ElectraNet

3 July 2015

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Australian Energy Regulator
GPO Box 520
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Via email – SAelectricity2015@aer.gov.au

Dear Sebastian

re: Submission - AER's preliminary determination on SA Power Networks' 2015-20 regulatory proposal

ElectraNet appreciates the opportunity to provide comment on SA Power Networks' 2015-20 Preliminary Revenue Determination released by the AER on 30 April 2015. This submission addresses the following key issues:

- Depreciation;
- WACC;
- Opex Step Changes; and
- Consumer Engagement.

Depreciation

ElectraNet notes that the AER was not satisfied that SA Power Networks' proposed regulatory depreciation profile reasonably reflects the nature of the assets over their economic life.

Consistent with the NER requirements in clause 6.5.5(b), the AER applied a straight-line depreciation method to the weighted average remaining life of SA Power Networks' asset base.

ElectraNet notes that while this approach provides a level of certainty and consistency for customers, it could be considered more appropriate in an environment where demand for energy is expected to be constant or growing over the life of the asset/s. While this has been the case in the past, it is unlikely to reflect the environment of the future.

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ElectraNet notes that clause 6.5.5(b) and 6A.6.3(b) of the NER give the AER the discretion to apply different depreciation schedules so that the depreciation profile reflects the nature of the asset/s or category of asset/s over the economic life of that asset/s or category of asset/s.

Further, the Determination has also applied RAB indexation to a straight-line depreciation profile for assets which has the effect of 'back loading' depreciation to the latter years of an asset/s' life. This 'back loaded' depreciation approach could also be considered more equitable in an environment where there is initially excess capacity, but there is an expectation that demand will increase over the life of the asset as more of the depreciation cost is absorbed in later years where the number of customers and/or demand is higher.

In the prevailing environment of flat or declining utilisation of the network, the AER needs to explore alternate depreciation approaches further. Given the growing uncertainty over long term network demand, a 'front loaded' depreciation approach applying either shorter asset lives or accelerated depreciation methods may be more appropriate, particularly for new network investments.

The key principle of a front loaded or accelerated depreciation approach is that the amount of depreciation decreases progressively for each year of the productive life of an asset. This makes sense in the current environment where there is uncertainty in the future over whether there will be a lower number of customers and/or demand to absorb largely fixed network costs and is in the long terms interests of consumers.

WACC

As noted in the Preliminary Determination, the rate of return framework recognises that there may be several plausible answers that may achieve the allowed rate of return objective. The final rule determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 No.9, considered that the estimation of the required rate of return could be improved by permitting the AER to take account of a broad range of information. The rate of return Guidelines therefore specifically do not include preferred methods for determining the rate of return and enable the AER to exercise judgement as to what is the best approach.

In assessing SA Power Networks' rate of return, the AER considered some options for determining the return on debt and equity in the first year which combined various forms of 'on-the-day' and 'trailing average' approaches. Under the Guidelines the AER has the ability to provide for variable transition paths for WACC depending on circumstances. However, the AER determined that SA Power Networks proposed approach which departed from the approach in the Guideline would not result in an outcome that better achieves the allowed rate of return objective.

ElectraNet notes the AER's view as per the Rate of Return Guidelines that there should be a gradual transition from the on-the-day approach to the trailing average approach to determining the cost of debt. However, ElectraNet believes the AER should afford greater flexibility to NSP's in transitioning.

ElectraNet encourages the AER to ensure that in all of its determinations it carefully considers any alternate approaches proposed through thorough examination of the evidence as to whether they can achieve the rate of return objective more effectively.

Opex

The AER did not accept the majority of SA Power Networks' proposed opex 'step changes' on the basis that the proposed programs will generate efficiencies and therefore pay for themselves. The AER determined this on the basis that SA Power Networks is already rewarded through incentive payments through the Efficiency Benefits Sharing Scheme (EBSS) for opex efficiencies during the regulatory control period. Therefore, in its view, to award funding for programs over and above the historical expenditure would be inconsistent with the incentive based regime.

ElectraNet agrees that the purpose of the EBSS is to provide an incentive for service providers to pursue efficiency improvements in opex during a regulatory control period. The incentive provides for a fair sharing of benefits between service providers and network users and is designed to reward businesses for becoming efficient over time, and conversely penalising them for becoming less efficient.

However, the AER's preliminary determination becomes problematic if the proposed opex initiative/program does not achieve payback within the regulatory period, as the TNSP is entitled to retain the savings realised for a maximum of 5 years under the scheme. If an initiative does not return efficiencies until for example year 7 or 8, then the NSP would be unable to recover the cost of the initiative and there would be no incentive to fund the activity.

The NSP would in fact be penalised for appearing to overspend during the relevant period for such an initiative that should be pursued in the interests of consumers. This would run counter to the incentive based regime which is designed to incentivise, capture and share such efficiency benefits with consumers.

ElectraNet notes that the AER's assessment of opex factors in the Preliminary Determination does not appear to have had regard to project payback periods for step change projects. ElectraNet encourages the AER to further consider appropriate funding for efficiency initiatives that will deliver savings to the benefit of consumers over longer payback periods when assessing proposed 'step change' initiatives.

Consumer Engagement

The AER's Consumer Engagement Guideline requires network service providers to build consumers' capacity to understand issues where matters are complex and greater consumer understanding will improve consumer engagement[1].

This expectation appears somewhat at odds with the AER's statement in the Preliminary Determination that there are already a range of sources available to help explain to consumers how the electricity industry works and what tariffing options are available.[2] In order to promote meaningful and informed engagement, all regulated network businesses should be seeking to, and have adequate opportunity to, appropriately educate consumers.

The AER is required to have regard to the views of consumers on the operating expenditure forecasts as part of Network Service Providers' consumer engagement activities. However, it appears that the AER has placed more weight on the views expressed in a number of

1 AER Consumer Engagement Guideline for Network Service Providers November 2013 p.8

2 AER Preliminary Decision Attachment 7 – Operating expenditure SA Power Networks' Determination 2015–20 p.7-103

submissions rather than the information provided as part of SA Power Networks' detailed consumer engagement program, which appears statistically robust. Oakley Greenwood's peer review of SA Power Networks' Willingness to Pay study for example concluded that, whilst it could have been improved, the sample size used was likely to provide results that are statistically valid for the overall customer base[3].

The AER's Consumer Engagement Guideline requires Network Service Providers to obtain a cross section of views on their proposals. It is also acknowledged in the Guideline that there will be a wide range of views and even differing views from those affected by a proposal compared to the wider consumer base[4]. The AER should therefore afford appropriate weight to the evidence presented to it on the views of consumers from all sources to ensure a balanced assessment of Network Service Providers' proposals.

If you have any queries or require additional information please do not hesitate to contact Simon Appleby on (08) 8404 7324 to discuss any aspect of this submission.

Yours sincerely

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3 Oakley Greenwood Peer review of the willingness to pay research submitted by SAPN p.6
4 AER Consumer Engagement Guideline for Network Service Providers November 2013