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Ms Paula Conboy
Chair
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

cc Mark Grenning and Andrew Nance, CCP sub-panel 13.

Via email: paula.conboy@aer.gov.au, mark@grenning.com.au, and andrew.nance@energyproject.com.au.

Dear Ms Conboy

Chronology and outcomes of our customer and stakeholder engagement on rate of return

We thank your Board for our meeting on 4 February to discuss Power and Water Corporation's revised regulatory proposal. We appreciated the openness of the discussion and have prepared this letter in response to the discussions with your fellow Board members Cristina Cifuentes and Jim Cox. The letter sets out for the Australian Energy Regulator (AER) a chronology of our engagement on rate of return (RoR) during the preparation of our initial and revised regulatory proposals.

As observed by the Customer Challenge Panel (CCP) sub-panel 13, generating and maintaining customer and stakeholder interest in our engagement program for our first AER review has been a challenge in the Northern Territory (NT). This was not helped by our jurisdiction falling outside of the Energy Consumers Australia's (ECA) remit. Nonetheless, we are pleased that the CCP concluded in its 11 January 2019 submission that:

> *PWC has undertaken a quality consumer engagement programme recognising the constraints it faced from this being the first time PWC has gone through the AER review process, the level of knowledge and understanding of the reset process with NT consumers and the lack of funding support for consumer advocates.* [1]

Our engagement approach for RoR

We have worked consistently to:

- inform customers of the materiality of the rate of return to our forecast annual revenue requirements
- transparently explain our cost of debt approach, which is our only departure from the AER's binding RoR instrument, and

[1] Consumer Challenge Panel Sub-Panel 13, *Response to Power and Water Corporation revised proposal for a revenue reset for the 2019-24 regulatory period*, 11 January 2019, page 3.

- justify why we consider this departure is in NT customers' long-term interests given the effects of the Ministerial Direction in the current regulatory period, 2014-19. That is, the Ministerial Direction effectively set our return on debt allowance so that our average allowance over the 2009-19 period was much more consistent with a trailing average approach than an on-the-day approach – as such, adopting a trailing average over the 2019-24 period is more revenue neutral than adopting a transition from the start of it.

We presented the RoR approach and revenue outcomes of the Ministerial Direction to our Customer Advisory Council (CAC) at all major review milestones, and emphasised this key issue in our presentations to both of the AER's public forums.
Appendix A sets out our CAC membership. Appendix B provides the relevant excerpts from our engagement materials at each of the engagement forums.

The chronology of RoR engagement was:

1. CAC number 4 in December 2017 on our pre-submission draft regulatory proposal – this sought feedback to inform finalization of the regulatory proposal.
2. CAC number 5 in February 2018 on our initial regulatory proposal – this informed stakeholders on key issues to better enable them to make submission to the AER on our regulatory proposal.
3. First AER public forum in April 2018 – this also sought to inform stakeholders on key issues to better enable them to make submission to the AER on our regulatory proposal, and was an opportunity for them to hear the AER and CCP13's views on our approach to RoR.
4. CAC number 7 in September 2018 – this explained the AER's draft decision to our CAC and our immediate focus areas for our revised regulatory proposal planning. We consulted on what we were accepting, modifying, and not able to accept so that our customers could focus their submissions on matters still in dispute between us and the AER. Return on debt was flagged as a key area of dispute. The CCP13 observed at the second AER public forum that this was the most timely and thorough customer council briefings on revised regulatory proposal issues they had seen.
5. Second AER public forum in October 2018 – this was a further opportunity for our customers to hear from, and provide feedback to the AER, CCP13 and us on remaining issues of difference, of which the return on debt was again flagged as a key issue.

We have also engaged continuously with the NT Department of Treasury and Finance and the NT Treasurer who are accountable for designing and implementing the NT version of the National Electricity Rules (NT NER) and our shareholder.

Our RoR engagement outcomes

Understandably, the estimation approaches for return on debt are an area of arcane detail in the eyes of many of those we engaged with in the NT. Nonetheless, at our CAC meetings our return on debt approach was:

- Not rejected by our customers, and
- Commented upon as reasonable in our circumstances by one of our largest users.

In its submission on the AER's draft decision and our revised regulatory proposal, the NT Treasurer relevantly stated:

> *In addition to my concerns regarding PWC's operating expenditure requirements, I also note that the AER's draft determination will lower PWC's rate of return on its investments as a result of the AER's proposal for PWC to transition to the AER's approach for determining cost of debt.*
>
> *In reaching a final decision on rate of return I ask that the AER give particular consideration to the implications of the Ministerial Direction issued by the former Treasurer on 19 June 2014. The Ministerial Direction created a unique situation whereby it effectively overrode the former regulator's determination and required PWC to recover a rate of return significantly lower than permitted under the 2014-19 Network Price Determination.*
>
> *While PWC should not earn more than necessary, the AER should ensure there is no risk of being undercompensated*[2]*.*

If AER staff require more detail about our RoR engagement, please contact Djuna Pollard, Executive General Manager Power Services, on (08) 8995 5862 or djuna.pollard@powerwater.com.au.

Yours sincerely

Michael Thomson
Chief Executive

21 February 2019

Appendices:

A – Customer Advisory Council membership
B – Excerpts from engagement materials

[2] Northern Territory Treasurer, *Submission on draft decision and Power and Water's revised proposal*, 8 January 2019, page

Appendix A | Customer Advisory Council membership

Target membership of our Customer Advisory Council is listed below. As we noted in our initial regulatory proposal, attendance varies each meeting based on availability and each member's level of interest in the planned agenda items.

Membership:

- Chamber of Commerce
- GPT Group (Casuarina Shopping Centre)
- COTA (National Peak Organisation – Older Australians)
- Environment Centre NT
- NT Chamber of Commerce
- Master Builders Association
- NT Farmers Association
- Urban Development Institute
- Department of Defence (Sites across Darwin, Katherine & Alice Springs)
- NT Airports (Sites across Darwin, Katherine & Alice Springs)
- Charles Darwin University (Sites across Darwin, Katherine & Alice Springs)
- Multicultural Council of the NT
- St Vincent de Paul Society
- Tenants Advice (Darwin Community Legal Service)

Observers:

- Consumer Challenge Panel sub-panel 13
- Department of Treasury and Finance

Appendix B | Relevant excerpts from engagement materials

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Power Networks | CAC#4

Draft Regulatory Proposal
December 2017

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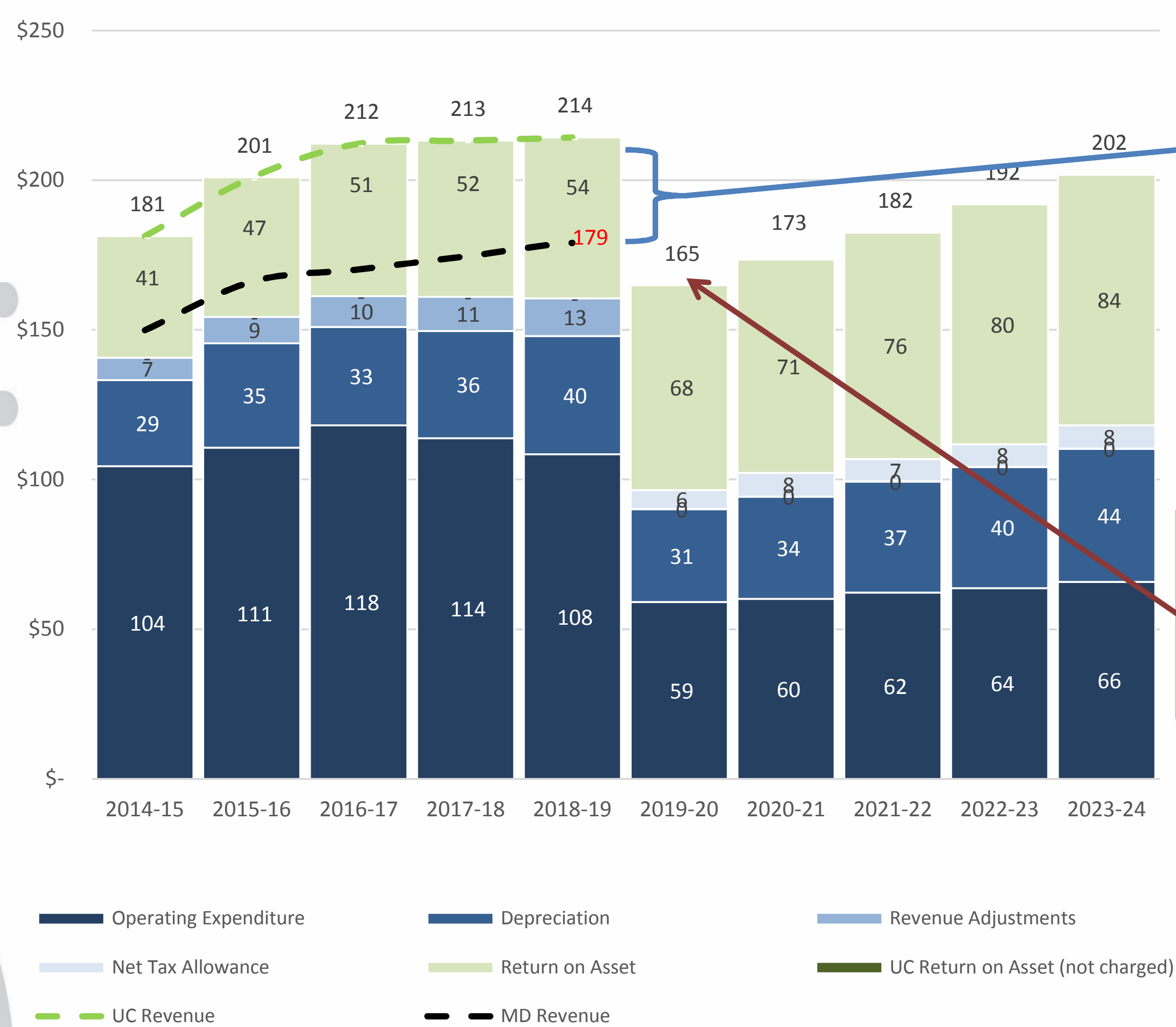
Revenue Forecast

Current forecast for FY19/20 to FY23/24 shows an initial reduction in revenue relative to the Ministerial Direction for FY19, and then a slight increase later in the period.



Ministerial Direction – Shareholder accepted a reduced rate of return (effectively based on debt coverage) to minimise customer tariff increases.

Expecting a revenue reduction in comparison to the UC's NPD and Ministerial Direction.

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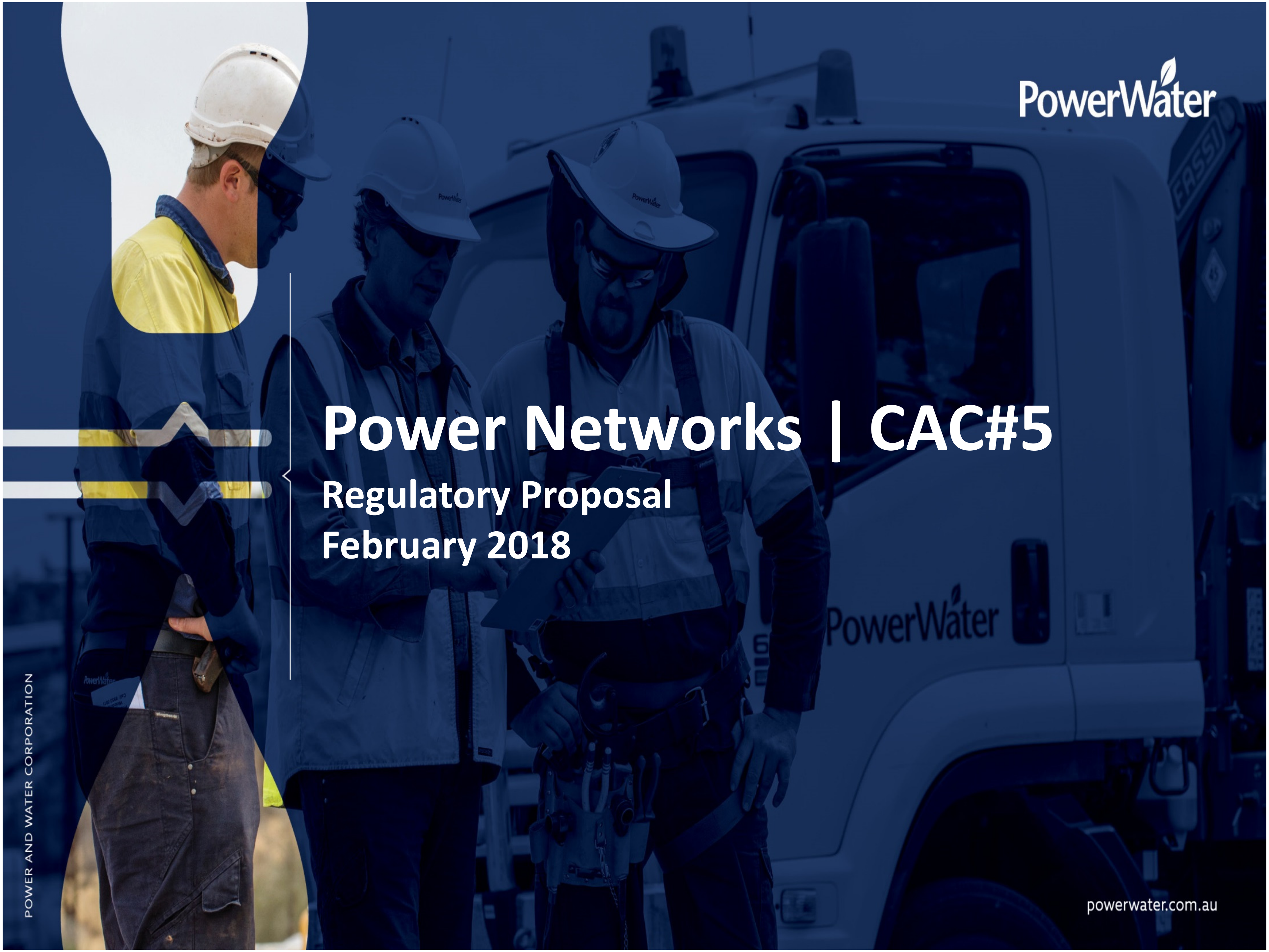
Snapshot of our proposal

Parameter	PWC proposed position
Service classification	Adopt AER F&A Decision – ACS metering and no negotiated distribution service
Control mechanism	Adopt AER F&A Decision – SCS revenue cap; ACS price cap
NT regulatory baseline	Base on instruments in place and apply at 1 December 2017
Demand forecast	Accept and apply forecast by AEMO
Regulatory asset base	Apply NT NER with Treasurer's adjustment - $67.7M reduction to $860.6M as at 1 July 2014 (Real $2014)
WACC	Adopt AER Rate of Return Guideline with immediate transition to trailing average return on debt
Depreciation	Apply year-on-year tracking approach
Capex	Forecast 'network' Capex remaining relatively flat and low in comparison to 2009-14 levels

Snapshot of our proposal

Parameter	PWC proposed position
Opex	Trending down with forecast reduction on 2014-19, due to 15% efficiency adjustment
Tax allowance	Apply approach AER used in recent approvals for other DNSPs plus established opening tax asset base for the first time
Cost pass through events	Apply events accepted by AER for other DNSPs plus further NT transitional regulatory change event after 1 July 2019
Incentive schemes	Accept AER proposal to apply EBSS, CESS, DMIS/DMIA and not to apply STPIS
ACS metering	Base on new and replacement advanced meters rollout –Current discussions with Treasury and AER regarding prepayment metering services
Tariff structure	Transition to more cost reflective tariffs with the introduction of peak demand charging for all customers with smart meters; and removal of declining block tariffs



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Power Networks | CAC#5

Regulatory Proposal

February 2018

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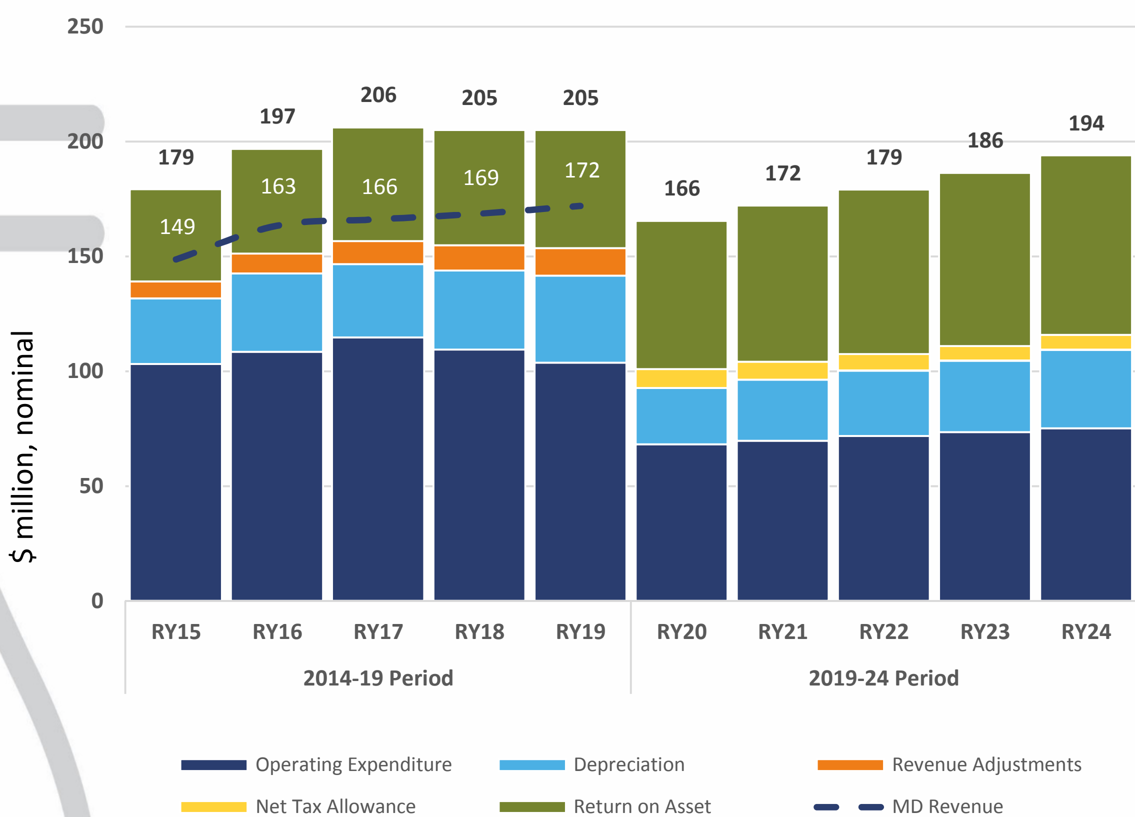
Overview of our proposed revenues

We will be cheaper

Our plan seeks less total revenue than we currently charge, with a reduction equivalent to $200 per year less, per customer, on average and in real terms.



Key assumptions and forecasts we'll explain today:

1. Forecast demand
2. Forecast operating and maintenance expenditure (opex)
3. Forecast capital investment (capex)
4. Forecast financing costs (WACC)

Other assumptions and approaches are summarised too

WACC

Our approach and forecast

- We need to be able to earn a fair rate of return of capital to continue investing in the network in a manner that best promotes customers' long-term interests

- We propose a rate of return of 6.62% for first year of the 2019–24 regulatory period. We determined this value using the values and approaches set out in the 2013 Rate of Return Guideline, except for the return on debt where we propose using the trailing average return on debt immediately without transition.

- The trailing average approach reduces the amount the return on debt allowance will vary over time, resulting in less price variation for electricity consumers.

Parameter	Value
Return on equity	7.00%
Return on debt	6.37%
Inflation	2.42%
Leverage	60.00%
Gamma	40.00%
Corporate tax rate	30.00%
Nominal vanilla WACC	6.62%

AER Public Forum #1

April 2018

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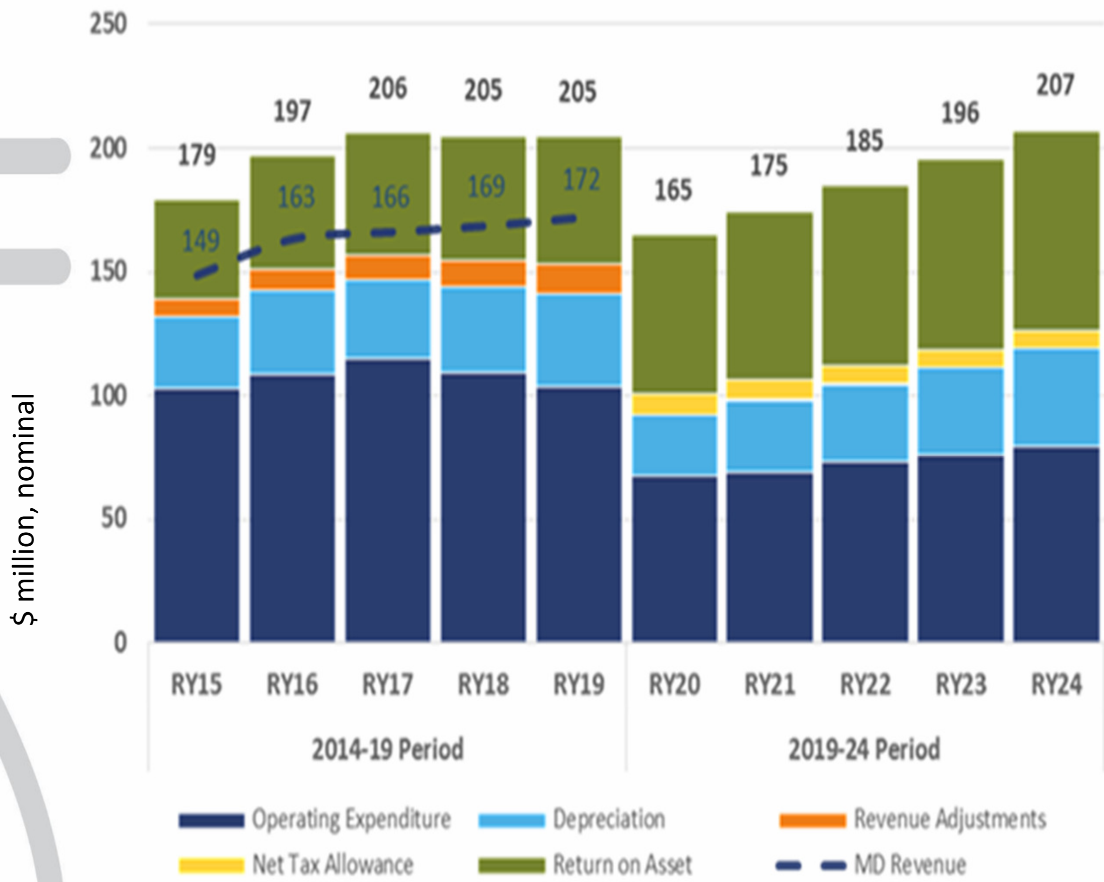
Overview of our proposed revenues
We will be cheaper

Our plan seeks less total revenue than we currently charge, with a reduction equivalent to $97 per year less, per customer, on average and in real terms compared to 2014-19.



Key assumptions and forecasts we'll explain today:

1. Forecast demand
2. Forecast operating and maintenance expenditure (opex)
3. Forecast capital investment (capex)
4. Forecast financing costs (WACC)

Overview of changes in proposed revenues

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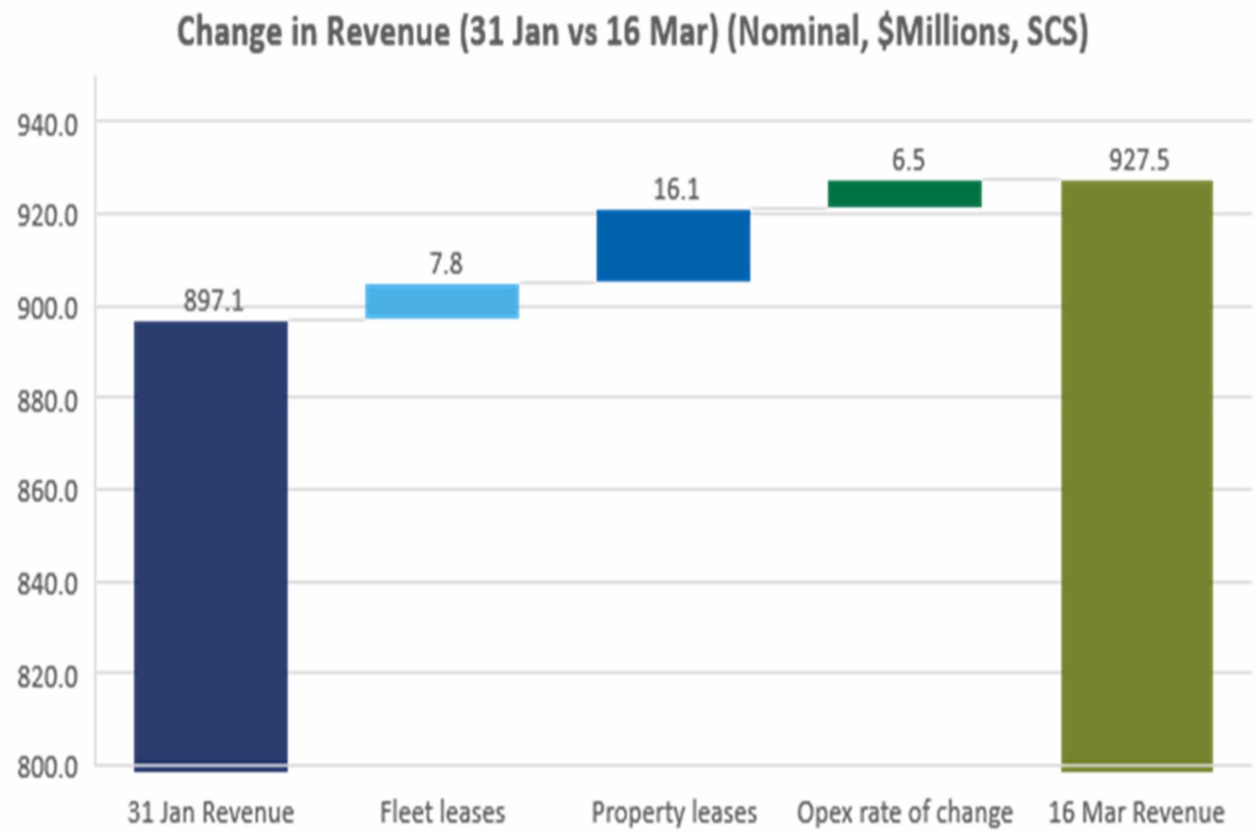
Our proposal still lowers average revenue per customer by $97pa, but has increased since the 31 Jan submission



Rate of Return

We need to be able to earn a fair rate of return of capital to continue investing in the network in a manner that best promotes customers' long-term interests

We have adopted the 2013 rate of return guideline to estimate our rate of return of **6.62%**, except for the return on debt transition. The next slide explains our reasons for our proposed departure to instead adopt the trailing average without transition.

Our proposed rate of return components are:

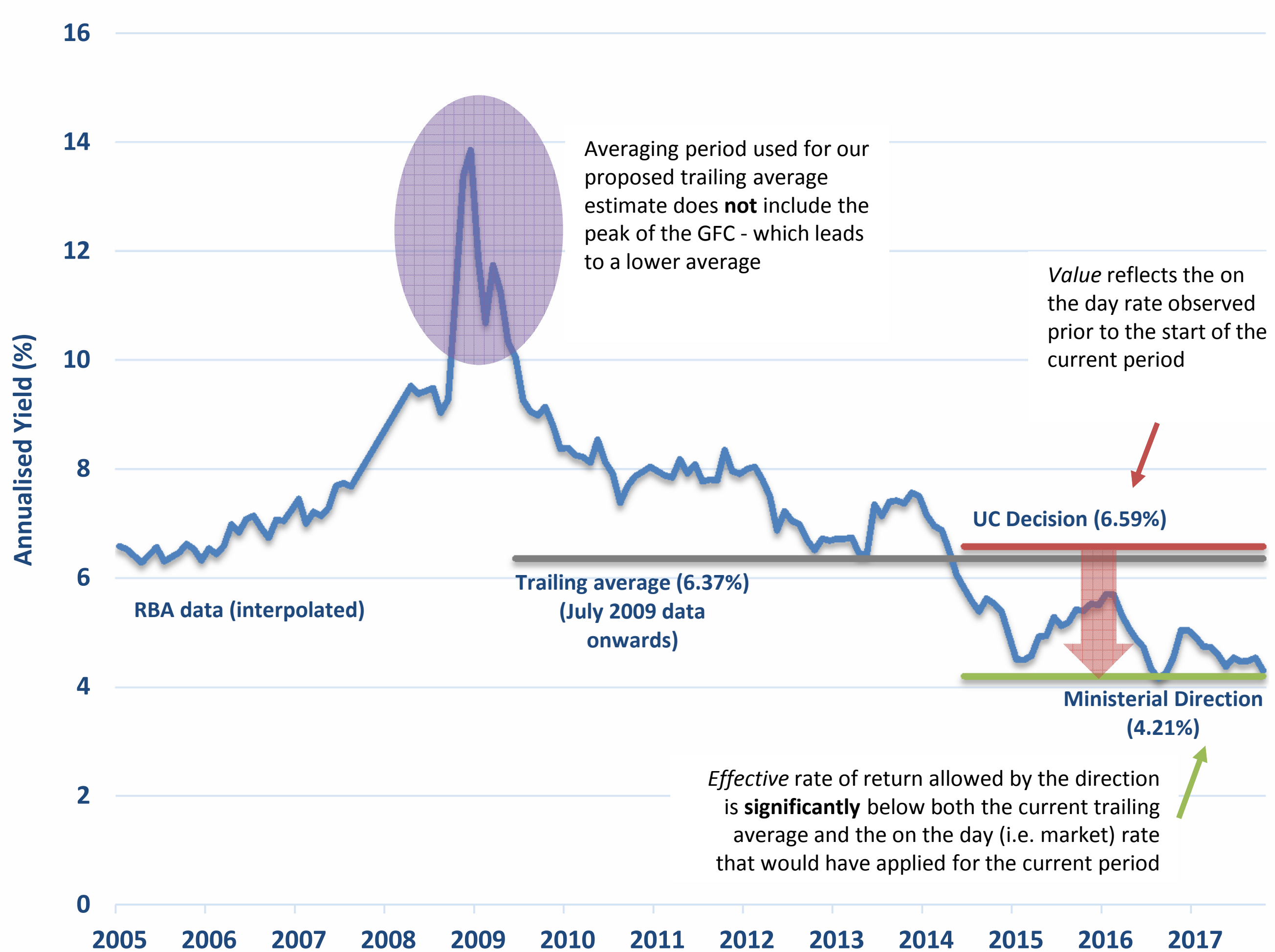
Component	Value
Return on equity	7.00%
Return on debt	6.37%
Inflation	2.42%
Leverage	60.00%
Gamma	40.00%
Corporate tax rate	30.00%
Nominal vanilla WACC	6.62%

Used the AER's preferred method

Estimated using placeholder averaging periods

Return on debt transition (cont.)

Comparison of observed 10 year BBB+ rate debt yields to UC decision and Ministerial Direction for the current period



Power Networks | CAC#7

Revised Regulatory Proposal Planning

September 2018

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Summary of Draft Determination

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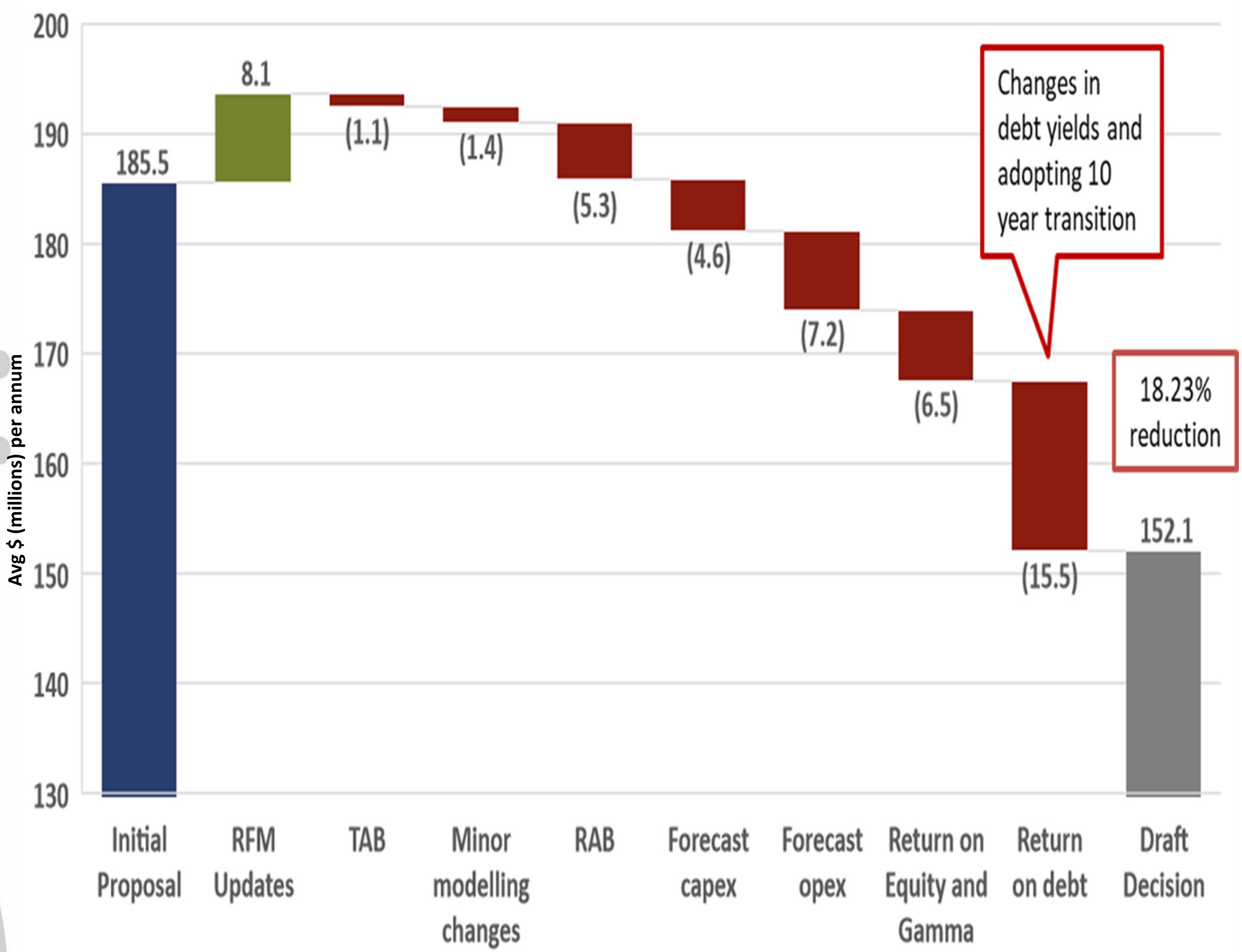
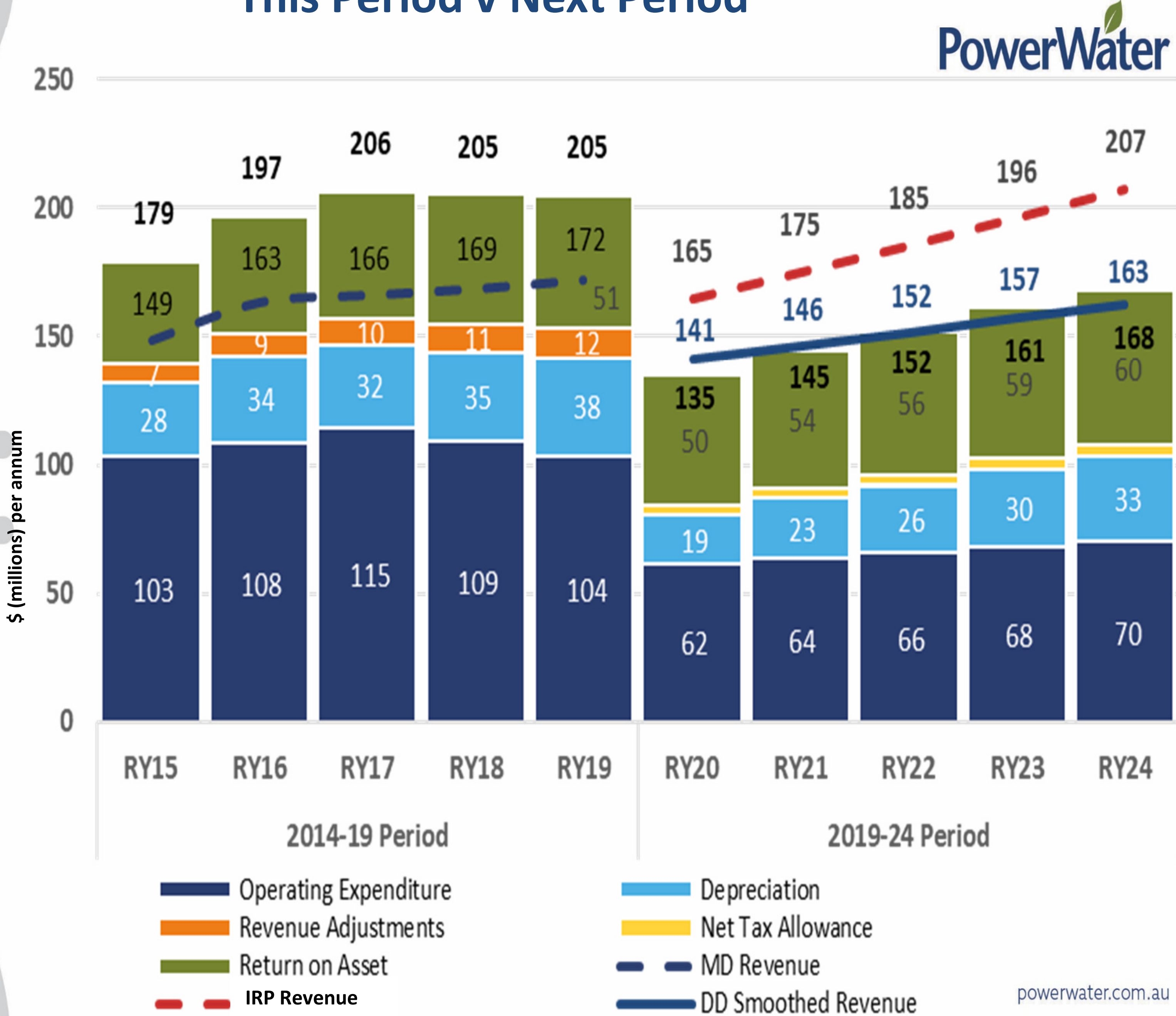


This Period v Next Period



Key draft findings | Rate of Return & SCS Pricing

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Rate of return

- Our IRP adopted the 2013 rate of return guideline to estimate our rate of return, except for the cost of debt transition.
- The draft decision applied the AER's draft 2008 rate of return guideline and did not consider our specific NT circumstances regarding our cost of debt transition.

Component	IRP value	DD value
Return on debt	6.37%	4.50%
Return on equity	7.00%	6.30%
Leverage	60%	60%
Rate of return	**6.62%**	**5.22%**
Gamma	0.4	0.5
Forecast inflation	2.42%	2.45%

Network service (SCS) pricing

AER accepted our proposals for:

- Tariff classes and tariff assignment policy
- Tariff structures for small customers (<750 MWh pa)
- Tariff structures for large customers (>750 MWh pa)
- 12-9pm peak charging window for all customers and seasonal application to small customers

AER Public Forum #2

October 2018

POWER AND WATER CORPORATION

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AER Public Forum| October 2019

Key Messages | Our remaining concerns

Debt | We will lower our WACC by adopting AER's new WACC approach for all items except cost of debt transition. We do not require a transition to a cost of debt trailing average

- Ministerial Direction mandated the effective start of trailing average funding arrangement and customer prices in this current period, so our reasons and situation are different to other networks
- The draft decision not only ignores our actual history in this way, but it fails to recognise the NT NER rules requirement to have regard to that direction

OPEX | We will update its RRP forecast for actual audited 2017/18 opex base year data, including adjusting this down to account for the impacts of Cyclone Marcus and a low capex year.

We believe the AER's additional opex cuts are unsustainable and risk the reliability and safety outcomes expected by our customers, employees and wider community:

- Our IRP proposed a 10% efficiency reduction
- The AER's DD reduced opex by 19%
- Our RRP will see us submit approx. 15% reduction from audited 2017/18 opex

CAPEX | We will lower our revised capex forecast

- The Draft Determination cut our forecast by 20%
- Our revised forecast will be approximately 10-15% lower than our IRP

Responding to AER's Rate of Return decision

We need to be able to earn a fair rate of return of capital to continue investing in the network in a manner that best promotes customers' long-term interests

Our IRP adopted the 2013 rate of return guideline to estimate our rate of return of 6.62%, except for the cost of debt transition.

The draft decision applied the AER's draft 2018 rate of return guideline and did not consider our specific NT circumstances as regards our cost of debt transition.

We will **lower our WACC** by adopting the AER's 2018 draft guideline for all matters except the cost of debt transition relevant to the NT. The next slide explains our reasons for our proposed departure to instead adopt the trailing average without transition.

Used the AER's preferred methods and parameter values

Component	IRP value	DD value	RRP
Return on debt	6.37%	4.50%	5.91%
Return on equity	7.00%	6.30%	6.19%
Leverage	60%	60%	60%
Rate of return	**6.62%**	**5.22%**	**6.02%**
Gamma	0.4	0.5	0.5
Forecast inflation	2.42%	2.45%	2.45%

Estimated using placeholder averaging periods

AER Public Forum| October 2019

Return on debt transition (cont.)

Comparison of observed 10 year BBB+ rate debt yields to UC decision and Ministerial Direction for the current period