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Submission to AER draft determination and SA Power Networks' revised revenue proposal for the 2015 to 2020 regulatory period

Thank you for the opportunity to provide the Energy User Association of Australia's (EUAA) perspectives on the AER draft determination and SA Power Networks' revised revenue proposal.

We are of the view the AER has the opportunity to apply far greater rigour to SA Power Networks' revised revenue proposal. This being particularly the case in the application of opex and selection of WACC parameters.

Our recommendations on these and other matters are clearly articulated in the submission.

We hope you find this of assistance for the AER final determination and we welcome further dialogue or clarification on any of the matters raised.

Please do not hesitate to contact me should you require any clarifications or further information regarding this submission.

Yours sincerely

Philip Barresi
Chief Executive Officer
Energy Users Association of Australia (EUAA)

SUBMISSION TO THE AER

AER DRAFT DETERMINATION FOR SA POWER NETWORKS
& SA POWER NETWORKS REVISED PROPOSAL

SA POWER NETWORKS 2015 – 2020 REGULATORY CONTROL PERIOD

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The views expressed in this document do not necessarily reflect the views of Energy Consumers Australia

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1 Executive summary

The EUAA recognizes the reductions the AER has made to the revenue proposal put forward by SA Power Networks. However, the members of the EUAA are disappointed the AER draft determination did not go far enough and also that SA Power Networks' revised proposal largely seeks to defend its original proposal.

We are of the view the AER had the opportunity to apply far greater rigour to SA Power Networks' revised revenue proposal. This being particularly the case in the application of opex benchmarking and selection of WACC parameters.

1.1 Recommendations

The following summarises the key recommendations by the EUAA that are discussed further in the main body of the submission.

Recommendation 1:
In its final decision the AER should take into account real falls in material costs that have occurred throughout 2014 and 2015 as these will have a direct impact on reducing augmentation and replacement expenditure.

Recommendation 2:
The AER should apply a productivity factor to the SA Power Networks allowance for operating expenditure for the 2015-20 period.

Recommendation 3:
The starting point for SA Power Networks operating expenditure in the next regulatory period should not automatically be the same as the final year of the previous period. The EUAA expects SA Power Networks to introduce efficiencies in its operating activities both within and between regulatory periods.

Recommendation 4:
The EUAA urges the AER to disregard any customer research findings that promote increased expenditure. In many cases the surveys do not appropriately take into account consumer cost impacts for corresponding expenditure. The findings do not adequately represent business customers.

Recommendation 5:
The $86 million for bushfire related augmentation capital expenditure should not be approved, and the AER's preliminary decision should be upheld.

Recommendation 6:
The $20.1 million of extra capital expenditure claimed by SA Power Networks in its revised proposal for pole top replacements shouldn't be approved by the AER.

Recommendation 7:
The $144 million of non-network capital expenditure should not be approved and the AER's preliminary decision should be upheld.

Recommendation 8:

The SA Power Networks regulatory depreciation allowance for 2015-20 should not include the extra $402 million as calculated from shorter asset lives.

Recommendation 9:

SA Power Networks shouldn't achieve a step change allowance for additional operating expenditure for items relating to regulatory compliance or proposed customer driven initiatives.

Recommendation 10:

The calculation of the SA Power Networks rate of return should include a Market Risk Premium of 5.00% and an Equity Beta of 0.40. This will result in a rate of return lower than the AER's preliminary decision WACC of 5.45%.

2 Response to AER Preliminary Decision

2.1 Introduction

On April 30th the AER released its preliminary decision on the revenue allowance for SA Power Networks in which it determined that the proposed revenue should be reduced by $1.5 billion (or 32%). The preliminary decision, if upheld by the AER, will result in much needed price reductions for South Australian electricity users. This is an important development for South Australian industry, who have for several years experienced significantly elevated electricity costs as a result of prior distribution regulatory decisions.

Many of the recommendations presented by the EUAA in its January 30th submission on the SA Power Networks proposal have been addressed in the AER's preliminary decision. This includes the feedback provided on the inadequacy of the consumer engagement program, problems with the assessment of asset failure risk, and additional compliance expenditure not being justified by any new regulatory obligations. In this respect the AER's decision provides a good basis in which it can progress towards the final decision in October. However some items from the EUAA's January submission still need to be addressed. These are material cost escalators, utilisation of a productivity factor, and step changes in operating costs. These items are addressed as follows:

2.2 Material cost escalators

Real materials cost escalators should be used to account for expected changes in the cost of network infrastructure over the next regulatory period. The AER has recommended that a zero percent real materials cost escalation is reasonable. Its preliminary decision stated that "*Recent reviews of commodity price movements show mixed results for commodity price forecasts based on futures prices.*"[1] The EUAA considers that the AER is taking an overly conservative position in its assessment of real material cost escalators. There have been substantial falls in global commodity prices throughout the 2014/15 year for materials applicable to network infrastructure, in particular; steel, copper, and aluminium. These should be reflected as a reduction in material costs (and proposed capital expenditure) for SA Power Networks.

<u>Recommendation 1:</u>
In its final decision the AER should take into account real falls in material costs that have occurred throughout 2014 and 2015 as these will have a direct impact on reducing augmentation and replacement expenditure.

2.3 Productivity factor

The EUAA noted in its January submission that SA Power Networks should be required to include a productivity factor in its operating expenditure. The AER however has applied a productivity factor of zero in its preliminary decision. The reasons were that it believes distribution businesses are likely to follow productivity growth rates for electricity transmission and gas distribution industries. As it stated in its preliminary decision: *"This is because the specific factors that have resulted in declining productivity for the [electricity] distribution industry are unlikely to apply over the medium to long term and the distribution industry should be broadly similar to other energy networks."*[2] The EUAA considers that distribution companies, like any other business, should be encouraged to improve efficiency and implement programs to reduce operating costs. The AER has based its decision on the view that future productivity will be driven as a result of external factors such as falling inputs costs, rather than good management

[1] AER, Attachment 6 – Capital Expenditure for SA Power Networks' determination 2015-20, p157
[2] AER, Attachment 7 – Operating Expenditure for SA Power Networks' determination 2015-20, p67

practices. This approach does not encourage the efficient operation and use electricity services, as mandated by the National Electricity Objective.

<u>Recommendation 2:</u>
The AER should apply a productivity factor to the SA Power Networks allowance for operating expenditure for the 2015-20 period.

2.4 Step Changes in Operating Costs

The EUAA also notes that the AER hasn't reduced the SA Power Networks base year operating costs. As stated in its preliminary decision "*We forecast that SA Power Networks will be able to operate and maintain its network with little change in opex from current revealed opex levels.*"[3] The AER appears to have assumed that the starting point for the operating costs in the new regulatory period are efficient. Consideration should be given to a step change reduction in these base year costs, which would bring the SA Power Networks operating expenditure in line with its allowances for the 2005-10 regulatory period.

<u>Recommendation 3:</u>
The starting point for SA Power Networks operating expenditure in the next regulatory period should not automatically be the same as the final year of the previous period. The EUAA expects SA Power Networks to introduce efficiencies in its operating activities both within and between regulatory periods.

[3] AER, Attachment 7 – Operating Expenditure for SA Power Networks' determination 2015-20, p23

3 Response to SA Power Networks Revised Proposal

3.1 Introduction

The EUAA does not consider that SA Power Networks has made a reasonable response to the AER's preliminary decision. Many of the AER's recommendations have been challenged by the SA Power Networks proposal. It comes as no surprise that where SA Power Networks has not accepted a component of the AER's decision, SA Power Networks' response will result in more revenue for their business. In other words, most, if not all of the revisions put forward by SA Power Networks in its revised proposal would result in an increase to its revenue allowance. The SA Power Networks revised proposal should be considered as an exercise aimed at maximising revenue on behalf of its shareholders, to the detriment of South Australian electricity consumers. South Australian industry has experienced significant price increases in the previous regulatory period as a direct result of changes to distribution revenue recovery. It is therefore important that the AER's preliminary decision is upheld to provide some relief to consumers from these elevated electricity charges.

3.2 Consumer Engagement

SA Power Networks suggests in its revised proposal that the AER has given too much weight to the submissions it received as they were too few in number[4]. The EUAA finds this statement extraordinary. SA Power Networks is suggesting that the views of the consumer groups who participated in the AER's process should be largely ignored. Considering that the original SA Power Networks proposal consisted of 16,807 pages a response by 27 different organisations to the proposal is an excellent result. These organisations are largely made up of prominent and respected community and consumer groups who contribute important views on the determination process that would otherwise not be heard. In addition, energy regulation is a highly technical area and many consumer organisations do not have large budgets to allocate to writing submissions - unlike most electricity networks. An attitude of ignoring submissions on the basis of lack of number explains why the SA Power Networks consumer engagement program has been such a failure. As the AER noted in its preliminary decision, the SA Power Networks consumer engagement program is very much a work in progress.

In its revised proposal, SA Power Networks has reiterated that it is entitled to incremental expenditure as a result of its "comprehensive, robust, and representative" consumer engagement program. EUAA's January submission provided a review of this consumer engagement program and found it far from being comprehensive, robust or representative. In particular the program did not present survey respondents with an accurate trade-off between the additional cost impacts versus proposed network service benefits. Expenditure items that are likely to draw an emotive response from respondents were selected, such as bushfire risk and road safety. It raises a question why the additional expenditure for items such as IT, vehicles and regulatory compliance were not treated in the same way. Obviously these items would not show up in the survey results as being items in which consumers are willing to pay more.

It is difficult for SA Power Networks to argue that South Australian electricity consumers require additional expenditure when its consumer engagement program found that 79% of SA Power Networks sampled customers were satisfied with the current level of network performance and associated service levels[5]. In addition 88% of sampled customers are satisfied with their current level of reliability[6].

[4] SA Power Networks Revised Regulatory Proposal p30
[5] Willingness to Pay, NTF Group p11
[6] Deloitte Online Consumer Survey Report July 2013 p7

The consumer engagement program did not adequately represent South Australian business customers. SA Power Networks commissioned two online surveys during its Customer Engagement Program. These were the Deloitte Online Consumer Survey and the NTF Group's Targeted Willingness to Pay Findings. Neither of these two online surveys adequately represent business customers. For example the Deloitte Online Consumer Survey included only 54 businesses in its sampling, which represented 2% of the total respondents[7]. The EUAA considers that this is a significant oversight given that the SA Power Networks network has 99,180 business connections and 23 major business customers. Any findings made from these surveys cannot be considered representative of the needs of South Australian businesses.

On page 26 of the revised proposal SA Power Networks attempts to discredit the review conducted by the AER's independent consultants of the Willingness to Pay (WTP) survey. SA Power Networks argues that since the Oakley Greenwood review was limited to the WTP survey (and not the entire consumer engagement program) the findings cannot be used to claim that the consumer engagement program as a whole was too limited in scope. These comments should be considered as semantics – there is no doubt the WTP survey was limited to bushfires and road safety and SA Power Networks should have included other expenditure items when asking survey respondents about willingness to pay for network services.

SA Power Networks stated in its revised proposal that the submissions to the AER were "unsubstantiated, or technically lacking, assertions and subjective observations"[8]. The EUAA considers that the SA Power Networks own consumer engagement program is unsubstantiated, technically lacking, and uses subjective observations - for the reasons described above and in its January submission.

Recommendation 4:
The EUAA urges the AER to disregard any customer research findings that promote increased expenditure. In many cases the surveys do not appropriately take into account consumer cost impacts for corresponding expenditure. The findings do not adequately represent business customers.

3.3 Augmentation capital expenditure

In its preliminary decision the AER reduced SA Power Networks proposed capital expenditure by $800 million, or 32%. Of particular note was the $287 million augmentation expenditure for road safety and bushfire risk mitigation that wasn't accepted. The EUAA agrees with the AER's assessment that this expenditure is not required under any new or additional regulatory requirement.

In its revised proposal SA Power Networks seeks to recover $86 million of capital expenditure for the bushfire risk mitigation that doesn't relate to undergrounding of cables.

SA Power Networks proposed these costs on the basis of its consumer engagement program and with reference to requirements in other jurisdictions (notably Victoria). The EUAA provided a review of the Willingness to Pay survey in its January submission where it identified errors in the sampling approach and a poor question formulation. The EUAA also notes that the proposed spending is not required by any new regulatory requirements in South Australia and SA Power Networks does not have a mandate to undertake these initiatives. Any new safety compliance requirements introduced in other states (such as bushfire mitigation in Victoria) do not give SA Power Networks an obligation to undertake additional spending.

[7] Appendix 6.5 Deloitte Online Consumer Survey Report July 2013 p6
[8] SA Power Networks Revised Regulatory Proposal 2015-20 p16

In its revised proposal SA Power Networks argues that it is required to spend additional amounts on bushfire safety given the requirements of the Work Health and Safety Act 2012 (SA). However to the EUAA's knowledge these requirements have not been recently amended and do not contain any new obligations in relation to SA Power Networks management of risk. SA Power Networks also asserts that the risk of bushfires has increased, despite evidence from the AER's consultants to the contrary[9]. The risk of bushfires is not new and the EUAA contends that this risk should be addressed with a capital expenditure allowance closer to historical budgeted levels.

Recommendation 5:
The $86 million for bushfire related augmentation capital expenditure should not be approved, and the AER's preliminary decision should be upheld.

3.4 Replacement Capital Expenditure

The AER's preliminary decision included a $163 million or 21% reduction in the proposed replacement capital expenditure. The regulator found that the proposed replacement program was not based on a realistic assessment of asset failure risk. An example of this was the near fourfold increase in forecast stobie pole replacements as proposed by SA Power Networks.

In its revised proposal SA Power Networks challenged the AER's assessment for estimating replacement expenditure for pole top structures because it was based on actual data from the prior regulatory periods. The EUAA finds that the AER's approach for making this assessment (based on its historical analysis) is a sound and robust for estimating the necessary expenditure. This is particularly the case given that SA Power Networks has, of its own accord, increased asset inspections in advance of the new regulatory period. These additional inspections have been used by SA Power Networks to build a case that the risk of asset failure has increased from historical levels and that it needs more expenditure to address the supposed problem.

Recommendation 6:
The $20.1 million of extra capital expenditure claimed by SA Power Networks in its revised proposal for pole top replacements shouldn't be approved by the AER.

3.5 Non-network Capital Expenditure

In the preliminary decision non-network capital expenditure was reduced by $220 million or 35%. The AER did not find that the proposed expenditure for IT, property, and vehicles reflected the costs of an efficient distribution business.

In its revised proposal SA Power Networks is seeking to recover $144 million of expenditure for IT systems, fleet and property, RIN compliance, and the metering rule change. The EUAA does not consider that the arrival of competition in metering in 2017 will create significant capital expenditure burdens on SA Power Networks. Consumers who participate in metering competition will be seeking metering services from parties other than SA Power Networks. In addition, SA Power Networks is now able to charge for metering services separately via a capital charge (enabled by a recent AER decision).

SA Power Networks also argued in its revised proposal that it faces additional capital costs as a result of reporting requirements for the AER's regulatory information notice (RIN). This was on the basis that 76% of the information submitted[10] in the RINs was estimated and yet this

[9] SA Power Networks Revised Revenue Proposal p87
[10] SA Power Networks Revised Revenue Proposal p153

information must be prepared on a “best endeavours” basis. As stated in its January submission, the EUAA does not consider that SA Power Networks is entitled to an extra $15 million of capital spending to enable it to prepare its RINs. SA Power Networks should either; achieve savings and efficiencies under its existing cost structure, continue with its current approach for preparing the information, or the AER should reduce the requirement of the information reporting requirements.

The EUAA supports the AER’s preliminary decision on expenditure for fleet and IT on the basis that these items are discretionary and not required to meet SA Power Networks obligations under the NER.

Recommendation 7:
The $144 million of non-network capital expenditure should not be approved and the AER’s preliminary decision should be upheld.

3.6 Depreciation

In its preliminary decision the AER didn’t accept the proposed regulatory depreciation of $936 million and instead has determined an allowance of $534 million for SA Power Networks. The main reason for the change was that the proposed average depreciation method was found to consistently underestimate the remaining asset lives. The AER has instead substituted this approach with remaining asset lives calculated using a weighted average method. This is considered to more accurately reflect the actual economic life of the SA Power Networks assets. The EUAA supports the view that an approach that underestimates the remaining life of assets results in customers paying for assets too quickly and may encourage inefficient use and an early replacement of assets.

In its revised proposal SA Power Networks states that its proposed depreciation method avoids impacts on future generations, described as “inter-generational” issues. This statement can hardly be considered reasonable or addressing the interests of South Australian consumers given that the proposal would impact the current generation by $402 million over the next five years. This is the same generation that has incurred the excessive electricity price increases from the prior regulatory period. It is obvious to the EUAA and its membership that the regulatory deprecation allowance for existing assets should be spread over a longer period than five years.

The SA Power Networks revised proposal also claims that it is reasonable to depreciate its assets early given that disruptive technology may make the distribution network obsolete. “*A method which prolongs the depreciation of the RAB produces intergenerational equity issues and contradicts an approach that could, according to the AER, be appropriate if disruptive technologies become a factor in the energy sector.*”[11] The EUAA notes that a recent AEMO report[12] predicts that electric vehicles will have no impact on South Australian system demand over the next 20 years and battery storage will have minimal impacts. This is certainly not something for consideration in the current regulatory period and it is clear that SA Power Networks has constructed a very weak argument in defence of its higher deprecation allowance.

Recommendation 8:
The SA Power Networks regulatory depreciation allowance for 2015-20 should not include the extra $402 million as calculated from shorter asset lives.

[11] SA Power Networks Revised Regulatory Proposal 2015-20
[12] AEMO Emerging Technologies Information Paper June 2015

3.7 Operating Expenditure

In its preliminary decision the AER reduced the proposed operating expenditure by $294 million, or 19%. It accepted the proposed base expenditure, but not the proposed step change increases (the exception being NECF and mobile radio expenditure amounting to less than $10 million). As mentioned earlier in this submission, the EUAA contends that SA Power Networks should be required to achieve a step reduction in its operating costs for the first year of the new regulatory period. It should also have a productivity factor applied to its operating cost annual rate of change. SA Power Networks, like any other business, should be required to achieve efficiency savings in its operating activities over time. SA Power Networks argues that it is already an efficient firm and it is much easier for an inefficient firm to find cost efficiencies[13]. EUAA considers that SA Power Networks cannot be considered as an efficient firm until it is benchmarked to international network businesses. Productivity levels in Australian electricity distribution networks has declined markedly in the last five years and a benchmark comparison limited to local firms is not representative or a demonstration of best industry practice.

In its revised proposal SA Power Networks proposed an additional $60.2 million for labour cost escalations. This is over and above the AER's estimates which adopted a 62% weighting for labour and 38% for non-labour, and applied Deloitte's wages price index forecast for the Electricity, Gas, Water and Waste Services industry sector to labour. No real price escalation was applied to non-labour components. The EUAA supports the AER's assumptions on this item including the weighting between labour and non-labour components.

In its revised proposal SA Power Networks proposed additional spending of $59.7 million for regulatory and legal costs. These items included $34.7 million for asset inspections and $21 million for energy laws and regulations. The 2015-20 period does not impose any significant additional compliance obligations for SA Power Networks and these costs should already be accounted for in the base operating costs. These items should not be included in the expenditure allowance and the AER's preliminary decision on this item should be upheld.

Expenditure of $42.9 million was proposed for "customer driven" initiatives. This included vegetation management, customer services, and community safety. The EUAA has already commented extensively on the shortcomings of the consumer engagement program and finds that these additional expenditure items cannot be justified.

Recommendation 9:
SA Power Networks shouldn't achieve a step change allowance for additional operating expenditure for items relating to regulatory compliance or proposed customer driven initiatives.

3.8 Rate of Return

The AER's preliminary decision resulted in a rate of return for SA Power Networks of 5.45%. This is 217 basis points lower than the proposed value and is a result of reductions to both the proposed cost of equity and debt. SA Power Network varied its position on the cost of debt assumptions during the determination process and the most recent position wasn't accepted by the AER. The AER structured this and its position on cost of equity in accordance with its December 2013 guideline.

[13] SA Power Networks Revised Revenue Proposal p192

The EUAA has made several submissions to the AER on the rate of return for various electricity distributors. We have also had an extensive involvement in the AER's *Rate of Return Workstream* and stakeholder consultation on the calculation of WACC parameters.

Recommendation 10:
The calculation of the SA Power Networks rate of return should include a Market Risk Premium of 5.00% and an Equity Beta of 0.40. This will result in a rate of return lower than the AER's preliminary decision WACC of 5.45%.