30 January 2015

Mr Sebastian Roberts
General Manager, Network Regulation
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

By email: SAelectricity2015@aer.gov.au

Submission to SA Power Networks Revenue Proposal (2015 to 2020)

Thank you for the opportunity to provide the Energy User Association of Australia's (EUAA) perspectives on the SA Power Networks revenue proposal that was submitted to the AER on October 31. The EUAA has a number of significant concerns with the proposal and these are presented in the attached submission.

I note the growing trend by network businesses to submit large volumes of information as part of their revenue proposals. The SA Power Networks proposal, for example, consists of 16,807 pages. This large quantity of material does not support or further the AER's goal of improving consumer engagement. It is also grossly inconsistent with the National Electricity Objective which mandates efficiency for the long term interests of consumers.

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

EUAA RESPONSE TO SA POWER NETWORKS' REVENUE PROPOSAL 2015 – 2020

Table of contents

1 Executive summary

This submission presents the EUAA's response to the SA Power Networks (SAPN) revenue proposal for the 2015-20 period.

While the EUAA acknowledges SAPN has attempted to reign in costs, our view is they have been rather conservative and there is significant scope for further savings to be returned to customers.

The following summarises the key recommendations made by the EUAA.

Recommendation 1
The EUAA recommends the AER disregard claims there is an increased risk of asset failure in the SAPN network. Network outage and asset failure data should be used to estimate network risk, not the asset replacements identified as a result of SAPN's own increased inspection rate.

Recommendation 2
We urge the AER to reject the proposed 19-fold increase in safety expenditure. These increases cannot be justified on the basis of any new regulatory or compliance requirement. The EUAA does not consider there is adequate customer support for these cost increases.

Recommendation 3
We recommend the materials cost escalators take into account the significant fall in commodity prices already seen in the 2014/15 year.

Recommendation 4
The operating cost forecast should not receive a 12% step increase in 2015/16. SAPN does not face significant changes to its compliance regime in 2015-20 and resulting increased costs.

Recommendation 5
SAPN should be required to include a productivity factor in its operating expenditure forecast path for 2015-20.

Recommendation 6
The SAPN cost of equity calculation (for the rate of return) should adhere to the AER's Rate of Return Guideline.

Recommendation 7
We recommend that the AER give consideration to the likelihood that SAPN has set its proposed revenue path for 2015-20 in advance of preparing its expenditure requirements. This brings into question the validity of the proposed expenditure program.

Recommendation 8
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.

Note that all cost and revenue figures are presented in June 2015 dollars, unless otherwise specified. Revenue and cost figures are the total for a five year regulatory period, unless otherwise specified.

2 Capital Expenditure

2.1 Introduction

SAPN is proposing capital expenditure of $2.5 billion in the 2015-20 period, an increase of $1.0 billion. The increase in capital expenditure, in proportional terms, is significantly higher than the revenue proposals recently submitted by the NSW and Queensland distributors. The EUAA considers that the spending increase is unjustified, particularly since four out of five customers are satisfied with the overall performance of the SAPN network and associated service levels[1]. SAPN itself admits that it doesn't intend to improve reliability, but instead to merely maintain it: "*In particular, our forecast of the capital expenditure required for the delivery of Standard Control Services (SCS) during the 2015–20 RCP is predicated on SA Power Networks maintaining, not improving, the underlying reliability of its electricity distribution network.*"[2]

Maintaining reliability levels should not require a $1.0 billion increase in expenditure.

The EUAA has reviewed the SAPN replacement and augmentation spending programs separately in the following sections.

The key concerns are; increased asset inspections being used to justify pole and conductor replacements, a 19 fold increase in safety expenditure, and "demand driven" augmentation expenditure.

2.2 Replacement capital expenditure

SAPN proposes asset replacement capital expenditure of $792 million for 2015-20, a doubling in the amount spent in the prior period. It claims that it has the oldest average asset life of all 13 distributors in the NEM. The average SAPN asset age was 36 years[3] in July 2009 and 38.3 in October 2014. The EUAA does not consider that a doubling in replacement capital expenditure is required to stop the average asset age increasing further. It is also clear that SAPN was aware of the asset condition five years ago which questions the need for a sudden step increase in spending levels. SAPN has not presented adequate evidence to justify such significant increases. It should also be noted that SAPN didn't spend its full capital expenditure allowance in the 2009-14 period, which is inexplicable if the business is genuinely concerned about aging assets.

SAPN's main argument for such a significant rise in replacement expenditure is that it has increased the number of asset inspections and this has in turn revealed more asset faults. Inspection cycles for all asset categories are set by SAPN with its internal plans and manuals[4]. These procedures also define a defect and the timeframes to rectify these defects.

As a result of its own internally set criteria, SAPN has increased the frequency and scope of asset inspections which has directly increased the number of identified defects. SAPN believes that this has led to a corresponding increase of network risk to an unacceptable level:

[1] Willingness to Pay, NTF Group p11
[2] SAPN Regulatory Proposal 2015-2020, p174
[3] ETSA Utilities Regulatory Proposal 2010-2015, p28
[4] SAPN Regulatory Proposal 2015-2020, p180

"*Notwithstanding the increased expenditure, we are seeing an escalating increase in the network risks during this period which well exceed the historical levels of risk on which our [reliability and safety plan] is based*"[5]. SAPN states that as a result of higher network risk it must continue to invest in the network. "…*we aim to continue asset management and investment to drive reliability, (and) manage risk; and prioritise preventative maintenance to mitigate risk.*"[6]

The EUAA finds this logic flawed. Network risk should be reduced by an increased number of inspections as more data becomes available on the condition of assets. The business is in a better position to manage the assets and minimise the risk to reliability or safety. If there was a genuine problem with potential asset failures it would appear in the SAPN reliability performance indicators. These indicators (such as SAIDI and SAIFI) haven't worsened over the last five years and 88% of customers are satisfied with their current level of reliability[7]. In its October 2014 decision ESCOSA kept the reliability performance standards similar if not the same to the prior period. This decision was based on the regulator's own customer preference surveys which have consistently shown over the last ten years a high level of satisfaction with reliability across all customer types and geographic locations[8]. Also supporting the ESCOSA decision was the fact that SAPN receives a low level of customer complaints.

Recommendation 1:

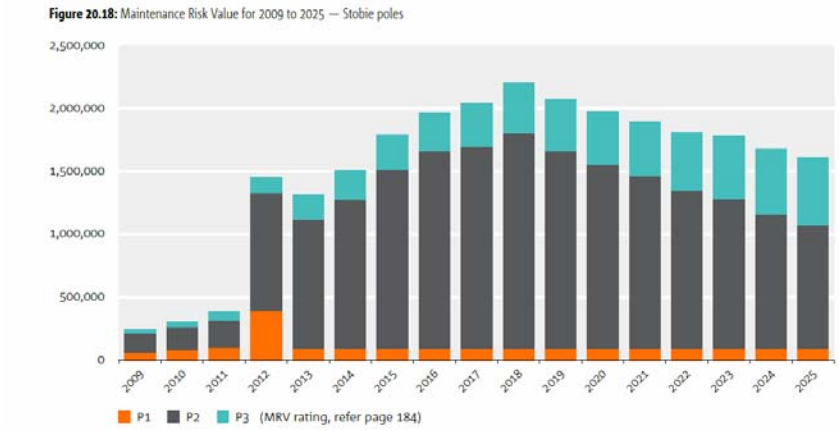
The EUAA recommends that the AER disregard claims that there is an increased risk of asset failure in the SAPN network. Network outage and asset failure data should be used to estimate network risk, not the asset replacements identified as a result of SAPN's own increased inspection rate.

2.2.1 Stobie pole replacement risk assessment

By increasing its number of asset inspections SAPN is attempting to justify increased expenditure. One example of this is the forecast for Stobie pole replacements in the 2015-20 period where SAPN proposes to spend $238.9 million. This is a significant increase on the prior period and stems directly from increased inspection rates and a higher assessment of risk. It is not driven by an increase in the number of failures, which have not been significant historically[9]. SAPN argues that the inspections have resulted in the identification of a large number of defects for the steel poles that do not meet the corrosion standards. Figure 2 shows the dramatic (and unrealistic) increase in pole failure risk from 2012 onwards defined by corrosion risk factors not actual failures.

[5] SAPN Regulatory Proposal 2015-2020, p183
[6] SAPN Regulatory Proposal 2015-2020, p186
[7] Deloitte Online Consumer Survey Report July 2013 p7
[8] ESCOSA Jurisdictional Service Standards for the 2015-2020 Regulatory Period Final Targets Fact sheet October 2014 p2
[9] SAPN Regulatory Proposal 2015-2020, p189

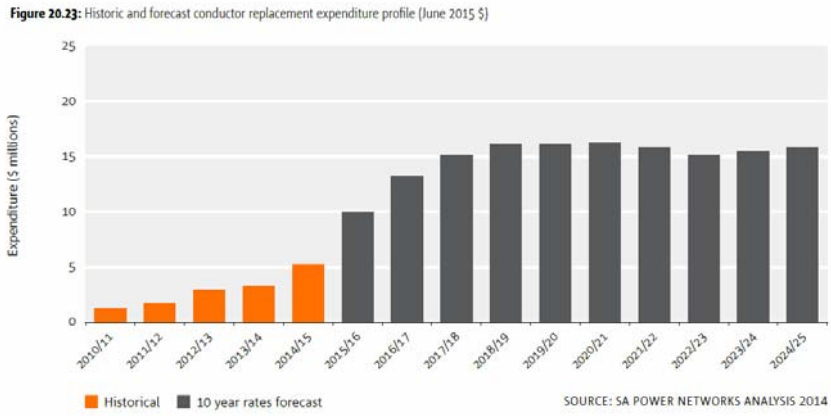
Figure 1: Increase to risk ratings for Stobie pole replacements not based on actual failures but different risk assessment criteria[10]



2.2.2 Conductor replacement

A further issue with the expenditure plan is the forecast replacement program for conductors. SAPN proposes to spend $72.2 million on these replacements in 2015-20, a substantial increase in the prior period (see figure below). SAPN argues that most conductors were installed over a very short period of time, this being from 1955 to 1960. However given that asset life of a conductor is over 80 years[11], it does not seem reasonable that the number of replacements is required to increase so dramatically in the 2015-20 period.

Figure 2: Increased expenditure on conductors



SAPN proposes to spend $85.5 million on safety in 2015-20 as part of its replacement program. The EUAA notes that despite being given an allowance of $100.3 million in the 2009-14 period for this item, SAPN only spent $55.9 million. This raises the question of whether SAPN needs the allowance it forecasts. SAPN states that the problem was due to it being unable to safely gain access to manholes in the Adelaide CBD. The introduction of a permanent afternoon shift will apparently enable SAPN to spend the allowance it is requesting. At best this is an example of poor planning in the prior period, at worst it is another example of an inadequate justification for expenditure.

[10] SAPN Regulatory Proposal 2015-2020, p191
[11] SAPN Regulatory Proposal 2015-2020, p196

2.3 Augmentation expenditure

SAPN proposes to increase augmentation capital expenditure significantly. This spending will increase by 49%, from $594 million to $885 million in the 2015-20 period. SAPN claims that its augmentation costs are primarily driven by Electricity Transmission Code (ETC) changes and forecast spatial demand growth[12]. The EUAA rejects this assertion and finds the evidence presented in the SAPN proposal on these points contradictory. The costs relating to ETC changes are not a significant part of expenditure in the 2015-20 period. The forecast expenditure for ETC projects is $14.1 million, which is hardly a major component of an $885 million program. The demand driven augmentation expenditure for 2015-20 amounts to $345 million. This means that more than $500 million of the augmentation costs do not relate to ETC changes or demand driven costs. The main reasons are new costs for safety, demand and vehicle costs.

2.3.1 19-fold increase in safety expenditure

By far the most dramatic spending increase for any one item is the 19 fold increase in safety expenditure (a total of $320 million in the 2015-20 period). This spending is mostly for tree trimming and undergrounding power lines in bushfire risk areas ($220 million) or at traffic black spots ($78 million). The EUAA notes that these changes are not required by any new regulatory requirements in South Australia and SAPN does not have a mandate to undertake these initiatives. Any safety measures introduced in other states (such as bushfire mitigation in Victoria) do not give SAPN an obligation to undertake additional spending.

Recommendation 2:

We urge the AER to reject the proposed 19 fold increase in safety expenditure. These increases cannot be justified on the basis of any new regulatory requirement.

SAPN claims its Customer Engagement Program showed that customers want additional safety measures, in particular the undergrounding of cables in bushfires areas and traffic black spots. "…*clearly outlines the extent of customer support including through customers' Willingness to Pay for targeted undergrounding works in BFRAs [bushfire risk areas].*"

The EUAA provides an extensive review of the Consumer Engagement Program in this submission where it identifies errors in the sampling approach and a poor question formulation.

If these survey results are to be considered by the AER then we note that the overhead/undergrounding mix is of little interest to consumers in respect to their overall satisfaction with SAPN[13].

We note that in the 2015-20 period capital expenditure on vehicles is increasing from $95 million to $146 million. The EUAA does not consider that a vehicle replacement program should require an additional $51 million of spending.

2.3.2 Double expenditure for reliability despite stable performance

SAPN is claiming a further $59 million for reliability within its augmentation spending program. This is double the amount in 2009-2014 and is despite its acknowledgement that underlying network performance remains relatively stable[14]. Severe weather events are suggested as the

[12] SAPN Regulatory Proposal 2015-2020, p174
[13] Targeted Willingness-To-Pay
[14] SAPN Regulatory Proposal 2015-2020, p218

reason for the increase. The EUAA notes that severe weather events were just as likely in the prior regulatory period as they are in the 2015-20 period are not a reason for $30 million of additional expenditure.

SAPN states that its demand driven expenditure is similar to the 2009-14 period as the global SA demand is forecast to remain relatively flat[15]. Flat demand should see large falls in this expenditure as the need for augmenting the network is significantly reduced. Despite this SAPN proposes to spend $345 million in anticipation of growth in electricity demand. Contributing to this total is $69 million for situations where demand exceeds planning criteria requirements. SAPN also claims that 29% of the $345 million (or $100 million) is for "general growth". To our knowledge this item that does not receive any commentary in the SAPN proposal (see Table 20.23). The EUAA does not consider that either of these spending items are necessary given the outlook for demand. Under the National Electricity Rules network expenditure must reflect that of an efficient and prudent operator and must meet demand forecasts. SAPN should meet this requirement without spending $345 million on augmentation activities.

SAPN identifies voltage control issues within its distribution network as a result of new residential roof-top PV. The business plans to spend $90 million on the low voltage (LV) distribution transformers to improve voltage control (and compliance with the Code)[16]. The EUAA does not believe SAPN should justify with granular clarity why such a large amount is necessary to achieve better voltage control within the LV network.

2.4 Non-network Expenditure

SAPN proposes to spend $354 million on IT in the 2015-20 period, up from $153 million. SAPN's reason for such a significant increase is an increased complexity and risk within the IT environment. The EUAA doesn't consider that the increase is supported by the information provided in the SAPN proposal, as the following sub-components demonstrate:

- $27 million for the IT costs associated with the introduction of cost reflective tariffs and advanced metering. The EUAA considers it unlikely that $27 million is needed to be spent on IT systems for a new tariff.
- $15 million to enable SAPN to prepare its RIN for the AER. Given that SAPN successfully submitted its RIN for the current regulatory process, this expenditure appears unnecessary.
- $31 million to "*Enhance and upgrade capabilities into an integrated enterprise approach to asset management including improvements in vegetation management.*" [17] The EUAA is not clear on what this item may represent but nonetheless does not believe it should require $31 million of IT capital expenditure.

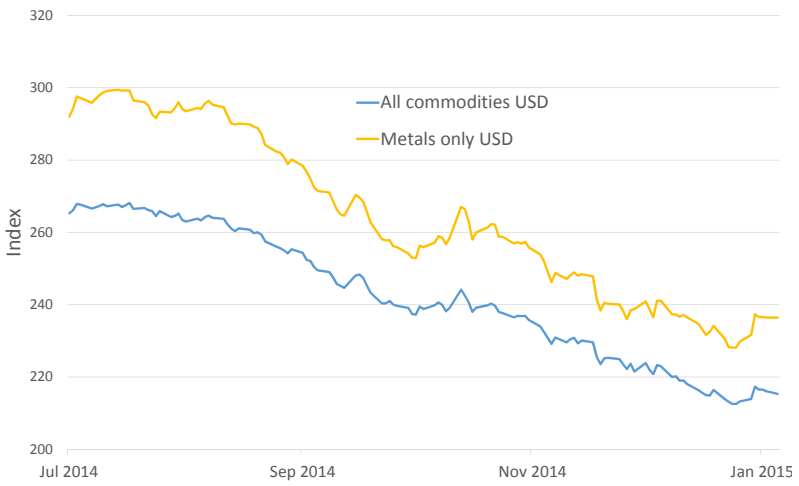
SAPN identifies $58 million of avoided costs and benefits[18] as a result of its significantly increased IT program. When compared to the $354 million program these benefits do not provide an adequate return on investment. If this was included in the Willingness to Pay study there is no doubt that SAPN's customers would arrive at the same conclusion.

[15] SAPN Regulatory Proposal 2015-2020, p217
[16] SAPN Regulatory Proposal 2015-2020, p215
[17] SAPN Regulatory Proposal 2015-2020, p231
[18] SAPN Regulatory Proposal 2015-2020, p223

2.5 Material Cost Escalators

The EUAA notes that during the current financial year the prices for commodities have fallen dramatically. This has occurred for crude oil, copper, aluminium and steel (as well as iron ore and coal). Figure 4 below shows the CBA Australian Commodities Price Index. In US dollar terms this index has fallen by almost a quarter since 1 July 2014. However the 2015/16 financial year materials escalator in the SAPN proposal is 0.71% in real terms[19]. This figure should be substantially lowered to reflect the step reduction in material costs that will be experienced by SAPN in the first year of the 2015-20 period. This amendment will reduce the forecast capital expenditure that is proposed by SAPN. We note that these escalators apply to capital and operating expenditure forecasts.

Figure 3: CBA Australian Commodities Price Index



Recommendation 3:

We recommend the materials cost escalators take into account the significant fall in commodity prices already seen in the 2014/15 year.

3 Operating Expenditure

3.1 Introduction

SAPN propose to spend $1,554 million on its operating costs in the 2015-20 period, an increase of $350 million, or 33%. The EUAA does not find this expenditure forecast to be prudent or efficient. Under the National Electricity Rules the AER must accept an operating cost forecast if it reflects a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives[20]. The EUAA notes that electricity demand in South Australia is flat or in decline and this suggests that the operating costs should follow a similar path. SAPN has alternatively proposed to increase spending by $350 million at a time when the underlying business drivers do not warrant such a change.

[19] SAPN Regulatory Proposal 2015-2020, p178
[20] National Electricity Rules 6.5.6(c)

3.2 Step Changes

SAPN forecasts that its operating costs will see a step increase in the 2015-20 period by more than $217 million, or 12% in the first year. The EUAA rejects the reasons for these increases. According to SAPN the increases are primarily due to:

- changes in legal and regulatory obligations ($105 million). These consist of increased asset inspections ($42 million), additional workplace health and safety compliance costs ($13 million), and energy law and regulation compliance ($49 million);
- extra operating costs arising from proposed capital expenditure ($70 million); and
- costs of meeting customer expectations as a result of the Customer Engagement Program ($42 million).

The decision to increase asset inspections has been an initiative of SAPN and have not been due to new South Australian regulations or compliance requirements. As discussed in section 2.3, changes to Victorian safety standards do not create a corresponding compliance requirement for SAPN.

Recommendation 4

The operating cost forecast should not receive a 12% step increase in 2015/16. SAPN does not face significant changes to its compliance regime in 2015-20 and resulting increased costs.

Within the $49 million energy law and regulation compliance component, SAPN is claiming an additional $9 million to enable it to prepare the AER's Regulatory Information Notice. It states that it is due to "*a one-off vegetation management scoping cost and additional field and back office resources to capture and process the data and internal audit*"[21] The EUAA rejects the notion that SAPN needs extra funding to prepare its RIN. SAPN prepared the RIN for the current regulatory determination process and will still meet its operating cost allowance for 2009-14. We also note that SAPN has also claimed $15 million for IT non-network capital expenditure for its RIN preparations (discussed in section 2.3).

Also within the energy law and regulation compliance component is a claim for $34 million to introduce a cost reflective network tariff. This cost estimate appears excessive given that it only covers customer support (which is the responsibility of retailers), retailer liaison, and process development. SAPN also states that the cost includes IT development, but this has already been claimed as a $27 million item of capital expenditure (discussed in section 2.3) and therefore should be considered as double counting. EUAA also notes that the recent AEMC rule change does not oblige distributors to create cost reflective tariffs[22]. SAPN claims that its Customer Engagement Program found that customers strongly support capacity tariffs[23]. As discussed in section 6 these survey questions did not include bill impact estimates for the respondents and should be disregarded.

SAPN states that its increased capital program will increase its operating costs in the 2015-20 period by $70 million. This includes $44 million for IT and $17 million for telecommunications. EUAA rejects the notion that a larger capital program drives greater operating costs. Increased capital expenditure should, over time, drive operating cost savings. In addition, the typical accounting treatment for an investment project is to capitalise the attributable operating costs. This should have already been carried out by SAPN in its capital expenditure assessments. The

[21] SAPN Regulatory Proposal 2015-2020, p257
[22] National Electricity Amendment (Distribution Network Pricing Arrangements), 27 November 2014
[23] SAPN Regulatory Proposal 2015-2020, p257

view of the EUAA is that much of the extra operating costs for this component are likely to represent double counting.

The EUAA doesn't consider that the consumer engagement program should be a claimable $42 million "step change" increase in operating costs. $32 million of this item consist of vegetation management, included because "*SA Power Networks has responded to a clear mandate arising from our Customer Engagement Program*". Section 6 of this submission raises concerns with the survey results being used to claim additional expenditure. Vegetation management was presented to survey respondents of the context of bushfire management and this would skew the results.

3.3 Rate of change

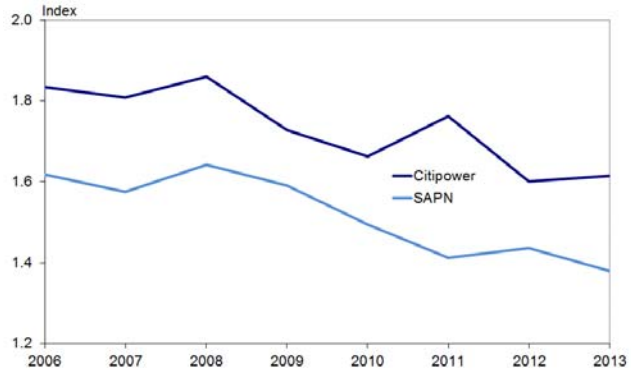
During the 2015-20 period the annual change in operating expenditure will be determined by an annual rate of change, as per the following:

Annual rate of change = annual output growth + annual real price growth – annual productivity growth

SAPN states that it will need to spend an additional $29 million for *output growth* operating expenditure due to network expansion and a further $10 million due to growth of the workforce. EUAA notes that if the AER reduces the SAPN capital expenditure program then these items are less likely to be needed and overall operating costs should fall.

SAPN has not included a *productivity growth* factor in its operating expenditure forecasts. SAPN believes that it is at the efficient frontier, and therefore a catch up figure is not applicable to it[24]. It also states that there is an inadequate basis for estimating and applying a productivity adjustment in the rate of change formula. However according to Economic Insights, SAPN is not the most efficient distributor in the NEM, as the following chart shows.

Figure 4: Multilateral total factor productivity[25]



The productivity index for SAPN is worse than Citipower and therefore SAPN is not at the efficient frontier. If international comparisons were taken into account it is likely that SAPN would have an even larger gap to make up in order to be at the frontier for best practice. EUAA also notes that the SAPN productivity index has been in decline over the last 8 years. To reverse this trend, the AER should include a factor for productivity in the rate of change formula to apply for SAPN in the 2015-20 period.

[24] SAPN Regulatory Proposal 2015-2020, p269
[25] Data from Economic Insights DNSP Productivity Files, November 2014

In its regulatory proposal SAPN states that it shouldn't be subject to productivity improvements because its business will incur costs during 2015-20 which at this time can't be identified[26]. SAPN is capable of identifying and achieving efficiencies in its business, and finding opportunities in its operational activities to reduce costs. For example in its proposal SAPN states that it incurred unexpected impacts to its operating expenditure in the 2009-14 period. These were higher than expected service level payments and the large administration costs for the administration of roof-top PV. Despite these unexpected costs, SAPN's actual operating expenditure in 2009-14 will be close to the AER allowance. This suggests that SAPN can find business efficiencies when it needs to.

Recommendation 5:

SAPN should be required to include a productivity factor in its operating expenditure forecast path for 2015-20.

4 Rate of Return

SAPN proposes a nominal vanilla weighted average cost of capital (WACC) of 7.62%, with a return on equity of 10.45% and a cost of debt of 5.74%. SAPN broadly accepts the 10 year trailing average approach for its cost of debt, as outlined in the AER Rate of Return Guideline published in December 2013. However SAPN does not intend to calculate a cost of equity that is consistent with this guideline. It argues that under the guideline the market risk premium and the risk free rate are not calculated across the same timeframe. The EUAA does not believe this is a valid reason to depart from the guideline and we urge the AER to reject SAPN's proposed cost of equity. Any departures from the guideline should be subject to an appropriate level of consultation (we note that the preparation of this guideline involved extensive consultation with stakeholders over a 12 month period). The EUAA also encourages the AER to give full consideration to the recommendations from the Consumer Challenge Panel's recommendations on the rate of return.

We also note that in the 2015-20 period SAPN will be regulated under a revenue cap, instead of a weighted average price cap (WAPC). This is a significant change in the new regulatory period as SAPN will no longer face electricity demand or consumption risk within a five year period. If SAPN under-recovers revenue in one year it can recover the shortfall using higher distribution prices in the subsequent year. This is a significant reduction in revenue risk for network businesses and should be taken into account in the AER's decision on the SAPN rate of return parameters.

Recommendation 6:

The SAPN cost of equity calculation (for the rate of return) should adhere to the AER's Rate of Return Guideline.

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 recent *Rate of Return Workstream* and stakeholder consultation on the calculation of WACC parameters. Some recent EUAA recommendations to the AER from these submissions have been:

[26] SAPN Regulatory Proposal 2015-2020, p269

1. The AER should consider a more broad range of information when making its determination on the WACC for electricity distributors. For example, there is growing evidence that acquisitions of Australian regulated network businesses are achieving substantial premiums above the regulated asset base (RAB). The offer by CKI for Envestra had an implied RAB multiple of over 150%. CKI's purchase of a stake in DUET has an implied RAB multiple of 128%.
2. The AER should use its discretion in a balanced manner when selecting the parameters for the rate of return. For example, in its first decision under the new rules, the AER set a transitional rate of return for NSW distributors of 8.1%. The 8.1% WACC is at the high end of the original range and was a result of an equity beta of 0.7 being selected from the range of 0.4 to 0.7. Compared to the most recent decision under the old rules (Ausnet Services with a WACC of 7.87%) the AER has in fact set a higher rate under the new rules.
3. The AER should take into account the decisions of overseas and jurisdictional regulators when selecting its parameters for the rate of return. Compared to state based regulators, the AER has consistently selected higher rates of returns. This has also occurred when a comparison is made to equivalent international regulators. 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% and is well below all of the AER's prior decisions on WACCs.

5 Revenue

SAPN has proposed a total revenue of $4.4 billion in the 2015-20 period which is an increase of $250 million. This revenue is largely driven by the increases to the expenditure program. SAPN's revenue outlook has resulted in near to CPI price increases for the 2015-2020 period. This is because the significant increase in expenditure has been offset by a reduction in the rate of return.

Table 1: Average Real Price Change for SAPN[27]

	2015/16	2016/17	2017/18	2018/19	2019/20
Average real price change	-4.3%	0%	0%	0%	0%

It is unlikely that the proposed price path is a coincidence. An 'at most' CPI revenue path was first presented by SAPN in the stage 1 customer consultations held in 2012[28]. A slightly modified, -4% (first year) scenario, was used in the NTF Group research in May 2014[29] and has become the version used in the recent SAPN proposal. A prudent and efficient forecast of expenditure requires a 'bottom up' assessment of costs. The revenue requirement should then be determined from this assessment using the building block components. We consider however that the SAPN expenditure program has instead been set by using a 'top down' revenue and price path target. It is likely that the 'at most' CPI price path was used by SAPN as an input (rather than output) and that the expenditure program was the output (rather than input). It suggests that SAPN is seeking to fully maximise its revenue over the 2015-20 period by not passing through to consumers the savings of reduced rate of return.

[27] SAPN Regulatory Proposal 2015-2020, p353
[28] SAPN Regulatory Proposal 2015-2020, p58
[29] Appendix 6.8 Willingness to Pay Research Findings, NTF Group, p5

Recommendation 7:

We recommend that the AER give consideration to the likelihood that SAPN has set its proposed revenue path for 2015-20 in advance of preparing its expenditure requirements. This brings into question the validity of the proposed expenditure program.

This submission presents a wide range of reasons why there should be substantial reductions in the revenue recovered in the next regulatory period. The 2015/16 (first year) revenue should fall significantly more than 4.3% in real terms. This is because of the reduction in the rate of return in the next period (down from a nominal vanilla rate of 9.76%). While the EUAA does not believe that the proposed WACC of 7.62% is reasonable or should be approved by the AER, a 2.14% reduction in WACC would see revenue fall by $82 million in 2015/16. If operating costs in the next regulatory period were similar or the same to the current period, this would contribute a further $46 million reduction on the first year revenue. Furthermore, if capital expenditure was held constant to 2010-15 levels, then there would be significant and additional reductions to revenue in the next period due to less depreciation on a lower RAB. All of these factors add up to a strong case for the first year revenue to be substantial lower than the proposed $902 million of smoothed revenue for 2015/16 (a result of an 'X factor' of only 4.3%).

EUAA notes that SAPN's revenue has significantly exceeded the AER allowance in the 2009 to 2014 period. This is as a result of the volume driven weighted average price cap (WAPC) formula. While the introduction of the revenue cap system is welcomed (it will prevent this over recovery), the EUAA notes that network businesses now face no risk in recovering revenue within a five year period. This should be reflected in a lower cost of capital (see section 4).

6 Consumer Engagement

The EUAA has significant concerns with the results of the Customer Engagement Program and how it has been used to justify expenditure above 2009-14 levels. The SAPN revenue proposal claims that consumers want additional expenditure to improve the reliability and safety of the network. The results of the consumer engagement program form the basis of this view:

"*At all stages of the Customer Engagement Program, our customers have consistently recognised the need to invest for the short term and the longer term.*"[30]
"*Our customers have strongly supported an appropriate level of investment in replacing and refurbishing assets…*"[31]

These findings appear highly unlikely given that 79% of SAPN sampled customers are satisfied with the current level of network performance and associated service levels[32]. As much as 88% of sampled customers are satisfied with their current level of reliability[33]. Considering that another survey question showed 86% of the sampled customers are concerned about electricity cost increases[34], it is clear that any investment above 2009-14 levels must be put in the context of price impacts to the consumer. In many cases this did not occur during the Customer Engagement Program.

[30] SAPN Regulatory Proposal 2015-2020, p29
[31] SAPN Regulatory Proposal 2015-2020, p186
[32] Willingness to Pay, NTF Group p11
[33] Deloitte Online Consumer Survey Report July 2013 p7
[34] NTF Targeted Willingness To Pay Research, p21

The methodology used for the online surveys is questionable and not representative of the SAPN customer base. SAPN commissioned two online surveys during its Customer Engagement Program. These were the Deloitte Online Consumer Survey (appendix 6.5 of the SAPN proposal) and the NTF Group's Targeted Willingness to Pay Findings (appendix 6.8). 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[35]. The EUAA considers that this is a significant oversight given that the SAPN 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.

Recommendation 8:

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.

The Deloitte Online Consumer Survey found respondents supported all proposed asset management initiatives[36]. This was because the survey questions did not contrast these spending initiatives with the associated customer bill impacts. For example the respondents were asked for their views on undergrounding overhead lines and having fit-for-setting substation facades. Not surprisingly 76% of respondents said that fit-for-setting substation facades will have visual benefits and 86% said undergrounding the network would result in visual improvements[37]. These questions (among many others) are poorly designed and are not testing whether consumers are prepared to pay for the initiatives. These survey findings shouldn't be used to suggest that consumers want further spending on the initiatives. The questions should have shown the bill reductions and savings that could be achieved by not undertaking the initiatives.

In the Deloitte survey only 4% of respondents who were dissatisfied with their reliability were given the opportunity to comment on price impacts[38]. It is somewhat obvious that customers who are dissatisfied with their reliability will be willing to pay more to have it improved. The survey should have also asked the 96% of respondents who were satisfied (or neutral) on reliability about whether they would like to pay more. This would have given a substantially clearer view on what the entire sample thought of having to pay more for reliability. As 88% of the respondents are satisfied with their current level of reliability[39] it is unlikely it would have been supported.

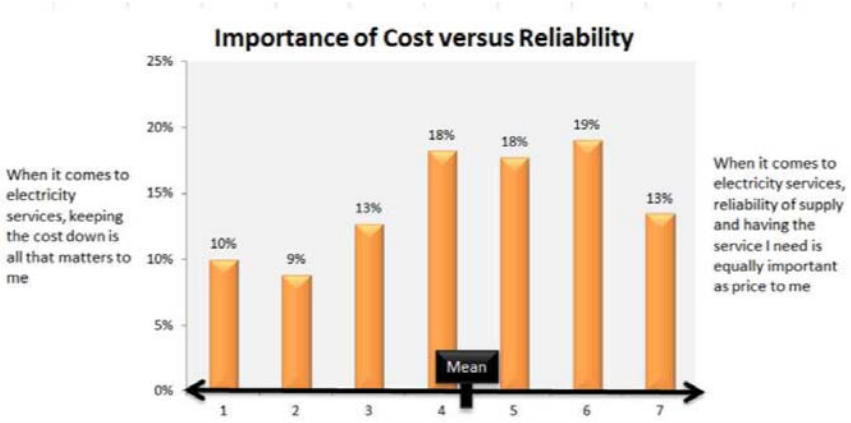
The second online survey commissioned by SAPN was the NTF Targeted Willingness to Pay Research. The survey aimed to test consumers' willingness to pay more for vegetation management and undergrounding of overhead lines. However in the survey these initiatives were presented to customers only in the context of limited options, such as traffic black spots and bushfire risk areas. Not surprisingly this unreasonably shifts the responses towards results that indicate consumers require more spending. SAPN didn't include other spending items in the survey such as the extra $153 million on IT or the extra $51 million for vehicles. These items are unlikely to receive the same responses from customers as the spending that was put in the context of bushfire risk and traffic blackspots.

[35] Appendix 6.5 Deloitte Online Consumer Survey Report July 2013 p6
[36] Appendix 6.5 Deloitte Online Consumer Survey Report July 2013 p30
[37] Appendix 6.5 Deloitte Online Consumer Survey Report July 2013 p7
[38] Appendix 6.5 Deloitte Online Consumer Survey Report July 2013 p39
[39] Deloitte Online Consumer Survey Report July 2013 p7

The EUAA also notes that the survey did not give consumers the option of choosing bill reductions as a result of avoiding additional spending (above 2009-14 levels). The starting point baseline for willingness to pay research should be for bill reductions (as opposed to increases) given that the 2015-20 period revenue would fall if the associated expenditure remained the same as the prior period level (due to a lower WACC).

The EUAA has significant concerns on how the survey questions were presented to consumers. They appear to be designed to encourage consumers to provide answers in favour of increased spending. For example a question asked consumers to indicate on a 1 to 7 point scale the importance of lower cost versus reliability of supply. One of the options presents a reasonable statement (reliability and price are equally important) while the alternative option is an extreme case (cost is all that matters). It follows that respondents will choose the option that is more moderate, and the results in the figure below confirm this. To avoid skewed results the question should instead show two extreme and separate options for price and reliability. Otherwise the results will be misinterpreted as suggesting that there is a consumer preference for increased spending on reliability.

Figure 5: NTF Targeted Willingness to Pay Research Findings (section 4.1.1)



Similar issues occur with other scalar questions in the survey. For example the question on maintenance (section 4.1.2) is skewed in favour of more spending on network maintenance. The two alternatives offered present one moderate proposition (*put as much into maintain the network for the future as previous generations did for us*) and one extreme proposition (*future generations can pay to maintain and upgrade the network*). It follows that the results will be skewed in favour of the more moderate proposition. It is important to note that these results cannot be interpreted as a customer preference for increased network spending.

SAPN also undertook a *Directions and Priorities 2015 to 2020* consultation as part of its consumer engagement program. A key document from the consultation presents a summary of SAPN plans for the 2015-20 period[40]. However this document does not show the total expenditure increase from previous period. It also does not show reduction in WACC from previous period or the potential bill savings from this reduction. By not providing a reference to the prior period the consumers participating in this consultation were not given an accurate representation of the implications of the SAPN proposal. By presenting the bill impacts as only a 1% increase in prices it would suggest to non-informed stakeholders that network expenditure only needs to go up by 1% in the 2015-20 period.

[40] SAPN Regulatory Proposal 2015-2020, p68,69

It should also be noted that the businesses surveyed in the Directions and Priorities 2015 to 2020 consultation do not support traffic blackspot undergrounding.[41] The undergrounding of assets at traffic blackspots are not required by any new regulations and should be undertaken by other entities. SAPN does not have a mandate to undertake this work but is using such to justify its support for expenditure increases.

[41] SAPN Regulatory Proposal 2015-2020, p109