

Draft decision: Essential Energy (distribution) 2015–19

We have made a draft decision for Essential Energy, one of three distribution network operators in New South Wales. Our draft decision allows Essential Energy to recover \$3678.6 million (\$nominal) from its customers over four years commencing 1 July 2015.

Overview

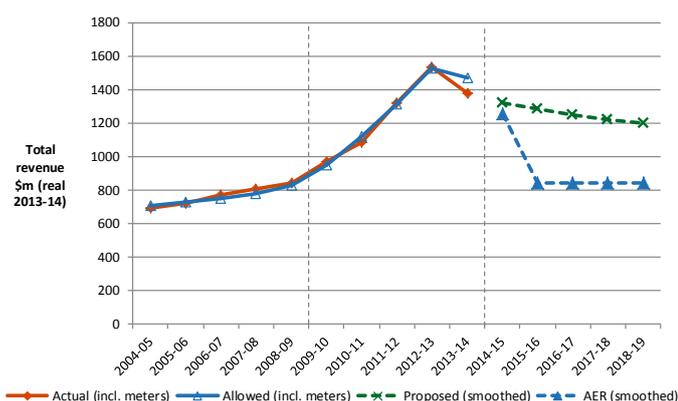
Essential Energy is one of three distribution network service providers (DNSPs) in New South Wales. It owns and operates the 'poles and wires' that transport electricity from transmission networks to NSW residents and small businesses. We, the Australian Energy Regulator (AER) regulate the revenues of Essential Energy and other DNSPs in eastern and southern Australia under the National Electricity Law (NEL) and National Electricity Rules (NER).

Our draft decision allows Essential Energy to recover \$3678.6 million in the 2015-19 regulatory control period. As a result, based on estimated energy use, we expect Essential Energy's average residential customer's annual bill to fall by \$346 in 2015-16.

We regulate DNSPs by setting the annual revenue requirement they can recover from their customers.

If we had accepted Essential Energy's proposal, it would have recovered \$5561.6 million (\$ nominal) over the 2015-19 regulatory control period. The difference between Essential Energy's proposed revenue, and what we have allowed in our draft decision, is shown below.

Essential Energy's past total revenue, proposed total revenue and AER draft decision revenue allowance (\$ million, 2013–14)



The revenue we determine affects the distribution component of a customer's final bill. Distribution charges make up about 43 per cent of Essential Energy's typical residential customer's final bill. Other components in consumer bills include the cost of generation, transmission network charges, and retailer costs.

In November 2012 major changes were introduced to the regulation of DNSPs under the NER. Essential Energy's distribution determination was due to commence on 1 July 2014, and apply for a period of five years. So that consumers could receive the benefit of the new rules, transitional rules required two regulatory control periods:

- A transitional regulatory control period from 1 July 2014 to 30 June 2015; and
- A subsequent regulatory control period commencing 1 July 2015.

We made a fast-tracked placeholder determination for the transitional regulatory control period on 16 April 2014. That determination will be adjusted (or 'trued up') in our determination for the subsequent regulatory control period, which is the subject of this draft decision.

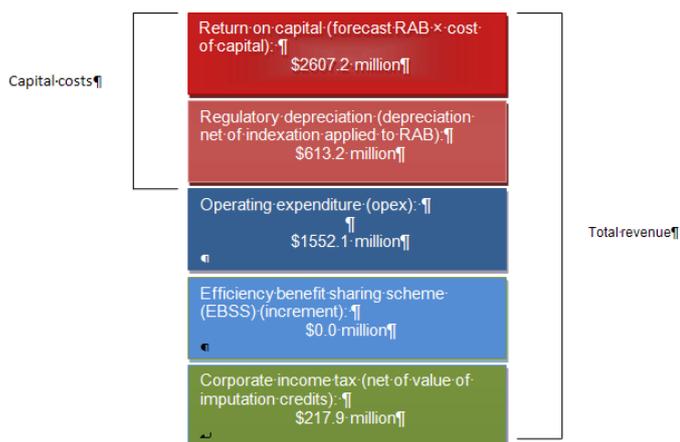
Our assessment

In making our assessment, a DNSP first proposes its forecast revenue requirement. This is based on an estimate of a number of cost categories called 'building blocks'.

Together, the building blocks determine the revenue Essential Energy can earn by levying distribution charges on customers. In this way, it should recover no more than the efficient cost of providing transmission services to its customers.

Our draft decision also provides effective incentives for Essential Energy to seek expenditure and service efficiencies.

Draft decision: Building blocks 2014-19 (\$ nominal)



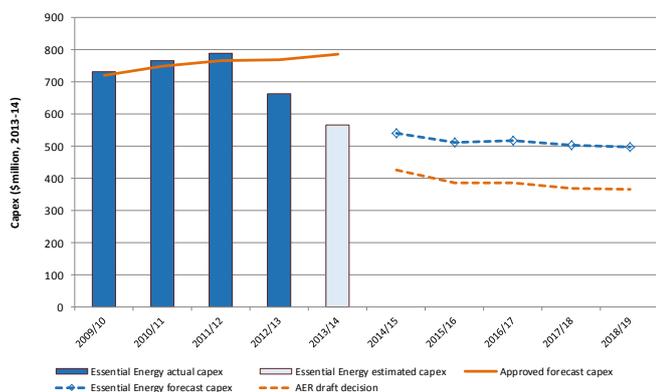
Capital expenditure

We did not accept Essential Energy's proposed forecast capital expenditure (capex) of \$2.6 billion (\$2013-14). We estimated a substitute forecast of \$1.9 billion (\$2013-14).

Essential Energy's forecast capex includes less expenditure on new assets to grow its network than in previous periods, because of slower demand growth. We are not satisfied that Essential Energy's proposed total forecast capital expenditure reasonably reflects the capex criteria. We therefore have not accepted Essential Energy's proposal. Our alternative estimate of Essential Energy's total forecast capex for the 2014-19 period that we are satisfied reasonably reflects the capex criteria, is \$1.9 billion (\$2013-14). The main driver for our substitute capital expenditure forecast is our reduction in the amount of forecast replacement expenditure.

Capex refers to the cost of building new facilities or replacing existing infrastructure. Factors that influence the required level of capex include the age and condition of existing assets.

AER draft decision compared to Essential Energy's past and proposed capex (\$million, 2013-14)



Operating expenditure

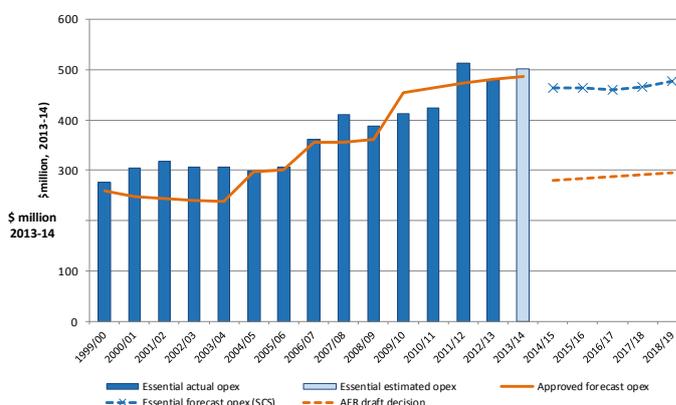
We did not accept Essential Energy's proposed \$2.3 billion (\$2013-14) operating expenditure (opex) forecast. We instead estimated a substitute of \$1.4 billion (\$2013-14).

Opex refers to the non-capital cost of running a business. It includes controllable and non-controllable costs.

Essential Energy proposed increases to several parts of its opex over the next four years. We are not satisfied that Essential Energy's proposed forecast operating expenditure reasonably reflects the opex criteria. We have therefore not accepted Essential Energy's proposal. Our alternative estimate of Essential Energy's total forecast opex for the 2014-19 period that we are satisfied reasonably reflects the opex criteria is \$1.4 billion (\$2013-14). The main driver for our substitute operating expenditure forecast is our alternative estimate for what we consider represents an efficient base level of operating expenditure.

The NSW distribution businesses, including Essential Energy, have proposed that NSW customers pay some transition costs to assist the NSW businesses to move to more efficient cost levels. We are seeking views on this in our draft decision.

AER draft decision compared to Essential Energy's past and proposed opex (\$million, 2013-14)



Rate of return

Our final decision sets the allowed rate of return (or 'cost of capital') at 7.15 per cent. In comparison, it was 10.02 per cent during the previous regulatory control period.

The investment environment has improved since our previous decision, which was made during the height of uncertainty surrounding the global financial crisis. The lower rate of return in this decision will reduce Essential Energy's average annual revenue requirements compared to the past. This should help reduce electricity prices for consumers in the forthcoming regulatory period.

Significant investment is required to build a distribution network. The return Essential Energy must pay lenders and investors is referred to as the rate of return. Even a small difference in the rate of return can have a big impact on revenues.

More information about our consultation process

Essential Energy may submit a revised proposal in response to our draft decision, no later than 20 January 2015. Stakeholders will also be able to make submissions on our draft decision and Essential Energy's revised proposal, by 13 February 2015.

More information on Essential Energy's proposal, our draft decision, and how to make a submission is on our website: www.aer.gov.au.