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Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601
Email: AERInquiry@aer.gov.au

Dear Mr Anderson

Submission to Australian Energy Regulator – NSW electricity distribution revenue determinations

EnergyAustralia is pleased to provide this submission to the Australian Energy Regulator's consultation process for the NSW electricity distribution regulatory proposals for the period 2014–15 to 2018–19.

EnergyAustralia is one of Australia's largest energy companies, providing gas and electricity to over 2.7 million household and business customers in NSW, Victoria, Queensland, South Australia and the Australian Capital Territory. EnergyAustralia owns and operates a multi-billion dollar portfolio of energy generation and storage facilities across Australia, including coal, gas and wind assets with control of over 5,600 MW of generation in the National Electricity Market.

Network costs represent a substantial component of the final bill that our customers face. Therefore, EnergyAustralia emphasises the importance of ensuring that approved expenditure is efficient and prudent, and that regulated tariffs sends appropriate signals to customers about energy consumption and investment. This includes the form and scale of investment in distributed generation and storage capacity. The AER's final determinations for the three NSW businesses are important for their own sake but also set important precedents for the forthcoming revenue proposals of the South Australian, Queensland and Victorian electricity distribution businesses.

This submission draws heavily on analysis undertaken by Oakley Greenwood that was jointly commissioned by EnergyAustralia, Origin Energy and AGL; Oakley Greenwood's report is included as an attachment and should be read in conjunction with this letter.¹ The analysis relates primarily to specific aspects of the distribution businesses' proposed operating expenditure programs and their proposed exit fees for meters across their networks.

However, EnergyAustralia also has observations about other aspects of the businesses' initial proposals and the AER's approach to their assessment. We note the significant network investment that occurred across the three networks during the most recent regulatory period and which is now apparent, has coincided with a decline in average (if not peak) electricity demand. While the three network businesses revised their expenditure plans during the last years of the regulatory period, actual network expenditure has been a significant driver of observed increases in energy prices.

Looking ahead, it is important that approved expenditure is efficient, reflects a reasonable expectation of future demand and how it varies across and within networks and the evolution of energy markets more generally. This includes the manner in which energy is generated and transported, and how this might evolve. The adjustment of some segments of the electricity supply is already occurring (through the withdrawal of generation capacity, for example). The Australian Energy Market Operator's *2014 Electricity Statement of Opportunities* further documents the decline in electricity demand across Australia.

To this end, EnergyAustralia fully supports and encourages the application of the AER's *Expenditure Forecast Assessment Guideline for Electricity Distribution* and its *Rate of Return Guideline*. Furthermore, EnergyAustralia is pleased that the AER drew attention to the following in its Issues Paper given their importance under the building-block model:

- financial markets are more certain than at the time of the previous determination and that the cost of finance has come down as a result;
- less onerous network planning standards mean there are reduced imperatives for network investment and that the owner of these businesses (the NSW Government) is also actively seeking tighter controls on network investment and operating efficiencies
- demand has been weakening for a number of reasons, including sharp increases in electricity prices.

The AER will need to carefully consider how changes to electricity demand will impact the three NSW distribution networks in terms of the adequacy of existing capacity, the volume of investment that is necessary to maintain and augment the network in line with reasonable estimates of demand, and the location of that demand.

An area of analysis for AER should be the interrelationship between operating expenditure and capital expenditure and, for example, whether the businesses' programs to reduce the age of the network necessitate reduced opex. We endorse the AER's proposition that more efficient operating practices should require less opex and capex than in the past. Similarly, it is reasonable to expect that the outcome of substantial capital investment programs that reduce the average age of assets across the network might be a material reduction in ongoing preventive / defect management / emergency repairs effort.

¹ While the businesses jointly engaged Oakley Greenwood, they have not collaborated in the preparation of their submissions to the AER's consultation process and each business has independently interpreted and referred to the report in their respective submissions.

The AER should carefully analysis expenditures from a total factor productivity and normalised benchmarking perspective that ensures all of the revenue building blocks are evaluated together, rather than in isolation. This approach, together with deep dives into specific areas of expenditure, is central to any well targeted prudence and efficiency review

EnergyAustralia also encourages the AER to give particular attention to proposed expenditure programs and specific items resulting from the businesses' regulatory obligations and licence conditions – in relation to environmental, safety and vegetation management, for example. This includes the extent to which the respective regulatory frameworks afford the businesses discretion in how they meet those obligations. As Oakley Greenwood notes, there are some examples where the businesses propose increased expenditure in order to comply with regulatory obligations even though the obligations themselves do not appear to have changed.

We recognise the challenges posed by the interaction of economic and technical / safety regulation but encourage the AER to give careful consideration to the businesses' compliance programs and resulting expenditures, including:

- the businesses' assumptions about the probability and severity of events and how they propose to manage risks;
- the range of options the businesses' have considered;
- processes for options identification and cost-benefit analysis, including techniques for quantifying benefits for which market prices cannot be readily observed, and evaluation and assessment criteria; and
- procurement processes.

EnergyAustralia further recognises there will be instances where regulatory obligations are more prescriptive and the implementation and ongoing administration may or may not be informed by effective cost benefit analysis. Similarly, these frameworks may create perverse incentives or allow for and encourage over-performance.

Metering exit fees

Regulated exit fees are an important input to any business case for a market led rollout of smart meters and therefore, their level can promote or obstruct any such rollout. Therefore, AER's determination has important implications in NSW and sets an important precedent for other jurisdictions.

The potential benefits of smart meters are well understood and most recently, were articulated in the context of the *Smart Grid, Smart City* project (for which EnergyAustralia was the retail partner), which tested a range of smart grid technologies and gathered information about the benefits and costs of implementing these technologies in an Australian setting.

EnergyAustralia has previously argued in its submission to AEMC's analysis of a rule change request seeking to establish arrangements that would promote competition in the provision of metering and related services in the National Electricity Market (*ERC0169*) that clearly defined and transparent exit fees for accumulation and manually read interval meters will encourage competition and investment in smart metering services.

In terms of their level, EnergyAustralia holds the view that meter exit fees should be set at a reasonable value that is capped with a transparent reducing fee path. The market will then have certainty when developing strategies for mass roll outs of smart meters.

EnergyAustralia encourages the AER to not only assess the efficiency of the cost of administering the installation of a smart meter but to also consider the relative merits of alternative approaches to cost recovery by networks (whereby metering costs could be reallocated into alternative network asset bases, exit fees are capped and stranded asset costs are then recovered primarily through Distribution Use of System charges, for example). This would result in a minimal (or zero) exit fee based solely on efficient administrative costs, which as Oakley Greenwood notes, are likely to be lower than the costs proposed by the NSW distribution businesses.

We note the AER indicated a willingness to consider various options for the recovery of efficient metering costs, stating in its submission to the AEMC's review of competition in the provision of metering and related services in the NEM that:

We are conscious of the need for exit fees to be efficient and cost reflective. We are also aware of the need to consider how the treatment of exit fees could affect customers wanting to switch to more advanced metering and competition in these services. There are various options here, including having high ongoing metering costs with low exit fees or vice versa, and the options of directly allocating fees to customers or smearing these across the customer base. We intend to examine and develop our approach in consultation. This would ideally be through a guideline that could provide our approach on a nationally consistent basis.

Given their importance in determining the likelihood of a market led rollout of smart meters, EnergyAustralia would like to draw particular attention to the following aspects of Oakley Greenwood's analysis of the NSW businesses' proposed exit fees:

- Ausgrid's proposal for a single exit fee based on a single volume-weighted depreciated value across the stock of meters, even though it can be argued that the rationale for the installation of Type 5 meters is unclear. As Oakley Greenwood notes, 'there has not been anything in the Rules or relevant regulation or legislation that has directed the NSW distribution businesses to install Type 5 meters in residential and small business facilities'.
- Where a Type 5 meter has been installed to provide a more cost-reflective price signal the additional benefits that accrue are likely to be categorised as network benefits, in which case, the amount by which the cost of Type 5 meters exceeds the cost of Type 6 meters should be a cost of providing Standard Control Services and therefore, more appropriately recovered through DUoS charges. Alternatively, EnergyAustralia suggests the absence of any policy directive or legislative / regulatory obligation to install Type 5 meters should prohibit the recovery of any additional stranded asset costs.
- Lack of clarity among the three businesses in their approach to the estimation of the costs on which proposed exit fees are based. This creates concerns about the following:
 - perceived inconsistencies in their approach to the estimation of stranded asset and administrative costs;

- excessive administrative costs for each business, particularly where the activities should involve little more than a change in information about the entity responsible for the meter, the identity of the Metering Coordinator and enough information to verify that the meter is appropriate for the relevant application and tariff;
- absence of any clear link between administrative costs and the time required to process a meter change;
- calculation and allocation of corporate overheads to both the administrative and stranded asset component of proposed exit fees
- Suggestion that the AER consider feasible options for the recovery of efficient metering costs based on Optimised Deprivation Value or the recovery of stranded asset costs primarily through DUoS charges rather than exit fees.

On this point, EnergyAustralia notes that the benefits of smart meters are diverse and widespread, and relate to retail and network operation. Such benefits include the following:

- development of retail products that are based on superior information about consumption profiles and as a result, are better aligned to customers' preferences and requirements;
- improvements to the accuracy of bills;
- improved fault detection and rectification;
- facilitation of more cost reflective tariffs that encourage more efficient network utilisation and investment;
- avoidance of certain faults and overload conditions;
- improved identification of tampering, bypass, imbalances and poor power factors.

Furthermore, these benefits also accrue to consumers who have not elected to install a smart meter at their premise when provided the total number of smart meters across the network has reached some significant level. A market led rollout of smart meters will ensure this occurs in a timely and efficient manner. Therefore, EnergyAustralia recommends that the AER should consider mechanisms for realising the aforementioned benefits.

Operating expenditure forecasts

Oakley Greenwood has also made a number of important observations about the businesses' operating expenditure proposals which warrant further consideration and utilisation by the AER of the full range of its analytical tools. This includes the new benchmarking techniques it has developed under the National Electricity Rules to use in conjunction with its existing assessment techniques to inform the assessment of networks' proposed expenditure. Those observations to which EnergyAustralia wants to draw particular attention are as follows:

- Questioning the selection of actual expenditure in 2012-13 as the base against which to assess expenditure in other years. Oakley Greenwood concludes that it is unclear whether expenditure in this year is efficient or whether it represents a move towards efficient levels and recommends the AER undertake its own analysis.
- Businesses' proposal to include dis-synergy costs at a conceptual level, in terms of the amount claimed and differences in its estimation across the businesses.
- Businesses' basis for calculating and estimating the average cost of various operational functions, such as inspections;

- Businesses' use of their Enterprise Bargaining Agreement as a basis for forecasting future labour costs, noting the AER's previous treatment of such an approach.
- Businesses' approach to the escalation of inspection and maintenance and in particular, the absence of any clear relationship between RAB growth and the number of 'required' inspections. Oakley Greenwood notes differences in methodology across the businesses and the notable difference between the NSW proposals and allowable escalations in other AER determinations. A further example is Essential Energy's proposal to recover stranded operating costs resulting from its reduced capital expenditure program. EnergyAustralia reiterates the importance of AER closely analysing the interrelationship between operating and capital expenditure.
- Endeavour Energy's proposed approach to vegetation management, including the justification for the proposed increase in vegetation management spend despite the absence of any apparent change in regulatory obligations. As noted, EnergyAustralia encourages the AER to focus on expenditure by each business that is undertaken in order to comply with regulatory obligations, particularly where the businesses are afforded discretion in how they comply with those obligations.

Importance of tariff reform

It is important to ensure expenditure is efficient, and reflects reasonable demand forecasts and the value of customer reliability. Inefficient or unnecessary capital expenditure that does not reflect future demand for network services should be disallowed and therefore, excluded from the Regulatory Asset Base.

However, it is equally important to encourage efficient utilisation of the existing asset base and to promote efficient network investment over the longer term; this will be achieved through tariff reform. More cost-reflective network tariffs mean customers will face the true cost of network utilisation and make informed and efficient decisions about how much and when to consume energy.

EnergyAustralia is mindful of the scope of AER's role and of the AEMC's analysis of proposed changes to the way by which distribution network prices are set and structured (*ERC0161, Distribution Network Pricing Arrangements*). However, EnergyAustralia takes this opportunity to restate those conditions that it considers necessary for achieving an orderly transition to more cost reflective network tariffs, namely:

- competitively determined pass-through of network charges by retailers to their customers – retailers are in the best position to design final energy offers that serve their customers based on all input costs, including network tariffs;
- steady progress toward the roll out of the lowest cost sources of advanced metering across jurisdictions – it is imperative to achieving the benefits of cost reflective pricing that retailers and their customers have the necessary information to respond to price signals and that this is delivered in the most competitive way;
- minimum standards to be established in the National Electricity Rules for engagement between network service providers and retailers (and their customers) – that ensure adequate consultation and advanced notice of significant changes to tariff structures and final changes to tariff levels;
- government support for vulnerable customers exposed to unacceptable price/cost increases as a result of more cost reflective network pricing – in the form of community service obligations/ out-of-market transfers; and

- government to assist with the task of creating awareness and acceptance of the inevitable transition to cost reflective pricing of energy network services – in the form of public communication campaigns that explain how and why such a transition is in the long term interests of the community.

If you require any further information with regard to this submission, please contact me on (03) 8628 1479 or via email at geoff.hargreaves@energyaustralia.com.au.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'G Hargreaves', with a stylized flourish at the end.

Geoff Hargreaves

Regulatory Manager, Retail