

8 August 2014

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General Manager, Network Regulation
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Submission: Endeavour Energy 2015-19 Price Proposal

Trans Tasman Energy Group Consultants (TTEG) provides specialist energy sector advice including commercial, environmental and regulatory aspects pertaining to Public Lighting.

In Australia TTEG currently acts as public lighting consultants to over one hundred Council municipalities and road authorities in most Australian states.

TTEG has prepared a separate submission for Camden Council in response to the public lighting aspects of Endeavour Energy's (**Endeavour**) price proposal. TTEG supports the claims and recommendations in that proposal and refer the AER to that proposal for supplementary discussion regarding the points raised in this submission.

The distributors have submitted exceedingly complex pricing proposals to the AER and the same applies to their public lighting proposals, making stakeholder assessment and review of proposals problematic. A further concern for stakeholders was the entirety of each DNSP's submission was not available on the AER's web site, requiring stakeholders to seek these proposals from the AER which has unfortunately restricted our time for review.

In providing our submission we advise the AER that we have not been able to review any proposal in sufficient detail due to time constraints. We have conducted an initial review of Endeavour's public lighting proposal, and also a cursory reviewed of Essential Energy's proposal but we have not reviewed Ausgrid's proposal. We advise the AER that if we have not commented on an aspect, it should not be interpreted that we agree with this aspect.

To assist the AER in assessing the DNSP public lighting pricing proposals we submit the following for the AER's consideration.

Process and Classification

To effectively assess the voluminous and complex proposals requires significant resource and time, both which are not readily available to stakeholders. It also requires expertise, not only to assess the cost inputs and tariff outcomes but also to understand the complex workbooks. We **submit** to the AER that the complexity introduced by DNSPs in their proposals is unreasonable and prevents an effective assessment by most stakeholders. Further complications include that:

- DNSPs had removed key inputs and costs in its models and Regulatory Information Notice (RIN) response claiming confidentiality, and

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- We are not aware that the inventory or revenue per Tariff Class has been provided by Endeavour which prevents an assessment by Tariff Class

Public lighting represents a specific business function for DNSPs with minor revenues versus network revenues. We **submit** to the AER that with costs for providing the service known to DNSPs there should be no need for complex modelling to establish these costs. There are only three basic cost components being capital, operating expense and overhead. Indeed the modelling could produce a materially different cost outcome to the costs actually incurred by the DNSP.

DNSPs should consider each of these components at the Tariff class level which can then be summated to establish the business unit (ie total public lighting service) level. Only once this has been undertaken should the DNSP allocate the costs to each light type to establish tariffs.

Recognising the issues we have raised in this submission we request the AER consider requiring DNSPs to (re)submit simplified proposals that can easily be understood and verified by stakeholders and importantly reflect their “cost incurred”. Cost incurred is an important regulatory consideration as if the AER had classified public lighting services as a Negotiated Distribution service then prices should reflect the cost incurred in providing the service. We do not believe there should be a material difference in prices versus a Negotiated classification simply because of the AER’s Alternative Control classification.

The cost incurred does not need to be modeled – it simply needs to be reported and form the basis of establishing prices.

We **submit** to the AER that all DNSPs are required to submit simplified proposals that can easily be assessed by stakeholders and importantly reflects the DNSP’s “cost incurred” (a Negotiated service pricing principle).

We **submit** to the AER that the process to be undertaken by DNSPs should initially establish the total ‘business unit’ cost comprising capital, operation and overhead before allocating the costs to individual light types.

In further considering the modeling approach adopted by the DNSPs, we request the AER to reconsider the classification of public lighting services as a Negotiated classification. This would not only provide additional information to customers (as confidentiality can be undertaken with the DNSP) but the process to establish prices would not be time constrained.

Too Many Tariffs

All DNSPs have multiple individual tariffs, but most light types (eg Sodium, Mercury Vapour) typically have very little cost difference between them. For simplicity, these charges could be grouped at the same rate.

The multiplicity of tariffs contributes to complexity of proposal and stakeholder assessment whilst having no material financial difference. It also creates confusion and complexity in billing, reconciliation etc

An example of an appropriate tariff structure is that currently employed by SAPN in South Australia.

Overhead and Profit

Overhead allocations must comply with the DNSP's Allocation Method (**CAM**).

The CAM however does not provide an effective methodology for stakeholders to be able to assess, let alone reconcile the DNSP's allocations. Whilst we have seen various claims in our review of Endeavour's proposal, they have been fragmented and we have not been able to reconcile versus its CAM. Our understanding is it should be the DNSP's role to demonstrate compliance and to reconcile their proposed and actual costs..

Frustratingly, Endeavour's overhead allocations have been blanked out in its RIN.¹ We do not see that this can be confidential information and request the AER to require Endeavour to publish. Without the allocations known stakeholders cannot assess compliance with Endeavour's CAM.

In the table below we have estimated Endeavours overhead component at \$6.85 million based on Endeavour's proposal.

Overhead Calculation²			
	lights	other	Total
rate	\$33.62	\$8.40	
inventory	156,372	190,691	
	\$5,256,453	\$1,602,528	\$6,858,982

Interestingly, Endeavour's 2012/13 operating overheads were \$4.0 million³

Endeavour's proposed 2015-16 public lighting revenue is \$21.7 million⁴. Its basic cost (net of overhead) is \$14.9 million. The \$6.8 million overhead represents around 45% on the basic cost which includes a significant (say 50%) capital component

Attributing \$6.8 million overhead to public lighting is not reasonable, particularly when there is no material effort required by the DNSP to manage the capital aspect. Further, much of the operational aspect, including maintenance can be subcontracted by the DNSP, relegating the DNSP's role to that of a project manager. The \$6.8 million overhead allocation is excessive when considered in this context.

From Endeavour's RIN response⁵, in 2012/13 Endeavour made a \$7 million after tax profit (\$10 million before tax) on \$27.7 million of revenue (including \$7.5 million of customer contributed assets).

¹ Endeavour 210213 RIN response Appendix 1a – public version, sheet number 15 “Overheads Allocation”

² Endeavour Energy proposal Attachment 8.2, model. Rates ex “Annuity” sheet column L and Inventory ex “RAB” sheet, column L– “TC4” sheet column N summated for the relevant components.

³ Endeavour 210213 RIN response Appendix 1a – public version, sheet number 11 “Operating Overheads”

⁴ Endeavour Energy proposal – 8.02A1 – Proposed relative major customer bill impacts (Public)

If we disregard the contributed assets, the \$20.2 million revenue less \$5.9 million depreciation and \$11.8 million 'other' provides a \$2.5 million or 14% net operating profit before tax on a total cost of \$17.7 million. If we allow \$6.8⁶ million overhead in the \$17.7 million, then Endeavour's basic cost becomes \$10.9 million. So Endeavour's contribution to overhead and profit becomes \$9.3⁷ million or 85% which is well above the 25% expected industry norm.

We **submit** that the allocation of overheads and resultant profit of all DNSPs requires review by the AER in terms of CAM compliance.

Asset Costs (RAB and TAB)

Endeavour's Opening Regulatory Asset Base (**RAB**) for assets installed prior to 2009 is around \$28.6 million and its taxation asset base (**TAB**) is around \$1.1 million, representing a material disconnect between the distributor's actual cost (the TAB) and the RAB cost it is proposing to its customers.⁸

Endeavour is claiming costs for Tariff Class 1 public lighting assets of around \$8.3 million over the regulatory period at ~ \$1.6 million p.a.⁹

We expect other DNSPs to exhibit a similar disconnect of their asset bases.

We **submit** to the AER that the Regulated Asset Bases (**RAB**) for assets installed prior to 2009 and as used by DNSPs to establish prices are not cost reflective, which, as discussed earlier should be a primary consideration (ie similar to a Negotiated Distribution service) of the AER in establishing prices.

We **submit** to the AER that DNSP's proposed capital components for tariff class 1 are not cost reflective, and if approved, would provide a windfall profit to the DNSP.

LED Luminaires and New Technologies

The public lighting market is undergoing considerable change, including the introduction of LEDs and other technologies primarily designed to achieve energy efficiency.

Attempting to establish tariffs under the Alternative classification is therefore problematic. An example is the AER's approval of Endeavour's 25W LED tariff (which the AER introduced without stakeholder scrutiny) on the basis that the tariffs were established in a manner consistent with current determination.

⁵ Endeavour 210213 RIN response Appendix 1a – public version, sheet number 1 "Income"

⁶ As derived for 2015/16 later in our Overhead considerations

⁷ \$6.9 million overhead and \$2.5 million profit

⁸ Endeavour Energy proposal Attachment 8.2, model – "RAB" sheet

⁹ Endeavour Energy proposal Attachment 8.2, model – "TC 1 & 2" sheet row 634

Whilst we understand the AER's reasons, and its pricing methodology, we advise the AER that the 25W LED light (and all other LED lights) must be considered an "emerging public lighting technology" for the 2015-19 period.

Like Victoria, SA and Tasmania, we believe these emerging technologies should be treated as Negotiated Services – an approach which will enable services and charges to be negotiated for these very different light types.

We **submit** to the AER that treating LEDs like any other light is fundamentally flawed. The characteristics of the LED light are materially different to that of other lights, in particular, the maintenance requirements of LED lights are significantly less.

The lower maintenance aspect of LED is of particular benefit to rural and remote areas and will have a significant reduction on cost – yet Essential appears to have ignored LEDs in its bulk replacement program.

Replacement luminaire requirements are discussed later.

Also of interest is Endeavor has proposed a 12 year life for LEDs yet a 20 year useful life for all other light types. This variation has not been explained by Endeavour and requires investigation.¹⁰

Additional considerations are included in the Camden submission.

We **submit** to the AER that it rejects Endeavour's proposed (excessive) LED tariffs and reclassifies emerging technologies as a negotiated distribution service.

We also **submit** that if any distributor intends to introduce any new tariffs during a regulatory period that the distributor's proposal is provided for stakeholder scrutiny.

Tax (TC 4)

Endeavour (and we expect other DNSPs) have included a tax recovery component in Tariff Class 4 for assets gifted to the DNSP.

As explained in the Camden submission, we are not disputing that the tax may need to be paid, but we **submit** to the AER that it must reject any claim by the DNSPs for inclusion of this tax cost in their tariffs. The tax payment relates specifically to the DNSP acquiring an asset, typically from a third party such as a developer.

We **submit** to the AER that any DNSP must seek the payment of any tax obligations from the parties gifting the lighting assets to Endeavour Energy. It must not be included in the SLUOS charge where we note Endeavour Energy treats it as capital and applies WACC and indexation.

If a person gifts the asset to the DNSP then the DNSP must seek the tax payment from that person.

Annual Adjustment

¹⁰ Endeavour Energy proposal Attachment 8.2, model – "Annuity" tab, row 32 column E and F

We notice that Endeavour has an Adjustment for Volume Growth in its model^{11, 12}

Unfortunately, as once again the data has been hidden by Endeavour, we cannot assess.

What we can gather from the information provided it appears that Endeavour has not made any allowance for reducing its tariffs year on year to reflect the additional (new) lights installed in that year. These new lights increase a DNSP's inventory, and would result in decreasing (on a \$/light basis), the fixed components of Endeavour's costs (eg overhead).

We **submit** to the AER that it should require Endeavour and all DNSPs to recognise the year on year impact of additional (new) lights in establishing its tariffs.

Energy Only Tariff

Unlike the "poles and wires" there is no natural monopoly requiring distributors to own public lights and to provide public lighting services, such as maintenance. An "Energy Only" tariff enables the capital and maintenance to be undertaken by customers or parties other than the distributor. An "Energy Only" tariff already exists in South Australia. Note: This is another ideal situation for a Negotiated service classification.

Whilst Endeavour has proposed a Tariff Class 6, it does not represent an Energy Only tariff.

We note from Essential Energy's proposal that it has introduced a Tariff Rate 99.¹³

"This was previously Rate 6 and is a tariff that does not attract SLUOS charges. It is in the system for lights that are connected unmetered to the low voltage network and as such there remains a need to calculate their consumption and retail and network charges however maintenance is performed by other parties and there is no SLUOS charge. This tariff has been renamed to Tariff rate 99 so that it does not get confused with SLUOS related tariffs.

Endeavour has not provided rates for its tariff class 6, neither has Essential for its tariff class 99, so we cannot comment on their appropriateness and compliance.

We **submit** that the AER requires all DNSPs to establish a "Tariff 99", being an Energy Only tariff, and that the DNSP's proposed rates are subject to stakeholder review.

We **submit** to the AER that without an Energy Only tariff (eg "Tariff 99"), the market cannot develop effectively as customers would not have a tariff allowing them to own and maintain lights.

¹¹ Endeavour Energy proposal Attachment 8.2, model – "TC3" tab, cell E 173

¹² Endeavour Energy proposal Attachment 8.2, model – Annuity sheet

¹³ Essential Energy Proposal, Attachment 8.1, page 14

Luminaire Replacement

For Tariff Classes 1 to 4, DNSPs have assumed they will automatically replace lights at the end of their useful life and that the DNSP will select the light type.

Whilst replacement may be indicated in the Public Lighting Code, recognising that customers are paying the bills, customers must be provided the opportunity to select at the time of replacement:

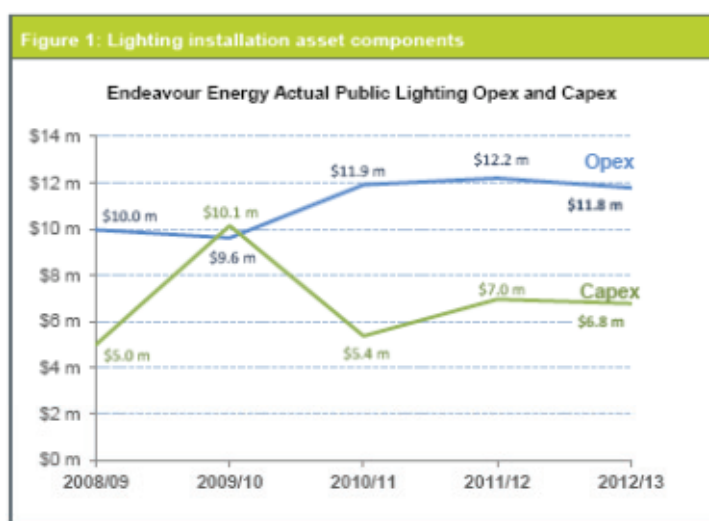
1. the replacement light type, and
2. the appropriate tariff, including changing to Tariff Class 6 (or 99 for Essential Energy), where customers own and maintain the replacement light.

LEDs must be considered as a replacement type, particularly due to their lower maintenance cost. Of concern is we note that Essential has installed up 50,000 CFLs in a bulk replacement program.

Both these aspects could effectively be addressed via the Negotiated classification.

Endeavour Capex

As explained in the Camden submission there appears to be a discrepancy between Endeavour's claimed \$6.8 million 2012/13 Capex component as it is at variance with the \$5.55 million of public lighting 2011/12 Capex in Endeavour Energy's Cost Allocation Method (CAM)¹⁴. The later being close to the \$5.86 million contained in Endeavour's 2012/13 RIN.



We **submit** that the AER should require Endeavour to confirm its 2011/12 actual Capex cost.

¹⁴ Endeavour Energy Cost Allocation Method, page 21, table 8

Overheads

In the table below we have assessed Endeavour's overhead component at \$6.85 million based on Endeavour's proposal.

Overhead Calculation ¹⁵			
	lights	other	Total
rate	\$33.62	\$8.40	
inventory	156,372	190,691	
	\$5,256,453	\$1,602,528	\$6,858,982

As Endeavour's proposed 2015-16 revenue is \$21.7 million¹⁶, its basic cost (net of overhead) becomes \$14.9 million. The \$6.8 million overhead represents around 45% on the basic cost.

Frustratingly, Endeavour's overhead allocations have been blanked out in its RIN.¹⁷ We do not see that this can be confidential information and request the AER to require Endeavour to publish. Without the allocations known, stakeholders cannot assess compliance with Endeavour's CAM.

Interestingly, Endeavour's 2012/13 operating overheads were \$4.0 million¹⁸

We *submit* that Endeavour's overhead allocation, and indeed all DNSP proposals, require careful consideration by the AER to ensure CAM compliance.

Maintenance Costs

DNSPs have modeled maintenance costs based on numerous assumptions including service levels – yet the DNSPs have not demonstrated that they have actually performed these (maintenance) services at the levels adopted in the models.

Further, if maintenance has not been performed at the appropriate levels, then the ad hoc failure rates increase – thereby increasing cost.

This is critical as if the services have not been performed in the manner and levels adopted in the models then DNSPs will be receiving payment for (maintenance) services they have not performed. In addition, DNSPs will be paid extra due to the increased costs associated with ad hoc failures.

Essential's 'rural premium' seems to be at the root of their large cost claims and requires investigation and validation.

¹⁵ Endeavour Energy proposal Attachment 8.2, model. Rates ex "Annuity" sheet column L and Inventory ex "RAB" sheet, column L – "TC4" sheet column N summated for the relevant components.

¹⁶ Endeavour Energy proposal – 8.02A1 – Proposed relative major customer bill impacts (Public)

¹⁷ Endeavour 210213 RIN response Appendix 1a – public version, sheet number 15 "Overheads Allocation"

¹⁸ Endeavour 210213 RIN response Appendix 1a – public version, sheet number 11 "Operating Overheads"

A further impact on the maintenance cost is the light type – which as discussed in our submission, must be approved by the customer.

Carbon Scheme Reduction

We are not aware that any DNSP has identified a reduction in their costs from the removal of the Carbon scheme from 1 July 2014.

We **submit** that this requires investigation by the AER.

Endeavour Tariff Class 1

We understand from Endeavour’s proposal that it has applied WACC on the opening RAB for each year. The RAB however decreases during each year.¹⁹ By adopting the approach it has, Endeavour will receive more revenue than if WACC was applied to the average asset base for the year.

Endeavour Tariff Class3

Whilst Endeavour has provided its capital cost to install a light, how this cost has been derived has not been explained and customers have therefore been denied the opportunity to assess. Importantly it is not clear if the capital cost includes overhead. If so, then Endeavour has not demonstrated compliance with Endeavour’s CAM.

Endeavour Tariff Class4

We have not had sufficient time to appropriately assess Endeavour’s proposal, but as established in our submission the tax component must be removed

Questions

We would welcome the opportunity to provide further views to the AER.

Yours sincerely

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¹⁹ Endeavour Energy proposal Attachment 8.2, model – “RF” tab, row 1563