8 August 2014

Mr Warwick Anderson
General Manager – Networks Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: AERInquiry@aer.gov.au

Dear Warwick

Submission to NSW Electricity Distribution Revenue Proposals (2014/15 to 2018/19)

Thank you for the opportunity to provide the Energy User Association of Australia's (EUAA) perspectives on the NSW electricity distributors' revenue proposals.

The EUAA has a number of significant concerns with the proposals that are highlighted within the attached submission. The submission is deliberately high level in nature and is aimed at commencing a constructive dialogue with the Australian Energy Regulator (AER) on the key issues identified herein.

We note the short timeframe to develop this response and reserve the option to highlight any additional concerns not outlined within this submission. The EUAA will provide more substantive submissions outlining any additional concerns in due course.

The EUAA is very keen to engage with the AER on the issues raised within this submission at the earliest possible opportunity.

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

Yours sincerely

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

Executive Summary

The Energy Users Association of Australia (EUAA) actively pursues the interests of its members solely focussed on energy issues impacting their business. Electricity costs are critical to the sustainable operation of all the EUAA member base.
This submission is in response to the release of the revenue proposals from the respective DNSP's Ausgrid, Endeavour Energy and Essential Energy; and the Issues Paper released by the AER.

The key observations and reasoning made in this submission are summarised below:

Price Reduction Drivers

There are a number of drivers that are producing significant downward pressure on prices, including:

- The new regulatory rules and strengthened regulatory powers
- Significantly lower cost of capital requirements
- The significant downturn in electricity consumption and demand
- Less onerous network planning standards
- The NSW Government Network Reform Program

The NSW distributors' proposals are not reflecting these drivers.

Return on Capital

The distributors have proposed departures from the AER Rate of Return Guideline that result in a significantly higher Weighted Average Cost of Capital (WACC) than necessary.

The AER's Transitional WACC determination is higher than the WACC that it determined under the old rules, and is over 50% higher than the WACC's currently being allowed by the UK electricity regulator.

The AER has adopted a highly conservative approach to its WACC determination, combined with insufficient consideration of relevant information, and an inappropriate use of the discretion provided under the new rules.

EUAA would support a process where any proposed departures are subject to rigorous analysis or consultation.

Capital Expenditure - Augmentation Capex

Given the continuing decline in demand, minimal augmentation capex should be anticipated.

The distributors are proposing over $1.5 bn in growth-related capex, based on non-credible demand projections.

The AER needs to substitute the distributors' demand forecasts with credible independent forecasts.

Capital Expenditure - Replacement Capex

The distributors are proposing a record high level ($4.8bn) of replacement capex with no substantial justification other than suggesting that their networks are ageing.

The AER needs to perform an extensive assessment of the proposed replacement capex programs, including robust, independent assessments of asset conditions and the risks of replacement versus alternative options.

Operational Expenditure - Labour Cost Increases

The distributors are forecasting total labour cost increases of around $320 million.

The EUAA does not accept that an industry that is undergoing major contraction due to declining demand for its product can credibly claim labour cost pressures in excess of CPI.

The AER needs to determine efficient allowances for labour costs that better reflect the long-term interests of consumers.

Operational Expenditure - "Loss of Synergy" Costs

The distributors are claiming over $230 million in "loss of synergy" costs associated with the sale of their retail businesses three years ago.

These costs should have been attributed to the sale of the retail businesses.

They are not legitimate regulatory operational costs and should not be passed on to consumers.

Operational Expenditure - Transferring Surplus Resources from Capex to Opex

The distributors are proposing to transfer the costs of their existing surplus capex resources into opex, amounting to a total increase in opex of approximately $140 million.

The AER is required to approve "efficient opex costs". Efficient opex costs do not include inefficient resourcing decisions relating to the capex program.

No other sector in the Australian economy would accept the "pass through" of poor resource management decisions to consumers.

Operational Expenditure - Other

There are a number of other aspects of the distributors' opex proposals that represent inefficient practices and the inappropriate transfer and "pass through" of risks and costs to energy consumers.

Efficiency Benefit Saving Scheme (EBSS) Outcomes

The distributors are claiming that they are entitled to major bonuses (totalling $585 million) under the EBSS for not fully spending their opex allowances during the previous period.

The outcomes of the EBSS to date confirm that the AER is consistently setting opex allowances well above the efficient level.

If the AER is not confident that it can refine the scheme to deliver genuine efficiency improvements, then in the long-term interest of consumers, the EUAA suggests that the AER no longer applies the scheme.

Benchmarking

The AER’ s first benchmarking report for the distributors is due in September 2014.

The EUAA is keen to engage with the AER following the release of its first benchmarking report to discuss the implications for the NSW distributors’ revenue determinations.

Reliability Standards

The NSW Government has acted to remove various planning standards and make its reliability standards more flexible.

These new standards do not appear to have been reflected in the distributors’ proposals.

The EUAA expects the AER to ensure that the distributors’ proposals reflect the recent changes to reliability standards.

1. Purpose

The purpose of this submission is to highlight the EUAA's key matters of concern regarding the New South Wales electricity distributors' revenue proposals, together with our concerns regarding the AER's initial application of new rules that now apply to the revenue determination process.

This submission is deliberately high level in nature and is aimed at commencing a constructive dialogue with the AER on the key issues that the EUAA has identified to date.

We note the short timeframe to develop this response and reserve the option to highlight any additional concerns not outlined within this submission. The EUAA will provide more substantive submissions outlining any additional concerns in due course.

2. Background

2.1 Recent Regulatory Reforms

As the AER is well aware, numerous reviews have concluded that a large proportion of the recent dramatic electricity price increases were unnecessary and arose from deficiencies in the regulatory framework - deficiencies that resulted in the AER approving excessive rates of return, over-investment and inefficient expenditure on electricity network infrastructure. [1] [2] [3] [4]

As the AER is also aware, the EUAA has been extensively involved in the consultation arrangements associated with the recent regulatory reforms aimed at addressing those deficiencies, including:

i. the stakeholder engagement associated with the AEMC's amendments to the National Electricity Rules in 2012, and
ii. the subsequent *AER Better Regulation Program*, to determine how the new regulatory rules should be implemented.

2.2 Price Reduction Drivers

As outlined within the AER Issues Paper, the NSW distributors are currently experiencing very different business drivers compared to the circumstances when the AER last reviewed their revenue proposals in 2008.

In particular, there are a number of drivers that are producing significant downward pressure on prices, including:

i. **Significantly lower cost of capital requirements** - the current costs of finance are significantly lower than the record high cost of capital allowances that the AER set for the distributors for the 2009–14 period. Consequently, significantly lower rates of return are now more appropriate.
ii. **The significant downturn in electricity consumption and demand** - demand dropped significantly over the previous regulatory period and is forecast to drop further in the next regulatory period, thereby requiring significantly lower capex and opex.
iii. **Less onerous network planning standards** – resulting in further reduced drivers for network investment, particularly since the recent high levels of network investment are now delivering major improvements in network reliability.

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[1] Electricity Network Regulatory Frameworks: Productivity Commission Enquiry Report, 9 April 2013

[2] AEMC Final Position Paper: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 .

[3] Putting the customer back in front: How to make electricity cheaper. Grattan Institute, December 2012

[4] Update Paper 8: Transforming the Electricity Sector. Garnaut R. (2011)

iv. **The NSW Government Network Reform Program** - aimed at delivering major savings in capital expenditure and operating costs across the NSW electricity network businesses

EUAA Members have therefore been eagerly awaiting the new revenue determinations for the NSW distributors, with high expectations that the strengthened AER powers and the above price reduction drivers will result in significant price reductions.

It is therefore of deep concern to the EUAA that the distributors' revenue proposals are not appropriately reflecting these changed circumstances.

3. Price impacts

Despite the price reduction drivers outlined above, all of the distributors are proposing to continue to increase their revenues and prices over the next 5 years.

The key drivers of the distributors' proposed price increases are:

i. **Proposed departures from the AER Rate of Return Guideline** – that would result in a significantly higher cost of capital allowances than necessary.
ii. **Major capex programs -** including significant augmentation capex and an unprecedented level ($4.8billion) of proposed replacement capex.
iii. **Ongoing opex increases** - heavily driven by the distributors' proposals to transfer the costs of their surplus capex resources to opex.
iv. **Major efficiency incentive payments** – including $585 million under the Efficiency Benefit Savings Scheme (EBSS).

The EUAA's perspectives regarding each of the above issues are outlined within this submission.

4. Return on Capital

4.1 The NSW Distributors' Revenue Proposals

The new rules require the networks to propose an indicative rate of return range that has regard to the *Rate of Return* guideline published by the AER. The AER *Rate of Return* guideline was published in December 2013, following 12 months of extensive consultation with a diverse range of industry stakeholders.

As the AER is aware, the EUAA devoted considerable time and resources to this consultation program, including extensive involvement as a participant in the *Rate of Return Workstream*.

The EUAA is therefore extremely disappointed that the NSW distributors have proposed significant departures from the *Rate of Return Guideline,* including proposing alternative approaches for the determination of the cost of equity, and an alternative an approach for the transition to the trailing average portfolio for the cost of debt.[5] [6] [7]

In essence, the distributors have combined estimates from the old and new approaches in a manner that results in a significantly higher WACC than would be determined by the application of the *Rate of Return* guideline.

The EUAA strongly objects to the distributors' proposed departures from the *Rate of Return Guideline.* For departures to the guideline to be credibly considered, they would need to be subjected to an equivalent level of consultation, and to raise new information that wasn't considered during the AER's consultation on the *Rate of Return* guideline.

These criteria have clearly not been met. The distributors' proposed departures have not been submitted to any rigorous analysis or stakeholder consultation. Furthermore, most of the information they have provided to support their departures was already considered by the AER during the development of the *Rate of Return* guideline.

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[5] Ausgrid Regulatory Proposal, 1 July 2014 to 30 June 2019. 30 May 2014 (Section 7)

[6] Essential Energy Regulatory Proposal, 1 July 2014 to 30 June 2019. 31 May 2014 (Section 7)

[7] Endeavour Energy Regulatory Proposal to the Australian Energy Regulator, 1 July 2015-30 June 2019. 31 May 2014 (Section 7)

4.2 The AER's Transitional Rate of Return Determination

The AER's Transitional Decision for the NSW distributors determined a total WACC of 8.1% - the top end of the AER's estimated range of 7.6-8.1%.

The EUAA acknowledges that the AER's final WACC determination may differ significantly from its Transitional WACC Determination. However, the EUAA has some significant concerns regarding the AER's approach to the Transitional WACC determination, and the implications it may have for its full WACC determination.

4.2.1 Comparison of Outcomes - Old Rules versus the New Rules

It is instructive to compare the AER's Transitional WACC determination for the NSW distributors with the most recent determination that the AER applied using the old rules – the AER's determination for SP AusNet in January 2014.

Both decisions applied almost the same risk free rate (4.3% versus 4.31%). However, the WACC that the AER determined under the old rules for SP AusNet was 0.23% lower than the WACC that the AER determined under the new rules for the NSW distributors (7.87% versus 8.1%).

In other words, NSW consumers would have been better off under the old rules.

Given the extensive evidence of excessive rate of return allowances being awarded under the old rules, a view that the AER has accepted and publicly espoused,[8] [9] the EUAA is deeply concerned that the AER's first opportunity to apply the new rules has resulted in an increased WACC, rather than a decreased WACC.

The EUAA considers that this outcome is the result of the AER adopting a highly conservative approach to the application of the new rules, combined with insufficient consideration of relevant information, and an inappropriate use of the discretion that the AER has been afforded under the new rules.

4.2.2 Insufficient Consideration of Relevant Information

The new rules provide the AER with a good deal of flexibility and discretion in determining the appropriate rate of return. The AER is required to consider to a range of factors, including relevant estimation methods, financial models, market data and other evidence.

The EUAA believes that there is a significant amount of market data and other evidence that the AER should have considered when determining the appropriate WACC for the NSW distributors.

For example, there is growing evidence that investors are paying substantial premiums above the Regulated Asset Base (RAB) when investing in Australian energy networks, e.g:

- The current offer by CKI for Envestra has an implied RAB multiple of over 150%
- CKI's recent purchase of a stake in DUET has an implied RAB multiple of 128%

The NSW distributors' profitability growth trends also indicate that the industry is significantly more profitable than the regulatory framework assumes.[10] [11]

There is clearly a broader range of relevant information that the AER can legitimately consider. The EUAA expect the AER to take account of such information when making its final WACC determinations for the NSW distributors.

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[8] AER Rule Change Proposal: Promoting efficient investment in the interest of consumers. Andrew Reeves, AER Chairman, November 2011

[9] Integrating the consumer voice into network regulation. Andrew Reeves speech to Annual EUAA Conference, October 2013

[10] Consumer Challenge Panel Presentations to AER Public Forum 10 July. CCP Presentation 2, Slide 3

[11] Consumer Challenge Panel Presentation to AER Public Forum 10 July. Hugh Grant Presentation, Slides 9-11

4.2.3 Inappropriate Use of the AER's Discretion

The new rule changes were aimed at providing the AER with additional strength and flexibility, providing high-level principles to guide the estimation, and leaving the judgement as to the best approach to the AER's discretion.

In applying the new rules to the NSW distributors' Transitional Determinations, the AER determined a WACC range of 7.6-8.1%. The AER then chose to apply a WACC of 8.1% to the Transitional Decisions – i.e. it selected the top end of the possible range. The EUAA is very concerned that the AER has inappropriately applied its discretion by selecting the highest possible value in the WACC range, thereby passing on unnecessary and excessive costs to NSW energy consumers.

This is confounded by a number of the input parameters in the AER *Rate of Return Guideline* having already been selected at the top of the possible ranges. For example, for the 'equity beta' range of 0.4 to 0.7 - the AER has adopted 0.7.

The EUAA therefore urges the AER to exercise its discretion in a more balanced manner.

4.2.4 Comparisons with other Australian and International Regulators

Over the past decade, consumers have repeatedly expressed their concerns regarding the AER's WACC determinations being consistently higher than the determinations of other regulators in Australia and overseas.

When compared with other Australian Regulators, the AER has consistently set higher WACCs compared to the previous determinations of the ACCC and state regulators.

The AER has also consistently set higher WACCs when compared to equivalent international regulators. For example, The UK regulator (Ofgem) recently outlined a WACC (real, vanilla) of 3.8% for five UK distribution entities. This equates to a nominal vanilla WACC of around 5.3%.

Therefore, the AER's Transitional Decision WACC of 8.1% is over 50% higher than the equivalent UK WACC.

With return on capital accounting for over 50% of the NSW distributors' revenues, the importance of the AER setting an appropriate rate of return cannot be overstated, particularly in light of the recent major growths in their Regulatory Asset Bases (RABs).

For example, Ausgrid and Essential Energy's RABs are now three times their 2005 value, and are proposed to further increase to four times that value by 2019.

5. Capital Expenditure

5.1 Augmentation Capex

As the AER is well aware, the energy consumption and peak demand projections used by the distributors to justify their record high capital investment program for the previous regulatory period were subsequently proven to be dramatically overblown.

Given the continuing decline in consumption and demand, minimal augmentation capex should be anticipated for the next regulatory period.

However, the distributors are proposing over $1.5 billion in growth-related capex in the next regulatory period. This appears to be based on their peak demand projections which suggest that the declining peak demand trend will dramatically reverse and that peak demand will increase significantly over the next regulatory period.

These projections are not supported by any credible demand forecasts. Given the distributors' track record in significantly overestimating energy consumption and peak demand, the AER needs to substitute the distributors' forecasts with forecasts provided by credible independent forecasters.

It is important to note that when the AER set the capex allowances for the distributors in 2009, there were many submissions from stakeholders that strongly challenged the distributors' demand forecasts. The EUAA urges the AER to pay appropriate attention to such critiques when determining its load forecasts for this revenue determination.

5.2 Replacement Capex

The NSW distributors have not provided information on the level of their replacement capex spend for the previous regulatory period. However, based on publicly available information it appears that they have significantly overspent their replacement capex allowances over the previous period.

By doing so, they have effectively 'pre-installed' a good deal of their replacement capex requirements for the next regulatory period. However, the distributors are now proposing a record high level of $4.8 billion of replacement capex for the next regulatory period, with no substantial justification, other than suggesting that the average asset age of their networks increased during the previous regulatory period.

It is well understood, and in fact acknowledged within Ausgrid's revenue proposal[12], that average asset age is a very simplistic indicator and not a credible measure of the "health" of a network.

Credible asset replacement justifications need to be based on robust assessments of asset condition, together with risk assessments that transparently identify the risks of replacement versus alternative options. Such justifications have not been provided within the NSW distributors' proposals.

The EUAA expects the AER to ensure that an extensive assessment of the distributors' proposed replacement capex programs is performed; including a robust, transparent and independent assessment of asset conditions, and credible assessments of the risks of replacement versus alternative options.

6. Operational Expenditure

The NSW distributors are proposing ongoing increases in their operational expenditures over the next regulatory period. There are many aspects of the distributors' opex proposals that are of major concern to the EUAA, particularly in light of the major increases in the distributors' opex in recent regulatory periods.

The EUAA has not attempted to cover all of those issues in this submission. Instead, we provide some examples of areas of concern and some key issues that we expect the AER to strongly scrutinise.

6.1 Labour Cost Increases

All of the distributors are forecasting significant real increases in labour costs above CPI, amounting to total labour cost increases of around $320 million.

The EUAA does not accept that an industry that is undergoing major contraction due to declining demand for its product can credibly claim labour cost pressures in excess of CPI. The EUAA urges the AER to strongly critique the rationale for these proposed increases.

It is important to note that the NSW distributors have now commenced their negotiations for their new Enterprise Bargaining Agreements (EBA) that are due to be re-negotiated during the current financial year. In light of current employment conditions, the NSW distributors are in a very strong negotiating position that should enable them to negotiate labour price reductions, rather than the significant real price increases being sought.

[12] Ausgrid Revenue Proposal, Page 36

There is already a broad range of evidence that demonstrates that the labour rates within the NSW electricity industry are significantly higher than they should be. The AER must ensure that the distributors do not continue with their previous approach of effectively treating EBA outcomes as a "pass through". The AER needs to determine efficient allowances for labour costs that better reflect the long-term interests of consumers.

6.2 "Loss of Synergy" Costs

The distributors are claiming over $230 million in "loss of synergy" costs associated with the sale of their retail businesses in March 2011. In essence they are claiming that the sale of their retail businesses (over 3 years ago) has left them with "fixed costs" that they need to recover.

The EUAA strongly challenges the validity of these costs, as:

i. If the distributors considered that these costs would be stranded in future, then standard commercial practice would have attributed the costs to the sale of the retail businesses three years ago.
ii. Clearly the distributors made a conscious decision to retain the staff to provide profitable non-regulated services to the retail businesses over the past 3 years.
iii. Now that the services contract is coming to an end, they are seeking to transfer the labour costs from their non-regulated activities to their regulated activities. Surely this violates the principles of the AER's Cost Allocation Guideline?

Furthermore, it is important to note, the decision to terminate the services is not definite. That decision is at the discretion of the retailers, who have not yet confirmed their intention to terminate the agreement.

It is the EUAA's strong view that these are not legitimate regulatory operational costs and they should not be passed on to energy consumers.

6.3 Transferring Surplus Resources from Capex to Opex

All of the distributors are proposing to transfer the costs of their existing surplus capex resources into opex, amounting to a total increase in opex of approximately $140 million.

The EUAA has a number of issues with these proposals.

Clearly, the distributors have made very poor resource management decisions that have resulted in them growing their workforce numbers well in excess of requirements. The AER is required to approve "efficient opex costs". Efficient opex costs do not include inefficient resourcing decisions relating to the capex program.

As far as the EUAA is aware, there is no other sector in the Australian economy that would accept the "pass through" of poor resource management decisions to consumers.

Furthermore, the NSW distributors' decisions to cut back on their capex programs were made early in the previous regulatory period, when it became evident that the load forecasts they used to justify their proposed capex programs were dramatically overblown.

Consequently, the distributors should have commenced their workforce reduction programs 3 to 4 years ago, rather than waiting for the next regulatory determination to attempt to pass through those costs to energy consumers.

The excess opex allowances provided in the previous determinations could have been used to fund those costs. Instead, the distributors are now claiming major bonuses under the Efficiency Benefit Saving Scheme (EBSS) for not fully spending their opex allowances (see below).

6.4 Efficiency Benefit Saving Scheme (EBSS) Outcomes

The distributors are claiming that they are entitled to major bonuses under the EBSS for not fully spending their opex allowances during the previous period. For example, Ausgrid is claiming a bonus of $455 million for under-spending its opex allowance by $43 million.

Whist the EUAA supports incentive schemes that deliver genuine efficiency improvements and long-term benefits to consumers, it is clear from the outcomes of the EBSS to date that the AER is consistently setting opex allowances well above the efficient level.

The EUAA urges the AER to perform a formal review the outcomes of the EBSS to date and to reconsider the design of the scheme and the AER's approach to determining efficient costs. If the AER is not confident that it can refine the scheme to deliver genuine efficiency improvements, then in the long-term interest of consumers, the EUAA suggests that the AER no longer applies the scheme.

6.5 Other Issues

There are a number of other aspects of the distributors' opex proposals that are of concern to the EUAA, including:

i. The major opex increases being claimed for asset growth, e.g. Endeavor Energy's proposed increase of $158M.
ii. Endeavour Energy's proposed $131 million increase for vegetation management costs due to "increasing market costs". This contrasts sharply with Essential Energy's $151 million reduction in vegetation management costs.
iii. Essential Energy's $94M ongoing contribution of funds to support the operation of Networks NSW.
iv. The major costs being claimed for harmonising the distributors' accounting practices – e.g. Essential Energy is claiming $55 million for this change.
v. Ausgrid's upfront costs of $52M for its "efficiency program".
vi. Ausgrid's Demand Management expenditure of $37.3 million.
vii. Ausgrid's proposed $25 million increase for private mains inspection costs .

7. Benchmarking

The new rules require the AER to publish annual benchmarking reports to assess the relative efficiencies of network businesses, with the first benchmarking report being due in September 2014. The AER is required to apply the outcomes of its benchmarking reports to determine efficient costs for the networks.

As the AER is aware, the EUAA has previously commissioned benchmarking studies that have demonstrated that the NSW distributors are amongst the least efficient in Australia. The EUAA is keen to engage with the AER following the release of its first benchmarking report to discuss the implications for the NSW distributors' revenue determinations.

8. Reliability Standards

A key driver of the expenditure increases in the previous regulatory periods was the distributors' expenditure to improve system security and reliability. The network performance reports prepared by the distributors indicate that they are significantly outperforming the key reliability targets mandated in their licence conditions.[13]

The NSW Government has now acted to remove various planning standards and make some of its reliability standards more flexible. These new standards do not appear to have been reflected in the distributors' proposals. The EUAA expects the AER to ensure that the distributors' proposals reflect the recent changes to reliability standards. The EUAA will provide further perspectives on this important issue in our future submissions.

13 Ausgrid, Electricity Network Performance Report 2012–13, November 2013, p. 23; Endeavour Energy, Electricity Network Performance Report, November 2013, p. 49; Essential Energy, Electricity Network Performance Report 2012–13, November 2013, p. 25.