly the importance of achieving efficient costs of 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 can 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

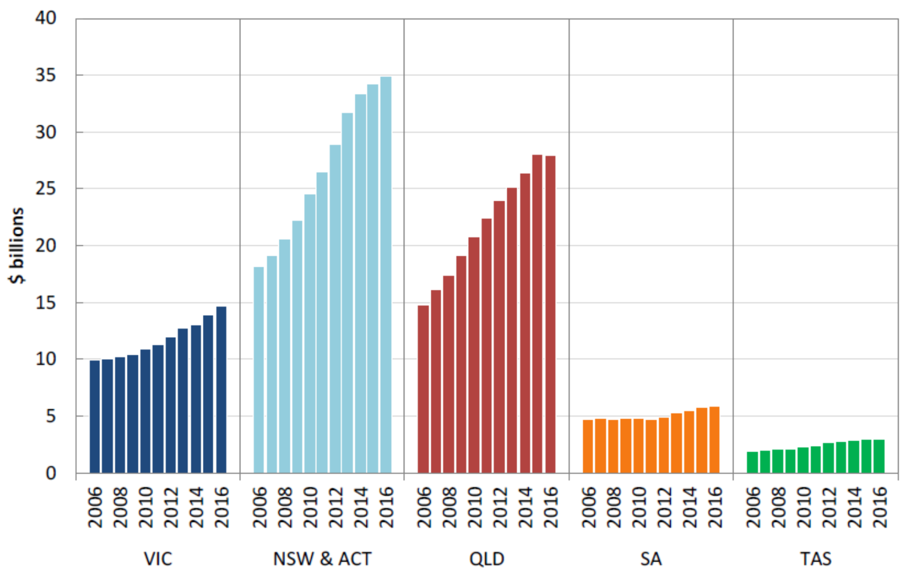
Energy Consumers Australia has engaged with Essential Energy throughout the process of the development of their proposal. There has been real improvement in the way Essential Energy has engaged with consumers and other stakeholders, compared with the previous period.

We agree with the assessment of the Public Interest Advocacy Centre (PIAC) that Essential Energy was *"transparent about its business plans and sought to reflect consumer preferences in its regulatory proposal".* In response to stakeholder feedback, Essential Energy made changes to reduce capital and operating expenditure in its proposal.

Essential Energy was transparent about its business plans and sought to reflect consumer preferences in its regulatory proposal

Growth in the regulated asset base

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



Source: AER economic benchmarking, Regulatory Information Notice responses.

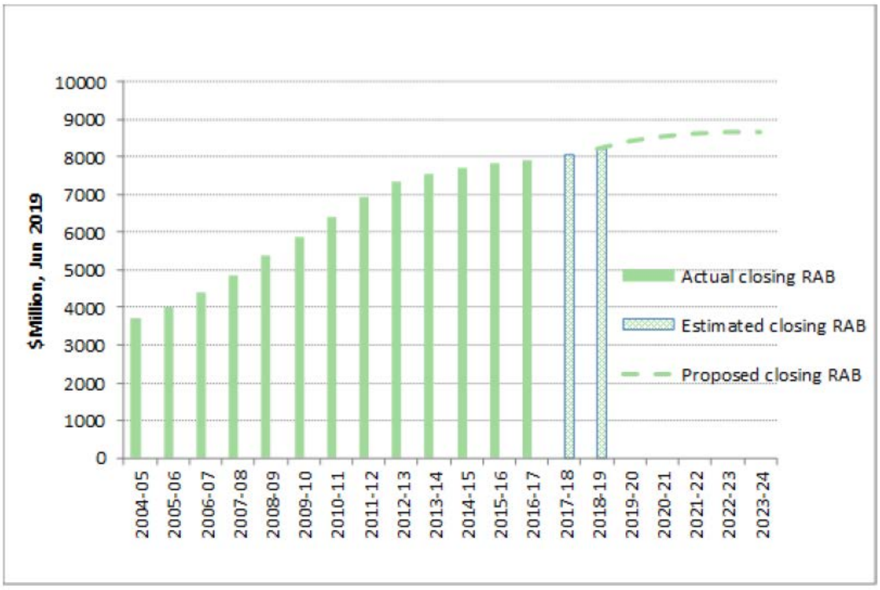
Across all three businesses in NSW we have seen significant increases in capital expenditure over the last decade that have resulted in combined regulatory asset bases that are too high as shown in Figure 1 (which is from the Australian Competition and Consumer Commission's Retail Electricity Pricing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

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

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.

The growth in Essential Energy's regulatory asset base since 2004-05 is shown in Figure 2. Essential Energy is proposing further growth in the regulated asset base over the period 2019-24 (5.7%).

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



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

Essential Energy is exploring approaches to arresting growth in its regulated asset base

In their proposal at Section 8, Essential Energy refers to work to explore approaches to arresting growth in its regulated asset base. Energy Consumers Australia would like transparency to be provided on this work and its findings to enable us and the AER to develop a considered view on regulated asset base outcomes given its central role in driving price increases for Essential Energy consumers.

Capacity utilisation

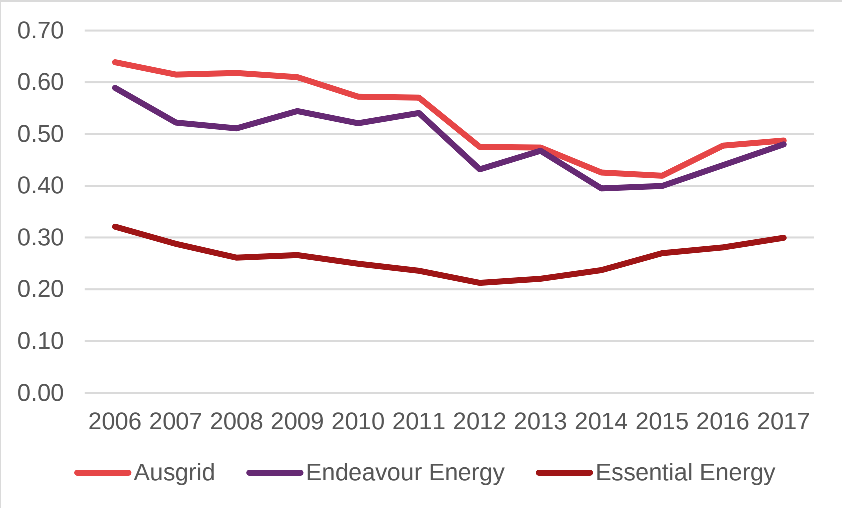
Capacity utilisation fell from 32% in 2006, to a low of 21% in 2012 and has since recovered to be 30% in 2017 (see Figure 3). As part of their future work on addressing growth in the regulated asset base, we will be seeking information from Essential Energy on how they propose to maintain or improve capacity utilisation rates on their network, including prudent and careful consideration of non-network alternatives, to improve price outcomes 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.

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

Figure 3: Capacity utilisation rates (RIN data)



Comments on key components

The key components of Essential 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 Essential Energy.

Table 1: Key components of the proposals

2019-24 SUMMARY	ESSENTIAL ENERGY
Revenue ($2018-19m) unsmoothed	$5,137
RAB June 2019 ($m)	$8,215
RAB June 2024 ($m)	$8,684
% change in RAB	5.7%
CAPEX	$2,100
OPEX	$1,698

Rate of return

Essential 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 Energy Council, it should apply to the 2019-24 final determinations for Essential 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.

Should the revised 2018 guideline be released by the end of the year and be binding on the distribution it should apply to the 2019-24 final determinations for Essential Energy

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. We support the AER’s preferred approach which is that businesses adopt a weighted average remaining life approach (WARL) to calculating straight line-depreciation, as Essential Energy has done in its proposal for 2019-24.

Capital expenditure

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

In relation to proposed growth in capital expenditure we are concerned that businesses remain locked into past practices in relation to risk. While Essential 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 consumers may be willing to bear a higher risk to reliability in return for lower bills.[2]

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

__In relation to proposed growth in capital expenditure we are concerned that businesses remain locked into past practices in relation to risk__

Essential Energy has proposed capital expenditure of $2,100 million ($2018-19m) in the 2019-24 period, which is made up of:

- growth expenditure of $185.8 million (9%);
- replacement expenditure of $819.7 million (39%)
- non-network expenditure of $495.2 million (24%); and
- capitalised overheads of $598.8 million (28%).

Essential Energy is significantly reducing its capital expenditure proposed for the 2019-24 period compared with the previous period, while seeking to maintain services and reliability. These proposals were able to be scrutinised in some detail in Essential Energy's engagement with local communities.

We note that there are only a small number of major projects related to the sub-transmission network, given minimum demand growth. Essential Energy is proposing investment in augmentation and growth capital expenditure, reflecting low but localised development requirements on the 11kV network.

We note that Essential Energy is proposing significant expenditure on non-network costs which include information and communications technology (ICT), property, fleet and plant. In this context we note that Essential Energy has justified its expenditure on the basis of the need to upgrade ICT generally, based on lack of spend previously.

The proposed expenditures on capitalised overheads for Essential Energy are high by comparison with businesses in other jurisdictions and are therefore unlikely to be considered efficient. We recognise that there are diseconomies of scale for a business such as Essential Energy. However, we consider that there should be a trend of reducing capitalised overheads as a percentage of capex over the period to recognize productivity improvements.

[2] AER Draft Rate of Return Guideline: Explanatory Statement, 10 July 2018, page 28

Operating expenditure (opex)

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.

We support the Essential Energy approach of offsetting increases in base opex with forecast efficiency gains to produce an overall decline in opex over the 2019-24 period

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 the three NSW distribution proposals, Energy Consumers Australia supports the view of the CCP 10 that the AER should consider reviewing its approach to considering efficiency and trend productivity.

In this context we support the Essential Energy approach of offsetting increases in base opex with forecast efficiency gains to produce an overall decline in opex over the 2019-24 period.

Concluding comments

Energy Consumers Australia has appreciated the opportunity to comment on the Essential Energy revenue proposal for 2019-24 and address the issues raised in the AER's Issues Paper. We have separately provided submissions for Endeavour Energy and Ausgrid, 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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