Energy Consumers Coalition of South Australia

Australian Energy Regulator

SA Electricity Distribution Revenue Reset

The SAPN revised proposal

A response

by

Energy Consumers Coalition of South Australia

July 2015

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The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission.

The content and conclusions reached are the work of the ECCSA and its consultants.

This response from the Energy Consumers Coalition of SA (ECCSA) to the South Australian Power Networks (SAPN) revised proposal is an adjunct to the response the ECCSA made to the original proposal made by SAPN and to the ECCSA response to the AER Preliminary Decision on the initial SAPN proposal. Accordingly, this response is to be considered in conjunction with the earlier ECCSA comments.

In its revised proposal, SAPN has proposed the following changes to the AER Preliminary Decision:

- $75 million in replacement capital expenditure to correct modelling and escalation errors made by the AER;
- $86 million in safety augmentation capital expenditure to enable our bushfire mitigation program to be implemented and to deliver on customer concerns;
- $144 million in capital expenditure to invest in the non-network category including our IT systems, fleet and facilities;
- operating expenditure to meet regulatory obligations and requirements ($64 million), improve vegetation management ($33 million) and address the impacts of our capital investment program ($30 million);
- $60 million for real increases in labour costs and output growth;
- an updated rate of return of 7.09% which, together with changes to our regulatory asset base, adjust the rate of return on assets revenue component by $348 million (nominal, $);
- $237 million (nominal, $) in our tax allowance to be consistent with a previous decision of the Australian Competition Tribunal plus higher overall proposed revenue;
- $505 million (nominal, $) in our regulatory depreciation allowance after applying our revised asset register approach plus capital and CPI; and
- $21 million of combined ACS capital and operating expenditure to address omissions and modelling errors made by the AER.

The ECCSA has already made its views clear regarding many of aspects behind these adjustments and sees little in the SAPN revised proposal to change the views earlier expressed.

However, the ECCSA provides the following additional points which give rise to a view that SAPN has not fully understood:

- The views of consumers,
- The intent of the revised rules relating to network regulation or
- The amount of effort that the AER went to provide operational guidelines that, as a suite of guidelines, provides a reasonable and reasoned approach to reflect the revised rules and the long term interests of consumers.

The ECCSA is concerned that throughout the revised proposal SAPN points to rule requirements as supporting their position in refuting points made by the AER in its preliminary decision. The ECCSA points out that in addition to complying with the rules, the AER now has an over-arching requirement that its decisions must deliver an outcome that reflects the National Electricity Objective (NEO) which requires the AER to ensure that its decisions are made in the long term interests of consumers. Thus, if there are competing views as to what is intended by a particular rule, then the AER (and any reviewer of the AER decision) must apply a test as to what is in the long term interests of consumers when reaching a conclusion.

Also throughout the revised proposal, SAPN discusses specific issues where it considers the AER has erred and that the allowance should be increased because of a perceived error in relation to the specific issue. What SAPN overlooks is that the AER independently builds up an overall cost to provide the services as if the provider was efficient and prudent. This means that overall, there will be different views as to what an allowance for a specific aspect might be, but it is recognised that there will be variances in views and that there will be variances in costs for specific elements of work. So for SAPN to focus purely on issues where they seek increased allowances does not reflect that in other areas the AER forecast allowance might be too high. It is for this reason that the rules and the law have been varied some that there is now a requirement to examine the issues holistically and to move away from the ability to "cherry pick" and look at aspects in isolation.

The ECCSA provides its view on the concerns it has with aspects of the SAPN revised proposal.

1. Long term interests of consumers

The ECCSA notes SAPN considers that much of its proposed increases in expenditure are supposedly to support the long term interests of consumers. A core aspect in the development of its revenue is supposedly based on the resultant prices for the services provided will not increase because consumers have advised that they do not want increases in prices and that current levels of reliability are sufficient. SAPN therefore effectively concludes that its proposal and revised proposal meet the requirement of the NEO.

The ECCSA points out that the outturn maintenance of current prices from the SAPN proposals are essentially predicated on the current low cost of capital. The ECCSA is sanguine enough to recognise that the current low costs for capital are unlikely to remain low for more than a limited time and at some point in the future, will return to and even exceed the long term averages. This will result in considerable increases in prices, especially as they will include costs for the additional work SAPN has included in its proposals, the costs for which are currently obscured by a relatively short term low cost of capital regime.

Where the SAPN cost structure development falls down is that if it applied the long term average costs for capital to its current proposals for opex and capex, then the costs for the service provided would show a massive increase in prices.

This shows that the only way that SAPN has been able to convince some consumers that its proposals for the discretionary expenditures proposed (eg road safety, bushfire related prevention, increased vegetation management, etc) was based on the view that prices would not increase. SAPN has implied that its new pricing can be contained with all of these new and discretionary issues. This is misleading in the extreme because the only reason that this is apparently possible is because it is based on costs of capital which reflect an aberration from long term averages.

So essentially, SAPN has proposed some massive increases in capex and opex that will have a severe impact, in the long term, on consumers as these costs will be embedded into the SAPN cost structure for many years, especially as the capex proposed has a life of many decades.

Put simply, SAPN has proposed using the short term low costs of capital to impose costs onto consumers that will have a negative impact on consumers over the long term. The ECCSA considers that the AER was correct not to include into the opex and capex many of the allowances as it developed its assessment of an efficient revenue allowance for the notional stand alone efficient and prudent electricity network services provider.

2 Consumer engagement program

In addition to the comments in the foregoing section, the ECCSA points out that SAPN has been less than open about the outcomes of the consumer engagement it has undertaken.

The ECCSA recognises that SAPN has been diligent in developing its consumer engagement program but equally, at such an early stage in the program, to assert that consumers are willing to pay more for discretionary services is an extreme extrapolation of the views provided by consumers. To make such assertions, SAPN has to demonstrate that consumers were able to provided fully informed input to the significant cost increases.

As noted in section 1.1, SAPN has been able to assert that prices would not increase (or if they do, by only small amounts) as a result of the discretionary expenditure proposed. In the consumer engagement ECCSA and its affiliates have been exposed to, such detailed information and understanding of the context in which such proposals were made by SAPN and others were conspicuously lacking, predominately because of the complexity of the issues and of the lack of information provided about the responsibilities SAPN has (or does not have for example in the issue of road safety and some bushfire mitigation) and the cost structures SAPN is already provided with to implement its responsibilities. The ECCSA pointed out these in its initial submission.

In its revised proposal, SAPN provides extensive criticism of consumer advocates and the AER because of their lack of preparedness to accept the SAPN assertions that its consumer engagement was, and is, robust and that its conclusions are valid. The ECCSA considers that it is not so much the process that SAPN has used that leads to the conclusion that the assertions made by SAPN about its consumer engagement are incorrect, but the amount of information that SAPN provided to consumers and the context that it was provided in.

SAPN makes it clear that consumers are not keen on prices increasing, now or in the future. Yet SAPN has not made it clear that the only reason prices will not increase with the inclusion of all of these new discretionary (nice to have) is because of the current low cost of capital which is unlikely to remain at such low levels into the future. SAPN challenges the "willingness to pay" assumptions made by the AER and some consumer advocates[1], yet without SAPN highlighting that prices would have increased considerably under long term average costs for capital, it continues to maintain that its consumer engagement has provided acceptance for these discretionary activities.

The ECCSA considers that, without SAPN providing the full context for the discretionary projects, then its assertions of consumer support cannot be accepted as consumers were not fully informed.

3. Bushfire mitigation

The ECCSA would like to see electricity networks not being the cause of any bushfires. However, the ECCSA is also aware that the cost to achieve this nirvana is well beyond the ability of consumers to fund[2]. Further, the ECCSA also notes that the bulk of bushfires are not caused by electricity networks so even making electricity networks perfect will not prevent bushfires occurring in the future.

Related to the points 1.1 and 1.2 above, whilst SAPN recognises that the Victorian Bushfire Royal Commission (VBRC) has made a number of recommendations involving electricity networks which the Victorian government is in the process of implementing, SAPN has not made it clear to those

[1] These assumptions include assessments of the large numbers of consumers who are already having difficulty in paying to electricity at current price levels, let alone increased prices
[2] This has been made painfully obvious through the detailed and extensive assessments made by the Victorian Government (and its agencies) as it endeavours to implement the recommendations of the Victorian Bushfire Royal Commission

consumers it consulted regarding SAPN bushfire mitigation proposals, that the Victorian government has both provided funding of its own to assist in mitigating network caused fire starts, and has also recognised that there are a number of more cost effective solutions to prevent network fire starts than those proposed by the VBRC. It must also be pointed out that the Victorian networks are only implementing action because the Victorian government is legislating for such changes.

If SAPN considers that the measures being implemented in Victoria are appropriate, it should, rather than seeking to implement such work as a result of consumer engagement, be seeking the SA government support for measures such as those implemented by the Victorian government, recognising that the Victorian government is addressing the issue in the most cost effective way.

This lack of context provided by SAPN adds further doubt on the SAPN assertions generated by supposedly fully informed consumers.

4. Weighted average cost of capital

SAPN does not accept the AER approach to setting the weighted average cost of capital in terms of return on equity, return on debt and tax imputation.

4.1 Return on equity

SAPN asserts that its risk profile has changed and therefore the AER approach to return on equity developed during the Better Regulation program does not reflect this change in risk. The ECCSA finds this assertion self serving in the extreme as the Better Regulation program was finalised within the past 2 years and must be considered to be contemporary.

SAPN offers little additional new information to that considered by the AER during the Better Regulation program and therefore the ECCSA considers that the AER preliminary decision is correct, albeit rather conservative as explained in our response to the AER preliminary decision on the SAPN proposal.

The main new information provided by SAPN relates to the staff report from the RBA which indicates that the return on equity sought by firms is more stable than the movement of the risk free rate for money. The ECCSA is also aware that the work done by the RBA staff reflects the needs of firms in competition rather than monopoly providers which have very low risk and a guaranteed cash flow.

The ECCSA members use a number of different tools for assessing future investments (such as DCF, IRR, payback period, etc) but this only applies to new investments and it is recognised that the set points identified with such tools include significant conservatism to make provision for unforeseen costs and for changes in the market. Whilst SAPN does have some risk exposure for costs, the greater risk faced by those firms in competition lies with future market changes. The structure of regulation applying to SAPN eliminates market risk and provides overt incentives to mitigate cost risk exposure. So for SAPN to imply that the RBA assessments apply to it, does not reflect the actuality of the risks that SAPN faces.

Further, firms operating in a competitive market do not use such models for assessing what they expect to achieve from sunk investments - in fact the market determines what the returns will be. As most of the return on equity sought by SAPN comes from sunk investments, the use of forecasting tools (such as DCF, IRR, payback period, etc) is, to a large degree, irrelevant for use in the setting of equity returns for SAPN assets. On this basis, the ECCSA considers that the RBA work has only minor relevance to setting an equity return for SAPN

The points raised by SAPN are the same as those raised by the NSW electricity networks and will be addressed by the Australian Competition Tribunal (ACT) in the near future. On this basis the ECCSA considers that the AER guideline on return on equity should stand unless the ACT determines otherwise.

4.2 Return on debt

SAPN appears to be seeking for the new approach to setting the return on debt to be a full trailing approach as proposed by the NSW electricity networks. This issue is also to be determined by the ACT so the ECCSA considers that the ACT decision will either support the AER approach or that proposed by the electricity networks.

What is concerning is the SAPN appears to be rewriting history as they have been supportive of the transition approach detailed in the AER guideline. What SAPN overlooks is that the AER approach addresses the different approaches used by those firms that have such a large debt requirements that debt acquisition could not be addressed as a single debt amount and those where they acquired their debt in a single tranche or hedged the "on the day" allowance so it has effectively the same outcome as a single acquisition of debt. The AER transition approach provides an equitable balance between the needs of all networks rather than the desires of one over another.

One other major issue for consumers is that the supposed acquisition of debt on a rolling basis by each network caused them to be exposed to high debt costs during the global financial crisis, yet examination of annual reports does not support this contention. To assume that SAPN (and other networks) acquired debt at these high rates when they did not actually incur the cost merely provides the networks with an "unearned" recovery of a cost that never occurred because of an assumed transition. The AER approach in its guideline prevents this occurring and the guideline therefore an outcome in the long term interests of consumers.

The ECCSA has previously provided its views on the AER guideline and these highlight that the guideline is quite conservative. Despite this conservatism, the ECCSA (and many other consumer advocates) accepts the AER guideline in its entirety rather than to cherry pick parts of the guideline that networks consider detrimental to them and propose alternatives.

The ECCSA notes that SAPN has views on other aspects for the setting of the return on debt and these have been addressed in the other submissions by the ECCSA.

4.3 Imputation

SAPN reiterates its view that the AER should have set gamma at 0.25, despite the AER assessments to the contrary. The ECCSA has provided its views on this issue in other submissions and the information provided by SAPN does not seem to provide new information that should cause a change to the AER position.

This issue is also to be reviewed by the ACT so the ECCSA considers that the outcome of that process should be made clear before entering into further debate.

5. Depreciation

SAPN has proposed a modification to the approach to depreciation used by the AER. The ECCSA recognises that there are a number of different ways assets can be depreciated but considers that depreciation needs to be made consistent across all electricity network regulation.

In particular, the ECCSA

- Considers that depreciation needs to be balanced so that there is not a transfer of cost from current consumers to future consumers or the reverse - each generation of consumers should pay equitably.
- Is aware that networks are potentially facing the need for asset write downs and that if faster depreciation rates used, the less risk networks would face in the event of write downs being required
- Notes that with the current low cost of capital, there is an incentive to accelerate depreciation when this acceleration would be less noticeable because the accelerated depreciation would offset lower prices (ie effectively current consumers would pay more for depreciation because this would not increase prices)

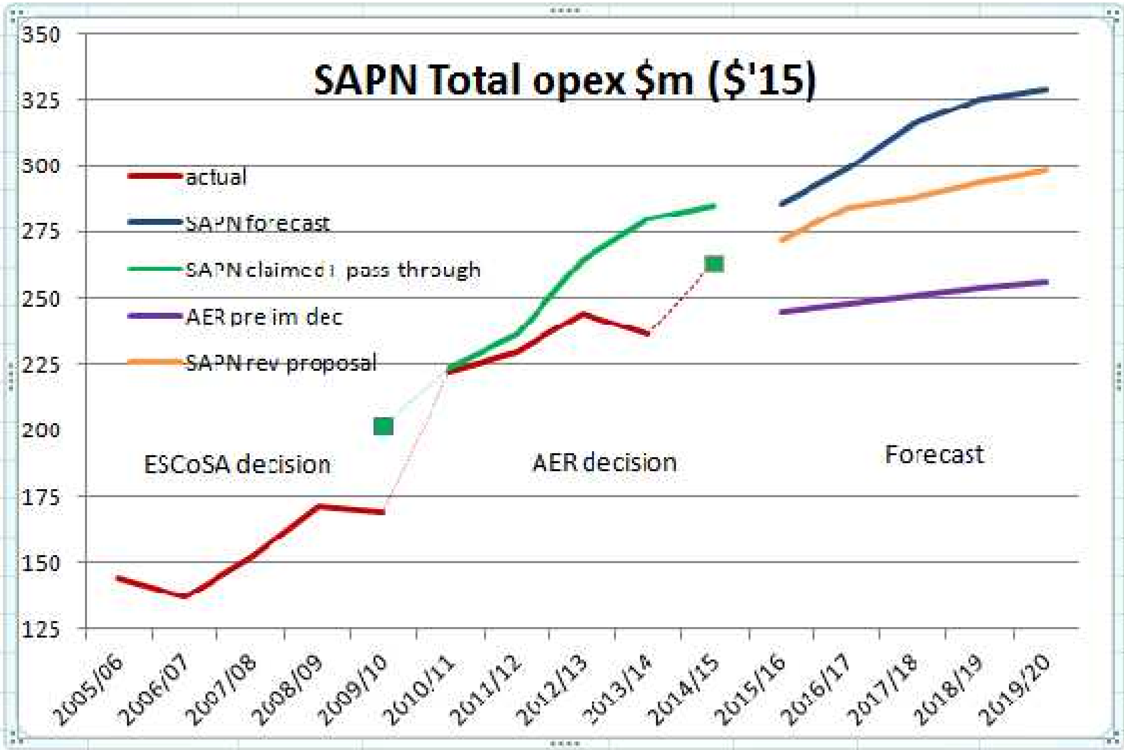
With these thoughts in mind, the ECCSA considers that there needs to be a standard approach to depreciation applying to all electricity networks. This is practicable because the AER is required to address regulation on the basis that it is setting revenues and prices for the notional efficient and prudent network rather than to a specific network which might have its own unique approach to depreciation.

The ECCSA notes that both the AER and SAPN agree that the correct approach to depreciation would be to depreciate each specific asset needed to provide the service. Both agree that such an approach is excessively intensive and there needs to be a method where some averaging can occur in order to reduce the administrative burden. SAPN proposes a model which has a higher cost of depreciation (with current consumers bearing a greater contribution) and the AER an approach which results in a lower cost of depreciation (with SAPN asserting future consumers bearing a greater cost - an intergenerational transfer of cost).

The ECCSA considers that the AER approach to setting depreciation is preferred because it is consistent with past regulatory practice and is seen to be equitable between current and future consumers using the services provided by SAPN.

6. Opex

Overall, SAPN has reduced its opex claim in its revised proposal as is shown in the following chart, but not to the level considered by the AER to be efficient.



Source: SAPN application, SAPN economic benchmarking data templates, SAPN benchmarking RIN 2013/14, AER prelim decision, SAPN rev proposal

Even though SAPN has reduced its opex, it is still claiming a significant increase from the current trend and is similar to the amount of opex allowed for the current period which SAPN significantly under cut. This appears to be inconsistent, and the ECCSA highlights these in the following comments

In its revised proposal, SAPN comments that the AER had accepted the base year opex as "not materially inefficient" as the "decline in productivity …was a consistent trend across all DNSPs" (see revised proposal page 189).

The ECCSA disagrees. Analysis of the decline in SAPN productivity over 2006-2013 is not consistent with that experienced by all DNSPs. Deeper analysis of the benchmarking data shows that the average decline in productivity across all networks as measured in opex partial factor productivity exhibits a median of -0.039 points pa with a standard deviation of 0.033 points.

In contrast SAPN rate of productivity change is -0.099 points pa, well outside the median plus one standard deviation. In fact the loss of productivity by SAPN is the second highest across the NEM exceeded only by Citipower’s rate of productivity loss of -0.11 points pa.

On this basis, the ECCSA considers that SAPN base year opex cannot be considered to be efficient by any stretch.

SAPN has modified marginally its proposed step changes. The reasons provided for retention of many of the step changes still do not address the concerns raised by the ECCSA in its response to the initial proposal or the reasons given by the AER in its preliminary decision for refusing them.

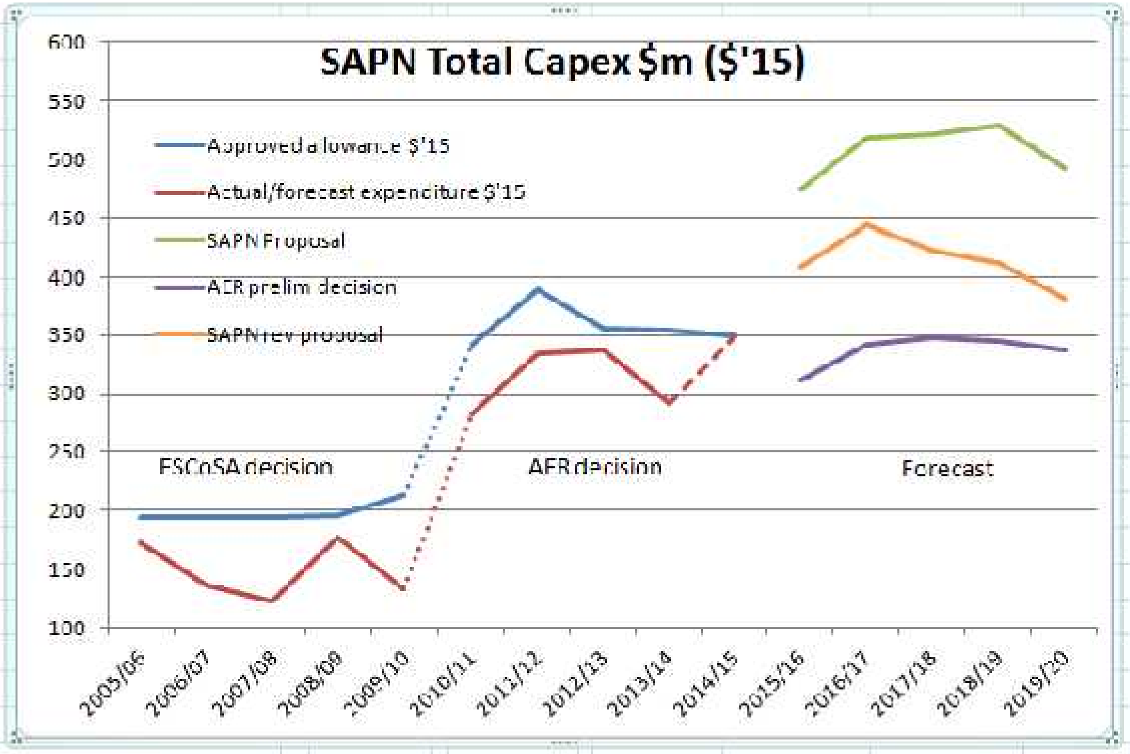
What SAPN appears to overlook is that:

- Step changes can only reflect a change in laws and regulations which impact the network, and if these changes occur before the base year (which would include the costs for complying with the change), then there is every expectation that the costs are embedded in the base year opex. The average loss of productivity seen across all DNSPs is in part caused by these imposts, so to claim them again is "double dipping".
- Capital programs (except those that actually increase the numbers and length of the assets) should result in a reduction in opex as replaced assets should require less attention than those existing before the replacement.
- Where there are non-network investments made, an efficient outcome is where opex is reduced to substantiate the capex incurred. Generally, firms in competition expect that the capital cost of an investment should see a payback in opex reductions in less than 4 years. To claim an increase in opex because of the inclusion of a non-network investment is patently not efficient.
- Opex proposed on the basis of consumer preference (eg more sympathetic vegetation clearing) has been addressed in earlier sections of this response and is not supported.

In opex growth SAPN considers that the AER approach to using ratcheted peak demand as the driver is an issue that was addressed at length during the Better Regulation program. It is inconceivable that installed capacity should be the driver of growth as this provides SAPN with an incentive to over invest in network assets. Consumers cause the increase in peak demand and this is the measure against what consumers should be exposed to in relation to growth in the network rather than an outcome of an action by the network.

7. Capex

Overall, SAPN has reduced its capex claim in its revised proposal as is shown in the following chart, but still not to the level deemed efficient by the AER in its preliminary decision.



Source: SAPN application, SAPN economic benchmarking data templates, SAPN benchmarking RIN 2013/14, AER prelim decision, SAPN rev proposal

Even though SAPN has reduced its capex, it is still claiming a significant increase in capex despite the forecast of demand remaining very low. This appears to be inconsistent, and the ECCSA highlights these in the following comments

7.1 Repex

SAPN is critical of the AER use of the Repex model to assist it in assessing the amount of repex claimed by a network. But this is not the only tool used by the AER is assessing the reasonableness of a network's claim.

Another key tool used is actual past practice used by networks to assist in identifying what is efficient. This use of actual performance to set a trend provides a useful second tool for the AER and this highlights the same outcome that the Repex tool identifies - that the proposed repex is excessive when seen in light of two approaches to assessing reasonableness of proposed repex. When two top down assessments concur, this highlights that the bottom up approach has a flawed outcome.

SAPN specifically highlights that the AER's Repex model has not properly identified the need for the rate of pole top structure investment to be increased; SAPN states that increased inspections led to view there will be increased failures. What SAPN overlooks is that even though inspections might have led to a view that a higher failure rate might eventuate, the actual failure rate does not support this assumption, as there has been no clear increase in failures. The ECCSA considers that the AER has appropriately addressed the need for replacement of pole top structures on the basis that the current rate of replacement has not seen an increase in failures, despite inspections indicating that this might be an outcome.

7.2 Augex - safety

The ECCSA has commented on the bushfire mitigation program in preceding sections and considers that the AER approach is appropriate and that SAPN claims are not sustainable.

With regard to the back-up protection program, the ECCSA agrees with the AER assessment of this program.

SAPN implies that the requirement for these works was initiated in 2013 and that it has already commenced implementation of the works within its current capex program. If this is the case, then there is an allowance already embedded in the "core program" which the AER has agreed is a reasonable allowance for safety capex.

In addition, the ECCSA notes that the program will have an impact on the measured reliability of the network and should therefore result in a bonus under the STPIS incentive scheme. The STPIS has large enough rewards within it so that SAPN could devote some of its own funds to this program (if it considers it sufficiently worthwhile) in order to gain a bonus under the STPIS to offset the costs.

7.3 Capex - reliability

SAPN considers that the AER has erred in not allowing some $30m is reliability capex. The ECCSA agrees with the AER in not including these projects within the capex program.

Consumers have stated clearly to SAPN that they are not prepared to pay more for increased reliability. The current level of reliability capex is adequate to maintain reliability at acceptable levels and the ECCSA considers that the proposed capex would have resulted in increased reliability. As noted above the STPIS is a reward for delivering increased reliability so SAPN can use its own funds to generate the bonus that is provided through this incentive.

It is inappropriate for consumers to fund improved reliability where SAPN would receive a bonus for improved performance.

7.4 Capex - strategic

In its response to the AER preliminary decision, the ECCSA does not agree with the premature funding of a second cable to Kangaroo Island, and its reasons for not supporting the AER preliminary decision are detailed in the response to the AER preliminary decision.

SAPN is critical of the AER not to allow the network control (SCADA) proposals as part of approved capex. SAPN points out that there are a number of benefits to consumers from the introduction and the ECCSA agrees. Equally the ECCSA considers that the improved reliability that SAPN asserts will be the benefit of this investment will generate for it a bonus under the STPIS incentive scheme and should also result in opex savings which would generate a bonus under the EBSS incentive scheme.

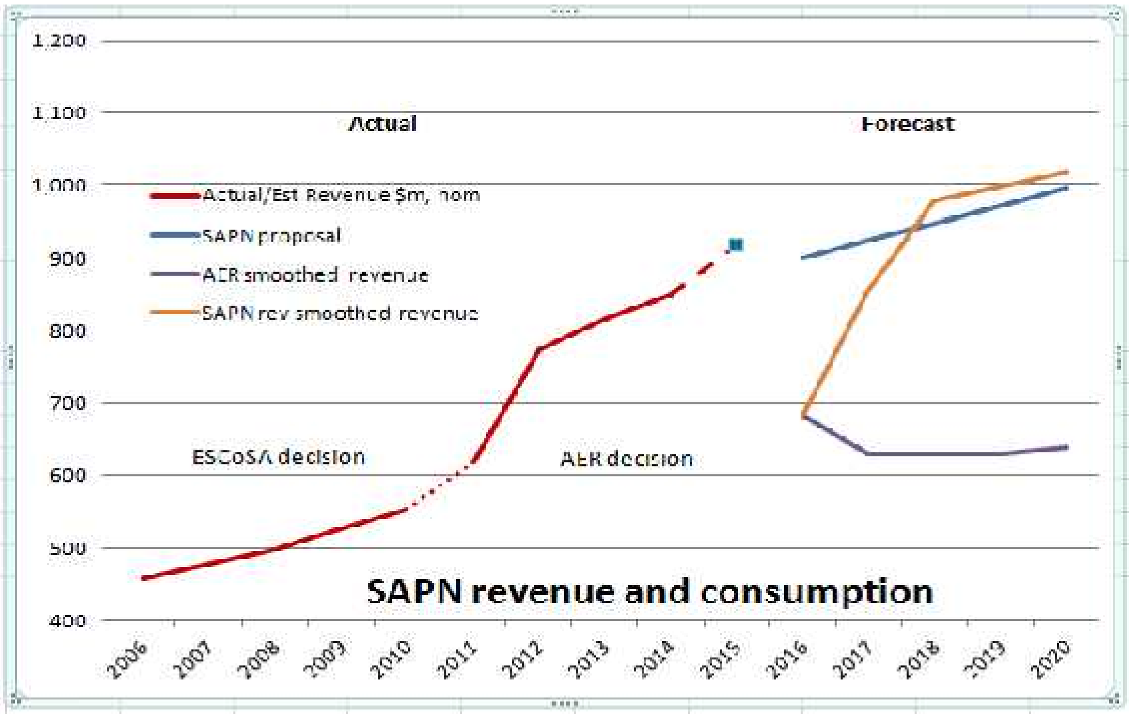
The ECCSA considers that the AER is correct to require a cost benefit analysis to support the proposal. If it is determined there is a net benefit from the investment then the AER should make adjustments to the STPIS and the EBSS to prevent consumers having to pay twice for the benefits that would flow from the funding the capex.

7.5 Capex - non-network

The ECCSA observations on non-network capex have been made in the responses to the initial proposal and the AER preliminary decision.

8 Impact of revised proposal

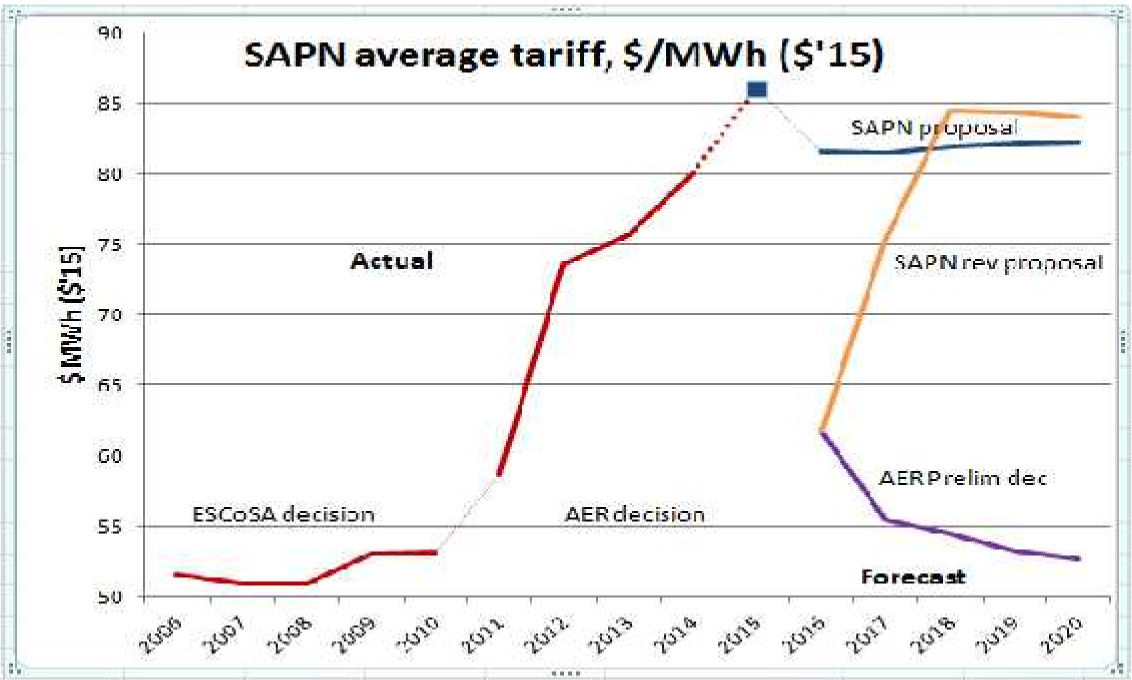
The impact of the SAPN revised proposal shows that it is really little changed from its initial proposal in terms of impact on consumers as the following chart highlights



Source: SAPN application, SAPN economic benchmarking data templates, SAPN benchmarking RIN 2013/14, AER preliminary decision, SAPN revised proposal

Except for lower charges in the first two years, the final revenue allowance is higher than what was initially proposed.

When this chart is converted into prices, the following is revealed.



Source: SAPN application, SAPN economic benchmarking data templates, SAPN benchmarking RIN 2013/14, AER preliminary decision, SAPN revised proposal

The outcome is that average prices will exceed those forecast in the initial proposal, although it is recognised that this is an outcome of the lower prices applying in the earlier years of the period

9. Conclusion

Generally, the ECCSA finds that there are little of the explanations provided by SAPN to substantiate the reasons for maximising their revenue in their revised proposal and that the AER preliminary decision (subject to the issues raised by ECCSA in its response to the preliminary decision) provides a more preferable outcome for consumers.

The ECCSA considers that the SAPN revised proposal does not deliver an outcome that is in the long term interests of consumers.