



# **Draft Decision**

## **Essential Energy 2014–19 electricity distribution determination**

March 2018

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# Invitation for submissions

Interested parties are invited to make submissions on this draft decision paper by 6 April 2018.

Submissions should be sent to: [EssentialRemittal2014-19@aer.gov.au](mailto:EssentialRemittal2014-19@aer.gov.au)

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Melbourne VIC 3001

Submissions should be in Microsoft Word or another text readable document format.

We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information should:

- clearly identify the information that is the subject of the confidentiality claim
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# 1 Executive Summary

The Australian Energy Regulator (AER) regulates energy markets and networks under national energy market legislation and rules. Our network regulatory functions, which relate to energy networks in all Australian states and territories, except Western Australia, include setting the amount of revenue that monopoly network businesses can recover from customers for using networks (electricity poles and wires and gas pipelines) that transport energy.

The National Electricity Law (NEL) and Rules (NER) provide the regulatory framework governing electricity networks. Our work under this framework is guided by the national electricity objective (NEO):<sup>2</sup>

... to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, safety, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.

This is our remade draft decision on the distribution determination for NSW electricity distributor, Essential Energy, for the 2014-19 regulatory control period, commencing 1 July 2014 to 30 June 2019. We set out the issues we have covered, our conclusions, and our reasons for why we are satisfied the decision, on the basis of the information before us, contributes to the achievement of the NEO to the greatest degree.

Our remade draft decision is to accept Essential Energy's proposal to recover total revenues of \$5102.9 million (\$, nominal) from consumers over the five-year 2014-19 regulatory control period.<sup>3</sup> This equates to our 30 April 2015 final decision with additional revenues of \$100 million and will maintain distribution network charges at the current levels.<sup>4</sup>

Our decision has been informed by our analysis, supported by a series of stakeholder engagement processes that have occurred since the second-half of 2017 involving interested stakeholders, including consumer groups and affected distribution businesses. The purpose of these discussions has been to identify and develop a common position on key matters that, in turn, could be put to us for consideration as being in the long-term interest of consumers.

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<sup>2</sup> NEL, s. 7.

<sup>3</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017. Essential Energy's 30 November 2017 proposal cites a revenue amount of \$5102.2 million (\$, nominal). We have since adjusted this revenue amount to reflect updated input information, such as lower annual cost of debt updates, actual consumer price index (CPI) and service target performance incentive scheme (STPIS) amounts. In consultation with Essential Energy, we will continue to update the revenue amount for any new information until our final decision is made.

<sup>4</sup> In May 2016, we accepted undertakings given by Essential Energy under section 59A of the NEL that set out how network revenues and tariffs will be determined in 2016–17. Essential Energy's Network Use of System (NUoS) tariffs in 2016–17 were set as their 2015–16 approved tariffs, adjusted for changes in the consumer price index (CPI). As of May 2017, the Full Federal Court had not yet handed down its decision, so we accepted further undertakings given by Essential Energy to establish new interim arrangements to govern the setting of network tariffs in 2017–18. Essential Energy undertook to continue to apply the terms of, including the price path determined in, our April 2015 final decision for 2017-18 and 2018-19, and to account for and give effect to the new tariff structure statements from 1 July 2017.

Key factors behind our decision to accept Essential Energy's proposal are:

- we are satisfied it is likely to contribute to the achievement of the NEO to the greatest degree and is in the long-term interests of consumers
- it comprises an overall revenue proposal that is broadly consistent (within 2 per cent) with the revenue allowance set out in our April 2015 final decision and is consistent with our forecasts of operational expenditure (opex) and the cost of debt in light of the information before us now
- it is supported by key consumer groups following extensive consultation undertaken by Essential Energy
- it will promote price certainty and stability for consumers
- it will provide a timely and certain resolution of Essential Energy's distribution determination for the 2014-19 regulatory control period, which will benefit both consumers and Essential Energy

We have had to remake our decision following the outcome of limited merits and judicial review processes relating to our April 2015 final decision. That decision allowed Essential Energy to recover an amount that was \$1719.6 million (\$, nominal) lower than what it proposed at the time. In response, Essential Energy sought limited merits review (LMR) of our decision by the Australian Competition Tribunal (Tribunal).

The Tribunal remitted our decision to us, specifically requiring that we remake our decision in relation to Essential Energy's opex forecast and the rate of return with respect to the trailing average approach<sup>5</sup>, and otherwise vary the distribution determination as set out in our April 2015 final decision as we consider appropriate (remade decision).<sup>6</sup>

On 30 November 2017, and following a series of consultations with its stakeholders, Essential Energy submitted a new proposal to us to resolve all outstanding issues relating to the decision we need to remake.<sup>7</sup> It is a total revenue proposal of \$5102.9 million (\$, nominal) for the five-year 2014-19 regulatory control period and is based on:<sup>8</sup>

- our April 2015 final decision, including the constituent decisions we made on opex and the rate of return (including the cost of debt)
- the revenue that Essential Energy has recovered thus far for the 2014-19 regulatory control period, up to a maximum limit of \$100 million above our April 2015 final decision

We have remade our April 2015 final decision in accordance with the NEL and NER. Among other things, this means we have taken into account the revenue and pricing

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<sup>5</sup> See Appendix A for background on our remade decision.

<sup>6</sup> *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1.

<sup>7</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017.

<sup>8</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017. Essential Energy's 30 November 2017 proposal cites a revenue amount of \$5102.2 million (\$, nominal). We have since adjusted this revenue amount to reflect updated input information, such as lower annual cost of debt updates, actual consumer price index (CPI) and service target performance incentive scheme (STPIS) amounts. In consultation with Essential Energy, we will continue to update the revenue amount for any new information until our final decision is made.

principles (RPP) and ensured that we are satisfied that the remade decision is likely to contribute to the achievement of the NEO to the greatest degree.

It is important to draw attention to the novel circumstances that we have faced in making this remade draft decision. These novel circumstances materially differ to what we faced when we made our April 2015 final decision, and what we would generally face in making a distribution determination. Specifically, we are making the remade draft decision at a time:

- That is far advanced into the 2014-19 regulatory control period to which the remade decision will apply.
- When we have applied interim pricing measures for the regulatory years of 2016–17, 2017–18 and 2018–19 by accepting enforceable undertakings to address pricing uncertainties arising from the limited merits and judicial review processes.
- When we have information on Essential Energy’s actual performance for the first three of the five regulatory years of 2014–19. Since our April 2015 final decision, Essential Energy has embarked on a significant reform program that has brought down its opex to a level consistent with our April 2015 final decision. Essential Energy has been able to achieve these reductions without compromising the quality, safety, reliability and security of electricity supplied on its network.
- When we have had a number of Tribunal and Federal Court processes, since the Tribunal’s decision on Essential Energy, that have considered and clarified the law in relation to ‘efficient financing costs’ and the determination of the cost of debt.
- When our remade decision has the potential to create significant retail price fluctuations if it differs materially from our April 2015 final decision (recognising that this prospect is to some extent alleviated by the rule made by the Australian Energy Market Commission (AEMC) on 1 August 2017 that allows us to let Essential Energy recover any additional revenues that result from our remade decision across both the 2014–19 and 2019–24 regulatory control periods).<sup>9</sup>
- When there is strong support from a range of consumer groups that Essential Energy’s proposal is in the long-term interest of consumers.

We are unlikely to face these novel circumstances again. In large part, these circumstances are the direct result of the time it has taken to resolve the limited merits and judicial review processes. On 6 November 2017, legislation came into force that abolished the application of the LMR regime in the NEL.<sup>10</sup> Therefore, it is likely that this remade draft decision will have limited precedent value, as it is unlikely that we will face the same circumstances again.

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<sup>9</sup> AEMC, *Rule Determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017*, 1 August 2017; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6*, commencing 15 August 2017.

<sup>10</sup> *Competition and Consumer Amendment (Abolition of Limited Merits Review) Act 2017* (Cth).



The novel circumstances we find ourselves in also heighten the importance of us remaking our decision in a timely manner. Timely decision-making is a tenet of best regulatory practice and, in our view, is a principle that is in the long-term interests of consumers.<sup>11</sup>

Essential Energy participated in the stakeholder roundtable meeting we convened on 16 August 2017, the purpose of which was to discuss possible options for how outstanding remittal-related matters could be resolved in a manner that is in the long-term interests of consumers.<sup>12</sup> Some of the key themes raised by participating stakeholders, which included industry and consumer representatives, were:

- an expedited resolution of the remaking of our April 2015 final decision, if possible, would provide a number of benefits for stakeholders, including greater certainty for the running of the businesses and certainty of price outcomes for consumers, compared to an extended timeframe of potentially up to 18 months for a regular determination process
- recognition that there is an increasing effort and goodwill towards better, and more clearly, aligning consumer and network business interests
- rising electricity prices have made affordability a key issue for consumers

Essential Energy also engaged with key energy consumers groups to inform its proposal, including Energy Consumers Australia (ECA), Energy Users Association of Australia (EUAA), Public Interest Advocacy Centre (PIAC) and the AER's Consumer Challenge Panel (CCP). These stakeholders endorsed Essential Energy's initiative and approach in consulting on, and putting forward, its proposal.

In light of the novel circumstances we are faced with, and the information before us, our remade draft decision is to accept Essential Energy's proposal for the 2014-19 regulatory control period. We are satisfied that this will result in a remade decision that is likely to contribute to the achievement of the NEO to the greatest degree and is in the long-term interests of consumers.

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<sup>11</sup> Regulatory best practice is also the way in which we have committed to act in undertaking our functions and powers: AER, *Statement of Intent 2017-18*, p. 5.

<sup>12</sup> AER, *NSW and ACT remittal roundtable (16 August 2017) summary note*, August 2017: <https://www.aer.gov.au/communication/aer-hosts-nsw-act-electricity-distribution-network-revenue-roundtable>

## 1.1 Next steps

Subject to stakeholder submissions received in response to this remade draft decision, we expect to publish our final remade decision in May 2018, as per Table 1-1.

**Table 1-1 Indicative timeline for finalising Essential Energy’s determination**

| Determination process                                  | Indicative date |
|--|-----------------|
| AER publishes remade draft decision for consultation   | 13 March 2018   |
| Stakeholder submissions on remade draft decision close | 6 April 2018    |
| AER publishes remade final decision                    | May 2018        |

## 1.2 Decisions for other NSW/ACT distribution businesses

We are yet to remake the draft decisions for Ausgrid, Endeavour Energy and Evoenergy for the 2014-19 regulatory control period, which the Tribunal also remitted to us.

For the purpose of advancing the decision-making process for these outstanding matters, we sought stakeholder feedback on an opex Issues Paper (October 2017) and cost of debt Position Paper (December 2017).<sup>13</sup> We will consider all stakeholder submissions received in response to these papers and engage with the relevant distribution businesses and interested stakeholders to remake these decisions in due course.

## 1.3 Structure of this document

This document is structured as follows:

- Section 2 presents our remade draft decision for Essential Energy
- Section 3 presents Essential Energy’s proposal
- Section 4 presents stakeholders’ views on Essential Energy’s proposal
- Section 5 presents the reasons for our remade draft decision
- Appendix A presents background to our remade draft decision

<sup>13</sup> AER, *Issues Paper – Remitted decisions for NSW/ACT 2014–19 electricity distribution determinations, Operating Expenditure*, October 2017.

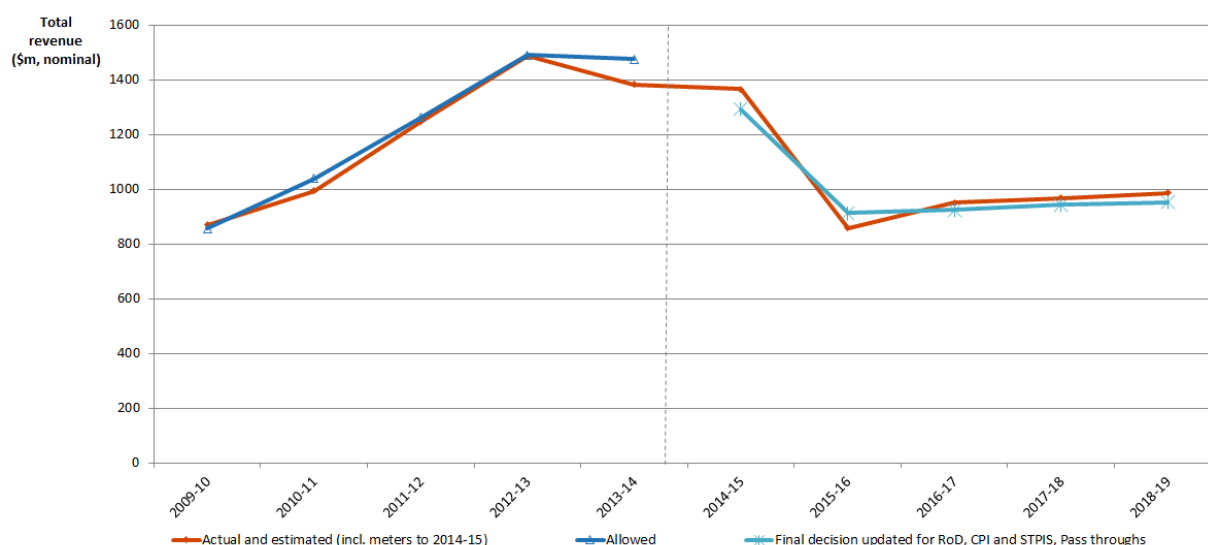
AER, *Position paper – Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

## 2 Our remade draft decision

Our remade draft decision, after remaking the constituent decisions for opex and the rate of return, as well as correcting some other minor aspects relating to our April 2015 final decision in accordance with the Tribunal's directions, is to accept Essential Energy's proposal.<sup>14</sup>

This means Essential Energy can recover total revenues of \$5102.9 (\$, nominal) from consumers over the 2014–19 regulatory control period.<sup>15</sup> We are satisfied that this draft remade decision, taking into account the RPP, is likely to contribute to the achievement of the NEO to the greatest degree.<sup>16</sup> Figure 2-1 below illustrates our overall decision.

**Figure 2-1 Essential Energy's past total revenue and AER draft decision total revenue allowance (\$million, nominal)**



Source: AER analysis.

Customers' bills have been impacted by our April 2015 final decision and the interim pricing measures for the regulatory years of 2016–17, 2017–18 and 2018–19 by us accepting the enforceable undertakings from Essential Energy to address pricing uncertainties arising from the limited merits and judicial review processes. Distribution network charges reduced, on average, by 1.7 per cent in the transitional year of 2014-15.<sup>17</sup> In 2015-16, distribution

<sup>14</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017.

<sup>15</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017. Essential Energy's 30 November 2017 proposal cites a revenue amount of \$5102.2 million (\$, nominal). We have since adjusted this revenue amount to reflect updated input information, such as lower annual cost of debt updates, actual consumer price index (CPI) and service target performance incentive scheme (STPIS) amounts. In consultation with Essential Energy, we will continue to update the revenue amount for any new information until our final decision is made.

<sup>16</sup> NEL, ss. 16(1)(d)(i) and 16(2).

<sup>17</sup> AER, *Transitional decisions: NSW/ACT 2014–15 Factsheet*, April 2014.

network charges fell significantly, reflecting a 31 per cent reduction in Essential Energy's real revenues resulting from our April 2015 final decision.

At the time of our April 2015 decision, this impact was estimated as a \$313 (11.9 per cent) reduction in the average bill for a residential customer and a \$528 (11.9 per cent) reduction in the bill for a small business customer. The analysis assumed distribution network charges made up 43 per cent of customers' bills on average.<sup>18</sup>

During the regulatory years of 2016-17 and 2017-18, distribution network charges increased by the change in CPI in accordance with the enforceable undertakings we accepted. At that time, we also agreed to defer any further reductions in distribution network charges until the limited merits and judicial review processes had concluded.

This remade draft decision allows for Essential Energy to recover a maximum of \$100 million more than the revenue allowance we set in our April 2015 final decision. For the 2018-19 regulatory year, the placeholder revenues on which distribution network charges are based will again rise in line with CPI.<sup>19</sup> If this results in Essential Energy recovering revenues that exceed the \$100 million cap we have allowed for in this remade draft decision, those revenues will be returned to its customers in subsequent regulatory years from 2019-20.

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<sup>18</sup> AER, *Final decision Essential Energy distribution determination - Fact Sheet*, April 2015.

<sup>19</sup> Essential Energy, *Undertaking to the Australian Energy Regulator for the two years ending 30 June 2018 and 30 June 2019*, 8 May 2017, pp. 4–5.

### 3 Essential Energy's proposal

On 30 November 2017, we received Essential Energy's proposal for the 2014–19 regulatory control period.<sup>20</sup> Its proposal for a revenue allowance comprises three parts:<sup>21</sup>

- Between 1 July 2014 and 30 June 2016, Essential Energy proposes to accept the revenue allowance as set out in our April 2015 final decision for 2014–19.
- Between 1 July 2016 and 30 June 2019, Essential Energy proposes to accept the revenue allowance calculated in accordance with the enforceable undertakings it provided to us to govern prices for the regulatory years of 2016–17, 2017–18 and 2018-19 under section 59A of the NEL.
- A maximum of \$100 million more in revenue than the revenue allowance set out in our April 2015 final decision. This additional revenue is due to differences between actual and forecast consumption, resulting in a difference between the revenue Essential Energy actually recovered during the 2014-19 regulatory control period and the revenue allowance set out in our April 2015 final decision.

Essential Energy's proposal is a total revenue proposal. It is not directly presented in terms of the building block components as was the case in its initial and revised regulatory proposals which preceded our April 2015 final decision (and the associated constituent decisions).

Essential Energy submitted that its proposal reflects extensive customer and stakeholder engagement and will avoid significant price shocks in both the 2014–19 and 2019–24 regulatory control periods. It further submitted:<sup>22</sup>

The proposal also provides far greater clarity and certainty for customers, stakeholders and Essential Energy. More specifically, the benefits include:

- A 35 per cent reduction in typical residential customer Distribution Use of System (DUoS) bills in real terms from 2014–15 to 2018–19;
- Future price certainty for consumers, particularly for 2018–19, with an increase on 1 July 2018 forecast at CPI;
- A 28 per cent reduction in revenue from 2014–15 to 2018–19, keeping downward pressure on network charges;
- Delivering stable network charges for our customers while enabling Essential Energy to recover its efficient costs;
- Maintaining the capital expenditure sharing scheme and service target performance incentive scheme to ensure benefits continue to be delivered to customers into the future;

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<sup>20</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017.

<sup>21</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017, p. 2.

<sup>22</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017, p. 1.

- Establishing customer prices in accordance with tariff structure statement requirements;  
and
- The submission of Essential's 2019–24 regulatory proposal by the end of April 2018,  
based on a remade 2015 determination.

## 4 Stakeholders' views on the proposal

Following initial discussions between Essential Energy and our staff on the key aspects of the decisions the Tribunal has required us to remake, Essential Energy undertook pre-lodgement consumer engagement on its proposal.

Subsequently, the following stakeholders issued letters expressing their views on Essential Energy's proposal:

- Energy Consumers Australia (ECA)
- Energy Users Association of Australia (EUAA)
- Public Interest Advocacy Centre (PIAC)
- our Consumer Challenge Panel (CCP)

The general consensus of these stakeholders is that Essential Energy's proposal for the 2014-19 regulatory control period is in the long-term interest its customers. Their letters in their entirety are available on our website, excerpts from which are provided below.

### 4.1 Energy Consumers Australia

In its letter to Essential Energy on its pre-lodged proposal, ECA stated:<sup>23</sup>

I write to express Energy Consumers Australia's (ECA) support for Essential Energy's proposed approach to resolving your regulatory allowance for 2014-19, following the remittal of that determination to the Australian Energy Regulatory (AER) by the Federal Court. Following close engagement between ECA staff, including myself [Rosemary Sinclair, CEO], and Essential's senior management, I believe that the proposal is in the long-term interest of your customers.

Based on our engagement and the draft letter from Essential to the AER that ECA has been shown, we understand that Essential intends to make a number of commitments to the AER as part of seeking the extension. Specifically, Essential will propose to the AER that there be no upward revision of your allowed revenue in 2017-18 or 2018-19 as a result of the Federal Court's recent judgement. Essential estimates that the potential additional allowed revenue that is being foregone under this proposal is \$397 million. Essential will, however, retain around \$90 million that has been collected due to errors in demand forecasting. Total over-recovery due to increased demand for the 2014-19 period will be capped at \$100 million.

I would also like to compliment Essential on its efforts to engage consumers in its consideration of the remittal issue and its business operations genuinely.

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<sup>23</sup> Energy Consumers Australia, *ECA Support for Application for Extension to Submit 2019-24 Regulatory Proposal*, 27 November 2017, p. 1.

## 4.2 Energy Users Association of Australia

In its letter to Essential Energy on its pre-lodged proposal, EUAA stated:<sup>24</sup>

The EUAA recently met with Essential Energy and received a briefing on their proposed approach to the 2014-19 remittal. Following examination of Essential Energy's proposed package of measures covering the 2014–19 period, the EUAA has concluded that the overall package of measures proposed is in the long-term interests of consumers. We appreciate Essential's approach to expediting the remittal process to reach an acceptable resolution of this long running matter and we hope this approach is an example for others to follow.

## 4.3 Public Interest Advocacy Centre

In its submission to our opex Issues Paper<sup>25</sup>, PIAC stated:<sup>26</sup>

PIAC supports the proposal made by Essential Energy, to accept the AER's final determination and retain some over-recovered revenue with a limit of \$100 million across the period.

...With respect to Ausgrid's and Endeavour's opex, PIAC would strongly support the approach that Essential has taken on its remittal, of seeking to reach an agreement between the AER, consumer representatives and the network on what would be an appropriate quantum. This approach needs to be underpinned by good consumer engagement...

## 4.4 Consumer Challenge Panel

The AER established the CCP in July 2013 to assist us to make better regulatory determinations by providing input on issues of importance to consumers. The expert members of the CCP bring consumer perspectives to us to better balance the range of views considered as part of our decisions.

In response to our request for advice on Essential Energy's proposal, CCP Sub-panel 10 (or CCP10) provided the following written advice:<sup>27</sup>

CCP10 supports Essential's proposal for resolving its regulatory allowance for 2014–19, following the remittal of that determination to the AER by the Federal Court. We commend Essential on its genuine and transparent consumer engagement on its proposal and on the way it has listened to that feedback and reflected it in its revised proposal. CCP10 believes that the Essential proposal is in the long-term interests of Essential's customers...It is our opinion that the benefits outweigh the costs, in aggregate, for consumers from this proposal.

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<sup>24</sup> Energy Users Association of Australia, *Re: Essential Energy - Determination 2014-19 – Remittal*, 30 November 2017, p. 1.

<sup>25</sup> AER, *Issues Paper – Remitted decisions for NSW/ACT 2014–19 electricity distribution determinations, Operating Expenditure*, October 2017.

<sup>26</sup> Public Interest Advocacy Centre, *Submission – Remitted decisions for NSW/ACT 2014-19 electricity distribution determinations – Operating Expenditure*, 30 November 2017, pp. 1–2.

<sup>27</sup> Consumer Challenge Panel, *Letter to AER on Essential Energy 2014–19 revenue allowance remittal proposal*, 26 November 2017, p. 2.



## 5 Reasons for our remade draft decision

Our reasons for arriving at our position in this remade draft decision are set out below. The steps we took to arrive at our position are:

- remake the constituent decisions for opex and the return on debt in accordance with the Tribunal's directions and reasons (as clarified by the Full Federal Court (Court))
- identify any other aspects of our April 2015 final decision that may be appropriate to vary, as a consequence of remaking the constituent decisions for opex and the return on debt
- of all the possible outcomes available, decide whether we are satisfied that the position we have arrived at, taking into account the RPP, is likely to contribute to the achievement of the NEO to the greatest degree<sup>28</sup>
- consider Essential Energy's proposal, as well as each of the consumer groups' letters on the proposal

### 5.1 Our approach

In this section, we set out the context within which we have made this remade draft decision, and the approach we have applied. As is the case with making any distribution determination, there may be several possible overall decisions that we could potentially make that will, or are likely to, contribute to the achievement of the NEO. In these circumstances, the NEL directs us to make the decision that we are satisfied will, or is likely to, contribute to the achievement of the NEO to the greatest degree.<sup>29</sup>

Determining whether any particular decision will, or is likely to, contribute to achieving the NEO is a matter of regulatory judgment which involves assessing the decision as a whole, taking into account the RPP and complying with the specific requirements of the NER. Implicit in this task is recognising that a distribution determination is more than just the sum of its constituent decisions or component parts as determined in accordance with Chapter 6 of the NER.

#### 5.1.1 The novel circumstances we face now

The approach we have applied in remaking this draft decision has necessarily been influenced by the novel circumstances that we face now. These are novel circumstances because they materially differ to what we faced when we made our April 2015 final decision, and what we would generally face in making a distribution determination.

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<sup>28</sup> NEL, ss. 16(1)(d)(i) and 16(2).

<sup>29</sup> NEL, ss. 16(1)(d)(i) and 16(2).

Specifically, we are making this remade draft decision at a time:

- that is far advanced into the 2014-19 regulatory control period to which the remade decision will apply
- when we have applied interim pricing measures for the regulatory years of 2016–17, 2017–18 and 2018–19 by accepting enforceable undertakings to address pricing uncertainties arising from the limited merits and judicial review processes
- when we have information on Essential Energy’s actual performance for the first three of the five regulatory years of 2014–19
- when we have had a number of Tribunal and Federal Court processes, since the Tribunal’s decision on Essential Energy, that have considered and clarified the law in relation to ‘efficient financing costs’ and the determination of the cost of debt
- when our remade decision has the potential to create significant retail price fluctuations if it differs materially from our April 2015 final decision (recognising that this prospect is to some extent alleviated by the rule made by the Australian Energy Market Commission (AEMC) on 1 August 2017 that allows us to let Essential Energy recover any additional revenues that result from our remade decision across both the 2014–19 and 2019–24 regulatory control periods)<sup>30</sup>
- when there is strong support from a range of consumer groups that Essential Energy’s proposal is in the long-term interest of consumers

We are unlikely to face these novel circumstances again. In large part, these circumstances are the direct result of the time it has taken to resolve the limited merits and judicial review processes. On 6 November 2017, legislation came into force that abolished the application of the LMR regime in the NEL.<sup>31</sup> Therefore, it is likely that this remade draft decision will have limited precedent value, as it is unlikely that we will face the same circumstances again.

### 5.1.2 Assessing the overall decision

Ultimately, assessing whether this remade draft decision achieves the NEO to the greatest degree involves us exercising our judgment to determine whether the overall decision will promote efficiencies in relation to investment, and the operation and use of Essential Energy’s network that is in the long-term interest of consumers. This involves us balancing the various, and at times competing, factors referred to in the NEO. We must also take into account the RPP in determining how the NEO may be achieved to the greatest degree.<sup>32</sup>

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<sup>30</sup> AEMC, *Rule Determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017*, 1 August 2017; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6*, commencing 15 August 2017.

<sup>31</sup> *Competition and Consumer Amendment (Abolition of Limited Merits Review) Act 2017* (Cth).

<sup>32</sup> See NEL, s. 16(2). As affirmed by the Federal Court in *Australian Energy Regulator v Australian Competition Tribunal* (No 2) [2017] FCAFC 79, [36].

This is the same approach that we applied in making our April 2015 final decision. As we stated in that decision:<sup>33</sup>

Energy Ministers have provided us with a substantial body of explanation that guides our understanding of the NEO. The long-term interests of consumers are not delivered by any one of the NEO's factors in isolation, but rather by balancing them in reaching a regulatory decision.

...

The NEL and NER aim to remedy the absence of competition by providing that we, as regulator, make decisions that are in the long-term interests of consumers. In particular, we might need to require the distributors to offer their services at a different price than they would choose themselves. By its nature, this process will involve exercising regulatory judgement to balance the NEO's various factors.

It is important to recognise that there are a number of plausible outcomes that may contribute to the achievement of the NEO. The nature of decisions under the NER is such that there may be a range of economically efficient decisions, with different implications for the long-term interests of consumers. At the same time, however, there are a range of outcomes that are unlikely to advance the NEO to a satisfactory extent. For example, we do not consider that the NEO would be advanced if allowed revenues encourage over-investment and result in prices so high that consumers are unwilling or unable to efficiently use the network. This could have significant longer term pricing implications for those consumers who continue to use network services.

Equally, we do not consider the NEO would be advanced if allowed revenues result in prices so low that investors are unwilling to invest as required to adequately maintain the appropriate quality and level of service, and where customers are making more use of the network than is sustainable. This could create longer term problems in the network and could have adverse consequences for safety, security and reliability of the network.

This approach was also affirmed by the Tribunal in its reasons of 26 February 2016:<sup>34</sup>

The ultimate objective reflected in the NEO and NGO [National Gas Objective] is to direct the manner in which the national electricity market and the national natural gas market are regulated, that is, in the long-term interests of consumers of electricity and natural gas respectively with respect to the matters specified. The provisions proceed on the legislative premise that their long-term interests are served through the promotion of efficient investment in, and efficient operation and use of, electricity and natural gas services. This promotion is to be done "for" the long-term interests of consumers. It does not involve a balance as between efficient investment, operation and use on the one hand and the long-term interest of consumers on the other. Rather, the necessary legislative premise is that the long-term interests of consumers will be served by regulation that advances economic efficiency.

In considering whether this remade draft decision is likely to contribute to the achievement of the NEO to the greatest degree, in respect of our assessment of Essential Energy's proposal, we note that there are potentially a range of possible outcomes that may meet the Tribunal's directions.

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<sup>33</sup> AER, *Final Decision, Essential Energy distribution determination 2015–16 to 2018–19, Overview*, April 2015, pp. 53–54.

<sup>34</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1, [77] and [78].

## 5.2 Assessment of Essential Energy’s proposal

As set out in section 3, Essential Energy’s proposal for a revenue allowance for the 2014–19 regulatory control period comprises three parts:<sup>35</sup>

- Between 1 July 2014 and 30 June 2016, Essential Energy proposes to accept the revenue allowance as set out in our April 2015 final decision for 2014–19.
- Between 1 July 2016 and 30 June 2019, Essential Energy proposes to accept the revenue allowance calculated in accordance with the enforceable undertakings it provided to us to govern prices for the regulatory years of 2016–17, 2017–18 and 2018-19 under section 59A of the NEL.
- A maximum of \$100 million more in revenue than the revenue allowance set out in our April 2015 final decision. This additional revenue is due to differences between actual and forecast consumption, resulting in a difference between the revenue Essential Energy actually recovered during the 2014-19 regulatory control period and the revenue allowance set out in our April 2015 final decision.

In light of the novel circumstances we are faced with, and the information before us, we are satisfied that accepting Essential Energy’s proposal will result in an outcome that is likely to contribute to the achievement of the NEO to the greatest degree and is in the long-term interests of consumers. Other key reasons for our decision to accept Essential Energy’s proposal are outlined below.

First, remaking the opex and cost of debt constituent decisions reveals a result that is consistent with the overall level of total revenues that we arrived at in our April 2015 final decision. This is respectively discussed in detail below in sections 5.3.1 and 5.3.2. This result also aligns with Essential Energy’s proposal that is in part premised on the revenue allowance set in our April 2015 final decision. In summary:

- Essential Energy has undertaken reforms to enable it to continue to provide safe and reliable electricity services to its consumers while incurring opex in line with the opex forecasts set out in our April 2015 final decision.
- Recent Tribunal and Court processes have clarified the law in relation to ‘efficient financing costs’ and the determination of the cost of debt. A revenue neutral transition from the on-the-day approach to a trailing average approach is appropriate and consistent with the achievement of the allowed rate of return objective (ARORO) and will contribute to achieving the NEO.

Second, the novel circumstances we find ourselves in heighten the importance of us remaking our decision in a timely manner. Timely decision-making is a tenet of best regulatory practice and, in our view, is a principle that is in the long-term interests of consumers.<sup>36</sup> We now find ourselves making this draft remade decision at a time that is far advanced into the regulatory control period to which the remade decision will apply.

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<sup>35</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017, p. 2.

<sup>36</sup> Regulatory best practice is also the way in which we have committed to act in undertaking our functions and powers: AER, *Statement of Intent 2017-18*, p. 5.

Resolving the uncertainty created by the limited merits and judicial review processes in a timely manner, by expediting this remittal process where possible compared to an extended timeframe of potentially up to 18 months for a regular determination process, is supported by several consumer groups and Essential Energy (particularly in light of its forthcoming regulatory proposal for the 2019-24 regulatory control period).<sup>37</sup>

This remade draft decision resolves this uncertainty and addresses the crucial issue of price stability, which informs consumers of their budgetary and investment decisions on the use of electricity services. Price stability, or minimising price volatility, is also in the long-term interests of consumers. This is one of the primary reasons that we accepted the enforceable undertakings that Essential Energy gave to us to govern prices for 2016–17, 2017–18 and 2018–19.<sup>38</sup> It is also one of the primary reasons that, on 1 August 2017, the AEMC made a rule to avoid significant retail price fluctuations following the remaking of our decision by enabling us to allow Essential Energy to recover any additional revenues that result from remaking our decision, across both the 2014–19 and 2019–24 regulatory control periods.<sup>39</sup> To that end, we agree with the following statement of the AEMC in its rule determination:<sup>40</sup>

**Is reducing price volatility in the long-term interests of consumers?**

A significant revenue adjustment could result from the remaking of the proponents' distribution determinations for the current regulatory control period. This may lead to consumers experiencing a large network price increase or decrease between 2018–19 and 2019–20. This price volatility may lead some consumers to make inefficient budgetary decisions on energy spending, or inefficient investment decisions on the use of electricity services. The Commission has considered whether minimising price volatility would be in the long-term interests of consumers in this case.

Third, we consider that Essential Energy's overall revenue proposal represents an efficient level of expenditure necessary for it to provide safe and reliable electricity services to its consumers.

As we discussed at section 5.1.2, the approach we have applied in this remade draft decision involves us exercising our judgment to determine whether the overall decision will promote efficiencies in relation to investment, and the operation and use of Essential Energy's network that is in the long-term interest of consumers. Of all the possible revenue allowance permutations that may allow for Essential Energy to continue to deliver the level of electricity supply service it has so far during the 2014–19 regulatory control period, the

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<sup>37</sup> For example, several participants expressed support to expedite this remittal process at the NSW and ACT remittal roundtable we held on 16 August 2017: AER, *NSW and ACT remittal roundtable summary note*, p. 4. Similarly, the EUAA stated in its letter of support: "We appreciate Essential's approach to expediting the remittal process to reach an acceptable resolution of this long running matter and we hope this approach is an example for others to follow": EUAA, *Re: Essential Energy - Determination 2014-19 – Remittal*, 30 November 2017, p. 1. See also, Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017, pp. 1 and 3.

<sup>38</sup> See AER, *Open letter to Stakeholders: Electricity network charges in the ACT and NSW from 1 July 2017*, 19 April 2017.

<sup>39</sup> AEMC, *Rule Determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017*, 1 August 2017; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6*, commencing 15 August 2017.

<sup>40</sup> AEMC, *Rule Determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017*, 1 August 2017, pp. 11 and 12; see also p. 16.

long-term interests of consumers are served by us identifying how that may be done at least cost. As the Tribunal has previously stated:

The national electricity objective provides the overarching economic objective for regulation under the Law: the promotion of efficient investment in the long-term interests of consumers. Consumers will benefit in the long run if resources are used efficiently, i.e. resources are allocated to the delivery of goods and services in accordance with consumer preferences at least cost. As reflected in the revenue and pricing principles, this in turn requires prices to reflect the long run cost of supply and to support efficient investment, providing investors with a return which covers the opportunity cost of capital required to deliver the services.<sup>41</sup>

With that in mind, the following observations are relevant. Essential Energy's proposal:

- is effectively \$914 million less than the revised regulatory proposal it submitted to us on 20 January 2015 on the issues of opex and the cost of debt
- represents a 28 per cent reduction in revenue in comparison to 2014–15
- represents a reduction in annual opex of around 30 per cent

As noted above, Essential Energy's proposal reflects the revenues it has been able to recover under our April 2015 final decision and the enforceable undertakings. Essential Energy has not submitted to us that the revenue it has recovered during the 2014–19 regulatory control period so far (or as reflected in its proposal) has been at the expense of the quality, safety, reliability and security of electricity supplied on its network. Or that such risks are likely to occur in the forthcoming 2018–19 regulatory year. Also, Essential Energy has forecast further opex reductions throughout the 2019–24 regulatory control period in its draft 2019–24 regulatory proposal that it is currently consulting stakeholders on.<sup>42</sup> This lends support to the contention that Essential Energy is able to provide a safe, secure and reliable supply of electricity in line with the opex forecast we have set in this remade draft decision.

Fourth, we consider that providing Essential Energy with its proposed maximum of up to \$100 million in additional revenue for the 2014-19 regulatory control period compared to the revenue allowance set out in our April 2015 final decision period, fits within an overall decision that contributes to the NEO to the greatest degree. As noted above, due to differences between actual and forecast consumption during the 2014-19 regulatory control period so far, this \$100 million of revenue is for the difference between the total revenue Essential Energy recovered and the revenue allowance set out in our April 2015 final decision and the enforceable undertakings. In support of this \$100 million cap, Essential Energy submitted:<sup>43</sup>

This cap provides revenue certainty for the two year[s] ending 30 June 2018 and 2019 and ensures that the revenue impact of unexpected increases in actual energy consumed in those years are returned to customers by way of revenue adjustments in the 2019–24 regulatory period.

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<sup>41</sup> *Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3, [15].

<sup>42</sup> Essential Energy, 2019–24 Draft Regulatory Proposal, February 2018, p.53, accessed on 21 February 2018: <http://www.woolcott.com.au/EssentialEnergy/media/2019-24%20Draft%20Regulatory%20Proposal.pdf>

<sup>43</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017, p. 2.

Generally, under a revenue cap form of price control, any difference between what a network service provider actually recovers in comparison to a revenue allowance set out in a distribution determination, as a result of differences between forecast and actual consumption in any given regulatory year, is reconciled through the annual pricing or revenue determination process. However, the \$100 million cap that Essential Energy has proposed is not subject to this reconciliation.

Ultimately, whether this remade draft decision should allow for \$100 million more in revenue than the revenue allowance set out in our April 2015 final decision must be considered in light of the novel circumstances we find ourselves in, and the overall revenue allowance that we are satisfied will continue to allow Essential Energy to deliver the level of electricity supply service it has so far during the 2014–19 regulatory control period at least cost to its consumers. In this case, our view is that the \$100 million, as part of Essential Energy’s overall proposal, which incorporates significant cost reductions in opex to date, will contribute to price stability for its consumers and result in an outcome that is likely to contribute to the achievement of the NEO to the greatest degree.

In coming to this view, we have considered the following factors:

- The \$100 million more than the revenue allowance in our April 2015 final decision represents an outcome that quantifies and appropriately balances the risk and uncertainty faced by affected stakeholders, including consumers. This is in the context where stakeholders have stated a clear preference for us to remake the decision in a timely manner and to resolve uncertainty in light of the novel circumstances described above.
- The \$100 million more than the revenue allowance in our April 2015 final decision represents approximately 1.9 per cent of the total revenues Essential Energy is otherwise proposing to recover during the 2014–19 regulatory control period. This is relatively immaterial within the context of the overall revenue determination.
- By allowing for \$100 million more than the revenue allowance in our April 2015 final decision, Essential Energy’s proposal forecasts annual price movements for a typical residential customer in its service area using 5 MW/h per annum of zero per cent in both 2017–18 and 2018–19. As Essential Energy submitted, this provides it with revenue stability over 2017–18 and 2018–19, and therefore also goes some way to reducing any further price instability.
- We have given weight to the strong expressions of support from the CCP10, ECA, EUAA and PIAC. Notably, each of these consumer groups have clearly expressed that given the circumstances, allowing for \$100 million more than the revenue allowance in our April 2015 final decision as part of a remade decision results in an outcome that they consider to be in the long-term interests of Essential Energy’s customers.<sup>44</sup> For example, the CCP10 stated:<sup>45</sup>

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<sup>44</sup> Consumer Challenge Panel, *Letter to AER on Essential Energy 2014-19 revenue allowance remittal proposal*, 26 November 2017, p. 2; Energy Consumers Australia, *ECA Support for Application for Extension to Submit 2019 – 24 Regulatory Proposal*, 27 November 2017, p. 1; Energy Users Association of Australia, *Re: Essential Energy – Determination 2014–19 – Remittal*, 30 November 2017, p. 1; Public Interest Advocacy Centre, *Submission – Remitted*

We understand that this involves Essential retaining up to \$100m in revenue..., but this needs to be considered in the context of the overall proposal. Consumers will benefit from:

- the certainty provided by the early resolution of the proposed price path
- the removal of the risk for consumers from the reopening of the contentious issues from the Federal Court decision, particularly in regard to debt costs, and
- on an ongoing basis from the reductions in operational and capital expenditure that Essential has achieved.

It is our opinion that the benefits outweigh the costs, in aggregate, for consumers from this proposal.

As noted by the CCP10, there is public interest in resolving this matter.

The variations to our control mechanism constituent decision that we have made in order to give effect to the \$100 million more than the revenue allowance in our April 2015 final decision is discussed in section 5.4.1 below.

For all of the reasons set out above, we are satisfied that accepting Essential Energy's proposal for the 2014-19 regulatory control period is likely to contribute to the achievement of the NEO to the greatest degree and is in the long-term interests of consumers.

### 5.3 Remaking the opex and return on debt constituent decisions

As noted in section 1, following the Court's decision, the Tribunal's directions that we are to comply with in remaking our decision for Essential Energy are as follows:<sup>46</sup>

- (a) the AER is to make the constituent decision on opex under r 6.12.1(4) of the National Electricity Rules in accordance with these reasons for decision including assessing whether the forecast opex proposed by the applicant reasonably reflects each of the operating expenditure criteria in r 6.5.6(c) of the National Electricity Rules including using a broader range of modelling, and benchmarking against Australian businesses, and including a "bottom up" review of Essential's forecast operating expenditure;
- (b) the AER is to make the constituent decision on return on debt in relation to the introduction of the trailing average approach in accordance with these reasons for decision;
- ...
- (d) the AER is to consider, and to the extent to which it considers appropriate to vary the Final Decision in such other respects as the AER considers appropriate having regard to

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<sup>45</sup> *decisions for NSW/ACT 2014-19 electricity distribution determinations – Operating Expenditure*, 30 November 2017, p. 1. Consumer Challenge Panel, *Letter to AER on Essential Energy 2014-19 revenue allowance remittal proposal*, 26 November 2017, p. 2.

<sup>46</sup> *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1. Note direction 1(c) is omitted following the Court's decision in relation to gamma: *Australian Energy Regulator v Australian Competition Tribunal (No 3)* [2017] FCAFC 80, [738]-[784].



s 16(1)(d) of the National Electricity Law in the light of such variations as are made to the Final Decision by reason of (a)-(c) hereof.

In the following sections, we set out our remade constituent decisions for opex and the cost of debt, as well as the variations to our control mechanism constituent decision.

### 5.3.1 Opex constituent decision

Operating expenditure (opex) refers to operating, maintenance and other non-capital expenses. Forecast opex for prescribed distribution services is one of the building blocks that typically make up a service provider's total revenue requirement.

As noted in section 3, Essential Energy's revenue proposal implicitly retains the opex forecast that we originally determined in our original April 2015 final decision. We have re-examined this opex forecast in light of the Tribunal's directions to us and updated information, where available, since our original decision. For the reasons set out in this section, we are satisfied that this opex forecast is consistent with the opex criteria. Table 5-1 sets out this opex forecast.

**Table 5-1 AER draft decision opex forecast (\$million, 2013–14)**

| 2014-15 | 2015–16 | 2016–17 | 2017–18 | 2018–19 | Total  |
|---------|---------|---------|---------|---------|--------|
| 316.3   | 319.6   | 322.9   | 326.4   | 330.0   | 1615.3 |

#### 5.3.1.1 Reasons for our decision

The rules in the NER and provisions in the NEL that govern our assessment of opex remain unchanged on remittal.

As the Tribunal refers to in its directions, we must remake our opex decision under clause 6.12.1(4) of the NER. This means we must either accept a distributor's proposed opex forecast, or reject it and determine our own substitute estimate. The Tribunal found that our decision to reject Essential Energy's opex forecast was not in error. Our task here is to reconsider our substitute estimate in accordance with the Tribunal's order and reasoning (as clarified by the Federal Court).

Clause 6.5.6 of the NER sets out the opex objectives, opex criteria and opex factors, under which we must make our constituent decision on opex. In summary, we must identify a level of forecast opex that is efficient and prudent and at a level that sustainably maintains the safety and reliability of the network in the long-term interests of consumers.

Setting an opex forecast is part of the incentive-based regulatory regime established in Chapter 6 of the NER. Incentive regulation of this kind is designed to encourage network businesses to improve their efficiency over time. Where a distributor is responsive to the financial incentives under the regulatory framework, the actual level of opex it incurs should provide a good estimate of the efficient costs required for it to operate a safe and reliable network and meet its relevant regulatory obligations. This is known as the 'revealed cost approach'. So long as we do not identify any material inefficiency in a distributor's revealed

costs, our preference is to rely on these costs in assessing the distributor's proposed opex forecast, and if necessary, in determining a substitute estimate.<sup>47</sup>

In remaking our opex decision, we have considered Essential Energy's revealed costs over the first three years of the 2014–19 regulatory control period, and its cost estimates for the remainder of the period. Essential Energy has achieved significant reductions in opex since 2012–13 and its recent opex is now consistent with our opex forecast set in our April 2015 final decision. Essential Energy appears to have responded to the strong incentives imposed by our regulatory regime, including the use of economic benchmarking.

Having regard to the Tribunal's directions, we have tested the efficiency of Essential Energy's revealed opex with:

- Additional economic benchmarking results, including updates for 2015–16. This shows that Essential Energy has significantly improved its opex productivity and its recent revealed opex is not materially inefficient when compared to its peers.
- Category level cost analysis that examines some of the underlying reasons for Essential Energy's reductions in opex since 2012–13. This shows that Essential Energy has made significant reductions in vegetation management and labour costs – two areas we identified as materially inefficient in our April 2015 final decision.

Taken together, we are satisfied that Essential Energy's proposed opex forecast reasonably reflects the opex criteria.

The next sections outline our consideration of Essential Energy's revealed costs, benchmarking results and category level costs analysis in more detail.

## Revealed costs

This section examines Essential Energy's revealed costs between 2012–13 (the base year) and 2016–17, and its projections for the remainder of the 2014–19 regulatory control period.

As outlined in our Expenditure Assessment Forecast Guideline, our preferred approach for forecasting opex is to use the revealed cost approach.<sup>48</sup> This is because opex is largely recurrent and stable at a total level between regulatory periods. Underpinning this revealed cost approach is the assumption that a distributor has responded to the incentive under the incentive framework to achieve efficiencies and spend less than the regulatory allowance whilst maintaining the safe and reliable operation of its network under existing regulatory obligations.

Relevantly, at our stakeholder roundtable meeting in August 2017, the distribution businesses stated they had faced a very strong incentive to reduce costs over the current 2014-19 regulatory control period given that our opex forecasts were significantly below the businesses' actual costs at the start of the period.<sup>49</sup> Given the timing of the remittal process,

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<sup>47</sup> AER, *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p.22.

<sup>48</sup> AER, *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p.31.

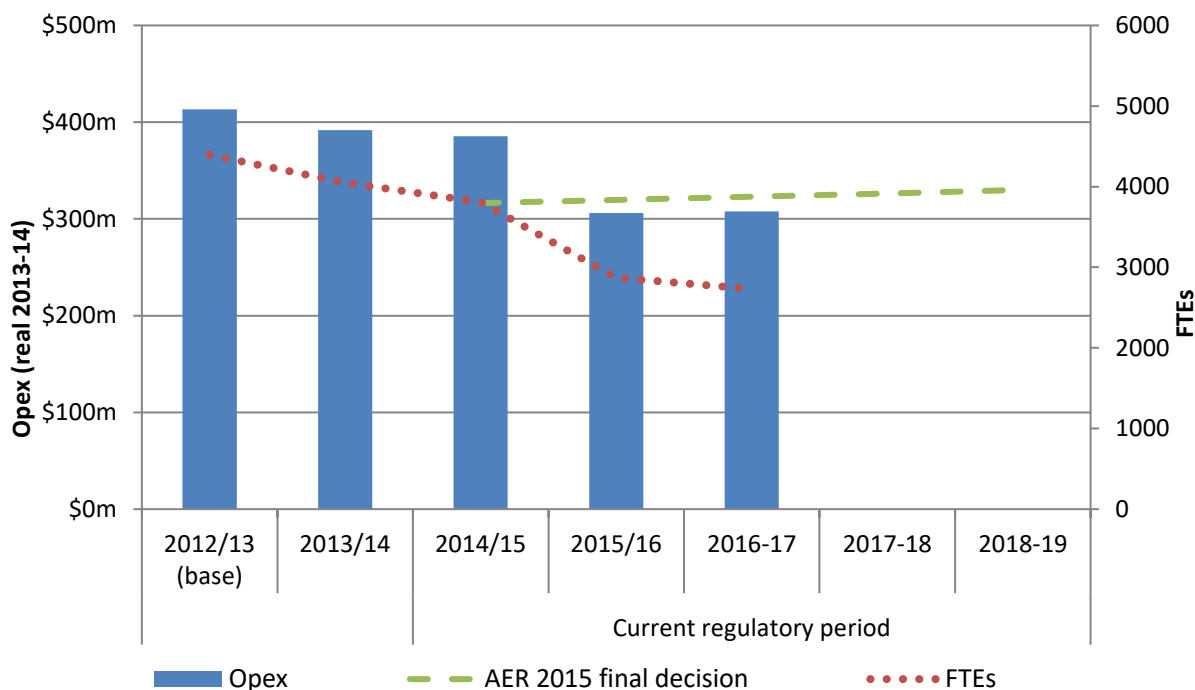
<sup>49</sup> AER, *NSW and ACT remittal roundtable (16 August 2017) summary note*, August 2017:

<https://www.aer.gov.au/communication/aer-hosts-nsw-act-electricity-distribution-network-revenue-roundtable>

we now have the opportunity to also consider the revealed costs that Essential Energy has incurred during the 2014–19 regulatory control period when remaking our opex forecast.

Figure 5-1 shows that Essential Energy's total actual opex has decreased by approximately 30 per cent since 2012–13 (its base year). It also shows that it has reduced its permanent full time equivalent staff (FTEs) by 38 per cent over this period. Its opex in 2015–16 and 2016–17 was below our original April 2015 final decision opex forecast.

**Figure 5-1 Essential Energy's actual opex, AER forecast opex in April 2015 final decision, including movements in FTEs**



Source: AER final decision; Annual RIN; Essential Energy response to AER information request; Annual reports.

Note: Actual opex has been normalised by excluding metering and ancillary costs prior to 2014–15.

In its proposal, Essential Energy stated that since 2012, it has improved the efficiency of its capital and operating programs through various reforms to its business:

Since the Federal Court order was delivered, these reforms have enabled Essential Energy to meet the significant challenge set by the AER and the business is currently operating in line with the expenditure allowances of the 2015 set-aside determination. As stated earlier, this will result in a 28 per cent reduction in revenue during the 2014-19 regulatory period.<sup>50</sup>

Essential Energy appears to have responded to the strong incentives imposed by our regulatory regime and use of economic benchmarking. Since our April 2015 final decision, Essential Energy had made substantial inroads in reducing costs. In addition, it has stated

<sup>50</sup> Essential Energy, *Remittal of Essential Energy 2014–19 revenue determination*, 30 November 2017, p. 3.

that it aims to continue delivering increased efficiencies throughout the forthcoming 2019–24 regulatory control period.<sup>51</sup>

These results lend support to our April 2015 final decision opex forecast, which forms the basis of Essential Energy's overall proposal, as being an efficient level of opex that reasonably reflects the opex criteria.

In the following sections, we test these findings with additional benchmarking and bottom-up analysis. This responds to the Tribunal's directions to us as part of the remittal.

## **Benchmarking analysis**

The Tribunal directed us to use a broader range of modelling, and benchmarking against Australian businesses in remaking our opex constituent decision.<sup>52</sup>

Whilst we are mindful of the Tribunal's findings, it is not practical for us to now revise our economic benchmarking analysis and apply it in remaking our opex decisions. The benchmarking techniques and data we have utilised to date were developed following an extensive public consultation process as part of our Better Regulation program during 2013. Any substantive revisions would therefore involve a considerable amount of re-development work and time to consult with industry, consumer groups and other interested stakeholders, further delaying resolution of all outstanding remittal-related matters for Essential Energy.

At our stakeholder roundtable meeting in August 2017, a number of stakeholders agreed there is a significant role for benchmarking in network regulation and supported its further development. At the meeting, stakeholders also expressed a clear preference for us to remake our decisions in a timely manner and recognised that revisiting our benchmarking would not be possible without further delaying the remaking of our opex decisions.<sup>53</sup>

Given these limitations, we have used additional benchmarking techniques beyond the SFA model (specifically, multilateral total and partial factor productivity) with updated data for the most recent years, to cross-check the efficiency of Essential Energy's recent revealed costs and to test the reasonableness of its opex proposal. More detail about these economic benchmarking techniques are set out in our annual economic benchmarking reports.<sup>54</sup>

Our recent Opex Multilateral Partial Factor Productivity (MPFP) index analysis, using the most recent data, indicates that Essential Energy has significantly improved its opex efficiency.<sup>55</sup> Figure 5-2 shows that, for the 2012–16 period, Essential Energy had improved its opex productivity (as shown by the red line) and is now amongst the middle group of efficient networks in terms of opex efficiency. While these MPFP results do not account for

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<sup>51</sup> Essential Energy, *Expenditure Forecasting Methodology 2019–24 Regulatory Proposal*, June 2017, p. 9.

<sup>52</sup> *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1(a).

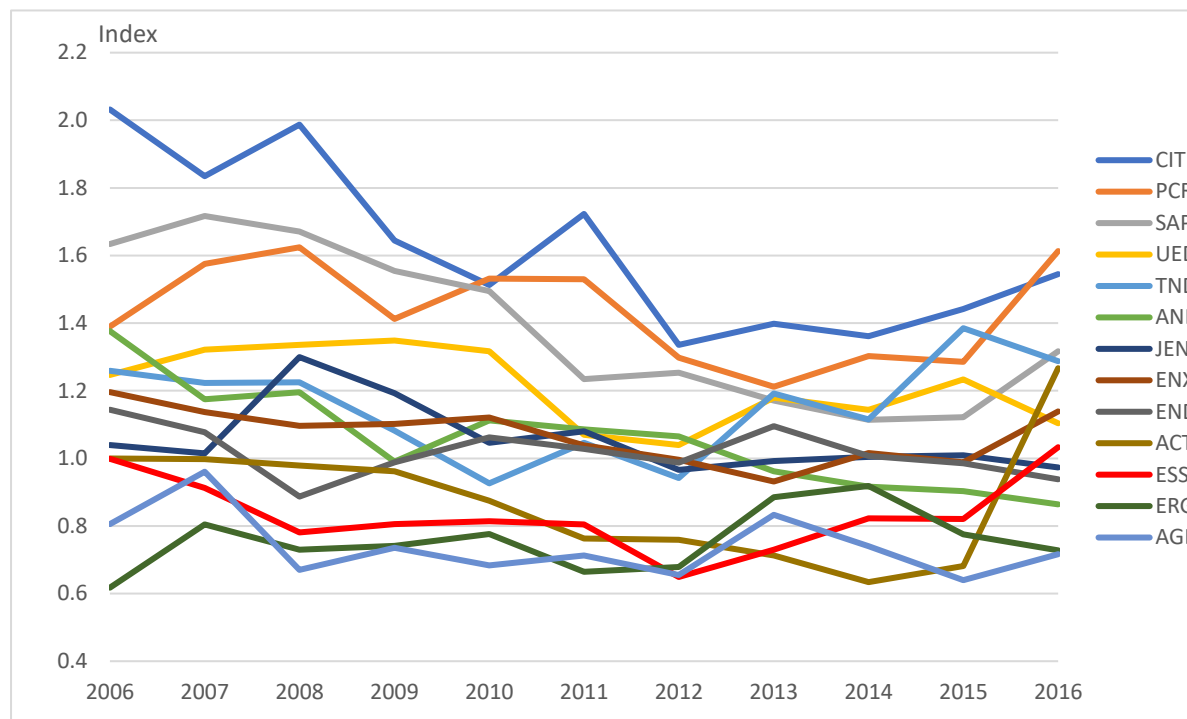
<sup>53</sup> However, consumer stakeholders have expressed support for ongoing use of benchmarking and we are committed to refining our benchmarking tools.

<sup>54</sup> AER, *Annual benchmarking report– Electricity distribution network service providers*, November 2017. Available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/annual-benchmarking-report-2017>

<sup>55</sup> The opex multilateral partial factor productivity (MPFP) technique examines the contribution of operational expenditure to overall productivity. This 'partial' approach uses the same output specification as multilateral total factor productivity (MTFP) but provides more detail on the contribution of the individual components of capital and opex to changes in productivity.

some differences in operating environment factors, Essential Energy's improvement in productivity suggests that it is no longer materially inefficient compared to its peers in the National Electricity Market (NEM).

**Figure 5-2 MPFP opex index**



Source: AER 2017 annual benchmarking report

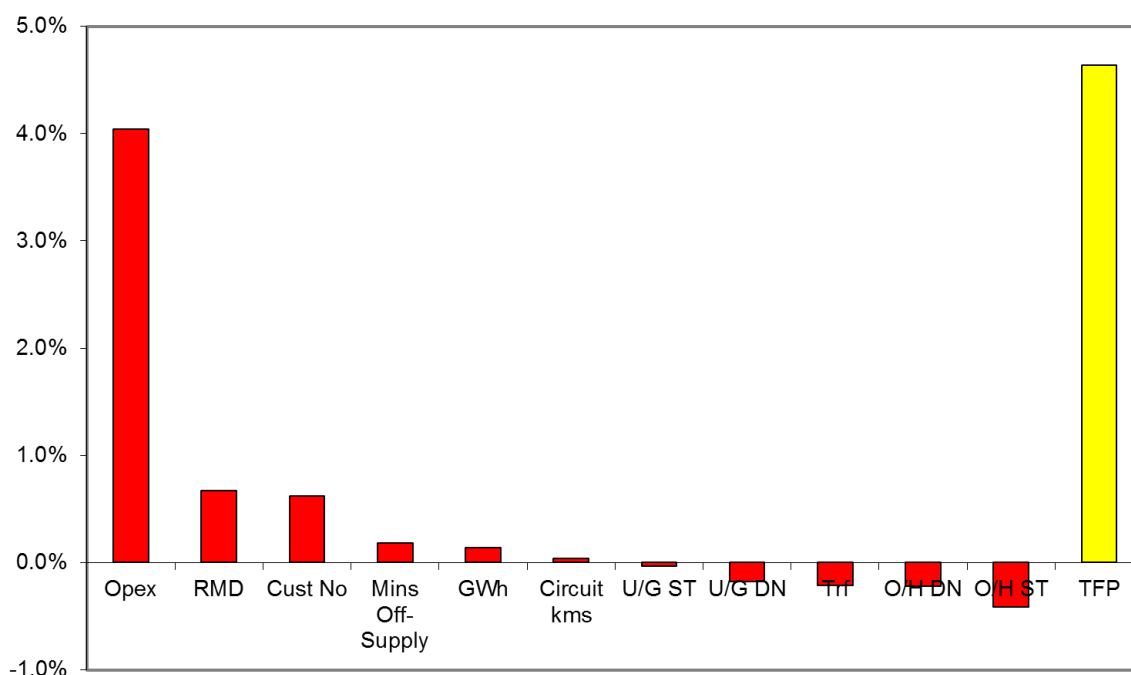
Essential Energy's multilateral total factor productivity (MTFP) results also show some improvement between 2012 and 2016. MTFP measures the relationship between total output and total input. MTFP takes into account inputs other than opex, such as capital expenditure.

Figure 5-3 provides a decomposition of contributions to annual changes in MTFP since 2012 (from the AER's 2017 distribution annual benchmarking report).<sup>56</sup> This shows that the primary contributor to this improvement in total productivity was Essential Energy's decrease in opex (or 4 per cent average annual decrease) over the period. The vast majority of these opex savings occurred in 2015–16.

These results support our view that Essential Energy's revealed opex in 2015–16 is not materially inefficient.

<sup>56</sup> AER, *AER 2017 distribution network service providers benchmarking report 2017*, November 2017. Available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/annual-benchmarking-report-2017>

**Figure 5-3 Percentage point contributions to annual MTFP change, 2012–2016**



Source: AER 2017 annual benchmarking report

### Opex category analysis

The Tribunal and the Court did not specify what form of bottom-up assessment we need to undertake in remaking our opex decisions. The Court stated that the issue of what form and scope of bottom-up review is a matter for us to consider.

Generally, a bottom-up approach involves a detailed review that assesses discrete opex projects, items or categories of opex, involving reliance on engineering and managerial expertise, economic analysis, or more granular forms of benchmarking (for example, at the category analysis level). In order to assess whether the total opex forecast is consistent with the NER requirements, aggregating the relevant items is necessary.

Where, based on the available evidence, the revealed costs of a distributor are likely to reflect a prudent and efficient level of opex that meets the opex criteria, and is at a sustainable level that will maintain the safety and reliability of services in the long-term interests of consumers, any bottom-up assessment warranted may be minimal in scope and nature. In cases where the revealed costs do not reflect a prudent and efficient level of opex that meets the opex criteria, we may undertake more comprehensive and detailed bottom-up assessments.

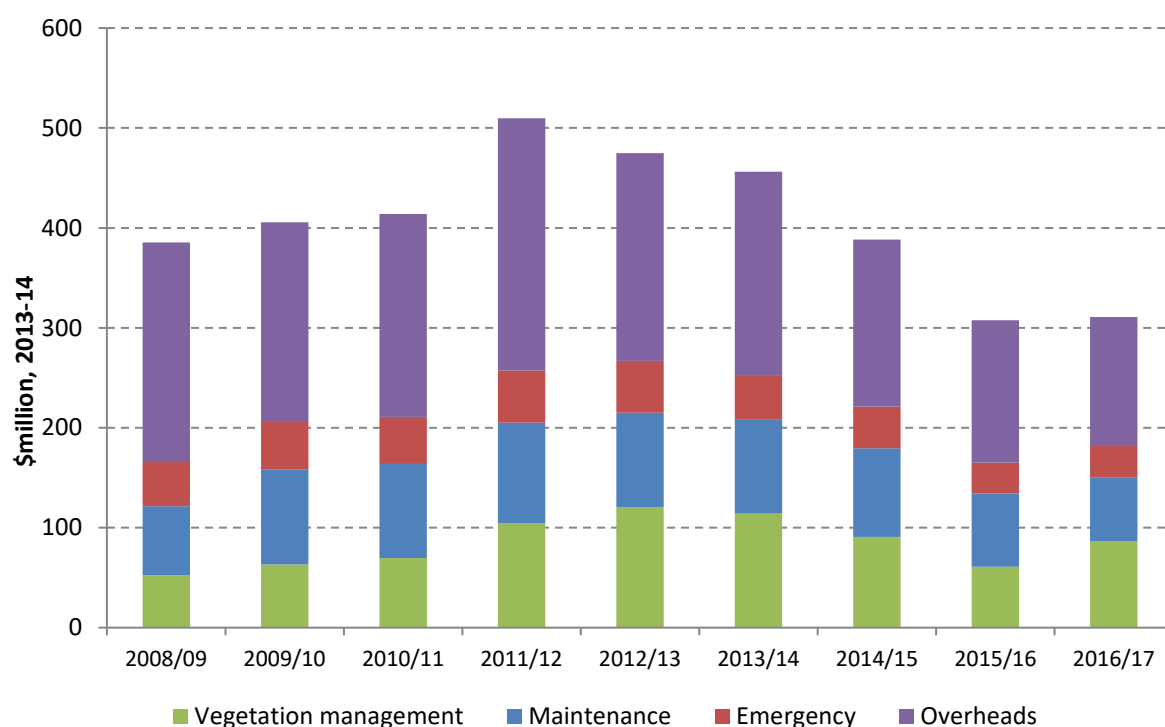
In addition to the available revealed costs and benchmarking information, we have examined some of Essential Energy's major opex categories. This is a limited form of bottom-up analysis that examines some of the underlying drivers for its reductions in opex since 2012-13.<sup>57</sup>

<sup>57</sup> At our remittal stakeholder roundtable meeting in August 2017, a number of stakeholders noted there may need to be a greater emphasis on detailed reviews in key opex areas such as labour and vegetation management costs. AER, NSW

Figure 5-4 shows the breakdown of Essential Energy's major opex cost categories. Since 2012–13 (our April 2015 final decision base year), there have been reductions across all of its major cost categories. Since 2012-13, it has made the following opex reductions:

- vegetation management (excluding allocated overheads) reduced by 28 per cent
- maintenance costs reduced by 33 per cent
- total overheads reduced by 38 per cent
- emergency services costs reduced by 37 per cent

**Figure 5-4 Essential Energy's opex cost breakdown**



In our April 2015 final decision, we found that Essential Energy was not efficient in the cost categories of labour costs and vegetation management. Since that time, it has made significant reforms in these operational areas.

First, Essential Energy has improved the efficiency of its labour costs since 2012–13. In our April 2015 final decision, we found Essential Energy had higher than efficient labour costs because it had engaged permanent staff in preference to contractors over the 2009–14 period.<sup>58</sup> These staff became stranded labour due to the restrictions on involuntary redundancies imposed by Essential Energy’s 2013 enterprise bargaining agreement.<sup>59</sup> These views were informed by a review conducted by Deloitte Access Economics.<sup>60</sup>

and ACT remittal roundtable (16 August 2017) summary note, August 2017

<sup>58</sup> AER, *Final Decision Essential Energy distribution determination 2015–16 to 2018–19, Attachment 7 – Operating Expenditure*, April 2015, pp. 7-24 and 7-150.

<sup>59</sup> Ibid.

<sup>60</sup> Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis*, November 2014, pp. i-v;

Essential Energy has taken steps to pursue efficiencies and flexibility in managing its labour force, including changes to its enterprise bargaining agreement, which has enabled it to sustainably reduce costs. As highlighted by Essential Energy in its proposal:<sup>61</sup>

Since 2012, major reforms to the way we operate have delivered significant benefits:

- 29 per cent reduction in full-time equivalent staff levels;
- 35 per cent real reduction in operating expenditure; and
- 41 per cent reduction in capital expenditure.

These benefits are, in part, attributable to major reforms to our Enterprise Agreement, resulting in a current Workplace Determination that includes improved consultation, dispute resolution and outsourcing clauses, and the introduction of involuntary redundancies, achieved during the current period.

Since the Federal Court order was delivered, these reforms have enabled Essential Energy to meet the significant challenge set by the AER and the business is currently operating in line with the expenditure allowances of the 2015 set-aside determination.

Secondly, Essential Energy has reduced its vegetation management costs. In its original proposal, it acknowledged that its vegetation management practices in 2009–14 were inefficient and required reform.<sup>62</sup> We agreed and this informed our view that Essential Energy's base year opex in 2012–13 was not efficient.<sup>63</sup>

As observed in Figure 5-4, Essential Energy has reduced its vegetation management costs (excluding allocated overheads) by 28 per cent. This reduction exceeds the vegetation management efficiency gain that it had forecast at the beginning of the 2014-19 regulatory control period.<sup>64</sup> We understand this reduction was driven by increased efficiencies, as well as under-delivery of its vegetation management program as a result of transitioning its contracts in its cyclic maintenance program and the voluntary administration of a national vegetation supplier. Essential Energy has since updated its vegetation management strategy to optimise long-term vegetation management expenditure. The reforms Essential Energy has made to these costs categories provide further supporting evidence, in addition to economic benchmarking, that its revealed total opex is no longer materially inefficient.

### 5.3.2 Return on debt constituent decision

The allowed rate of return provides a network service provider a return on capital that a benchmark efficient entity would require to finance (through debt and equity) investment in

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Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis: addendum to 2014 report*, April 2015, pp. ii–vii.

<sup>61</sup> Essential Energy, *Remittal of Essential Energy 2014-19 revenue determination*, 30 November 2017, pp. 2-3.

<sup>62</sup> Essential Energy, *Regulatory Proposal 1 July 2014 to 30 June 2019*, May 2014, p. 73; Essential Energy, *Vegetation Management Strategy and Implementation Plan for Additional Expenditure – FY 2013 to 14 (Confidential)*, February 2013; Select Solutions, *Review of Essential Energy Vegetation Management Strategy–Final Report (Confidential)*, 22 March 2013.

<sup>63</sup> AER, *Final Decision Essential Energy distribution determination 2015–16 to 2018–19, Attachment 7 – Operating Expenditure*, April 2015, pp. 7-25.

<sup>64</sup> Essential Energy proposed a reduction of \$150.4 million (\$2012–13) in vegetation management in its revenue proposal in 2014 due to achievement of efficiencies through strategic reform initiatives. Essential Energy, *Regulatory Proposal 1 July 2014 to 30 June 2019*, May 2014, p. 73.



its network.<sup>65</sup> The return on capital building block is calculated as a product of the rate of return and the value of the regulatory asset base (RAB). The rate of return is discussed in this section.

Essential Energy's revenue proposal has implicitly adopted our return on capital allowance that we set in our April 2015 final decision (with minor updates for updated return on debt data). This was based on a transition to a trailing average methodology for calculating the return on debt.

Since our April 2015 final decision, having regard to the decisions of the Tribunal and Court, we have revised our general approach to determining the return on debt. We now apply a revenue neutral transition when moving from the on-the-day methodology for estimating the cost of debt to a trailing average methodology. The basis for this revenue neutral transition is discussed in more detail later.

While our approach, and the reasoning to support it, has changed since the April 2015 final decision, the revenue outcome of our new approach is approximately the same as in the April 2015 final decision.<sup>66</sup> Essential Energy's proposal is consistent with our new approach to determining the return on debt.

The revised rate of return allowance is set out below under our initial decision. These numbers reflect our April 2015 final decision with respect to the return on equity and the gearing ratio and a revenue neutral transition calculated using updated debt yield data from the Reserve Bank of Australia (RBA) and Bloomberg. They also reflect the debt averaging periods we determined to use in our April 2015 final decision.

**Table 5-2 Essential Energy return on debt and return on capital, 2015 final decision (\$million, 2013-14) and percentage debt portfolio rate of return<sup>67</sup>**

|  | 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 | Total   |
|--|---------|---------|---------|---------|---------|---------|
| Final decision debt portfolio rate of return | 6.51%   | 6.40%   | 6.25%   | 6.10%   | 5.93%   |         |
| Final decision return on debt                | 264.46  | 275.98  | 284.86  | 292.35  | 297.47  | 1415.13 |
| Final decision return on capital             | 456.85  | 480.10  | 500.50  | 519.03  | 534.95  | 2491.42 |

<sup>65</sup> The term network service provider relates to service providers that provide gas and electricity transmission and distribution services.

<sup>66</sup> We note a very small change in revenue occurs due to the use of the most recent debt yield data available.

<sup>67</sup> These numbers reflect the final decision including annual debt updates.

**Table 5-3 Essential Energy updated return on debt and return on capital, 2018 draft decision (\$million, 2013-14) and percentage debt portfolio rate of return<sup>68</sup>**

|  | 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 | Total   |
|--|---------|---------|---------|---------|---------|---------|
| Draft decision debt portfolio rate of return | 6.51%   | 6.41%   | 6.26%   | 6.10%   | 5.93%   |         |
| Draft decision return on debt                | 264.71  | 276.30  | 285.09  | 292.32  | 297.41  | 1415.84 |
| Draft decision                               | 457.10  | 480.42  | 500.72  | 519.00  | 534.89  | 2492.14 |

For the reasons set out below, our remade draft decision is to accept the ex ante rate of return revenue allowance as set out in Table 5-3 above.

### 5.3.2.1 The NER requirements

The rules in the NER and provisions in the NEL that govern our assessment of debt remain unchanged on remittal.

We must determine a rate of return such that it achieves the allowed rate of return objective (ARORO).<sup>69</sup> The ARORO is that the rate of return is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of its regulated services (its standard control service in the case of electricity distributors).<sup>70</sup> Therefore, each remade debt decision must contribute to achieving the ARORO.

Other legislative requirements relevant to remaking our debt decision include the NEO, the RPP and any interrelationships with other related components of a distribution determination. The NEO is relevant because we are required to make a distribution determination that will, or is likely to, contribute to the achievement of the NEO to the greatest degree.<sup>71</sup> The RPP are relevant because we must take them into account in exercising this type of decision-making power.<sup>72</sup> We must also take into account any interrelationships between our remade debt decision and any other related component of a distribution determination.<sup>73</sup>

<sup>68</sup> These numbers use updated RBA and Bloomberg data and include annual debt updates.

<sup>69</sup> NER ss. 6.5.2(b), 6A.6.2(b).

<sup>70</sup> NER ss. 6.5.2(c), 6A.6.2(c).

<sup>71</sup> NEL, ss. 7 and 16(1)(d).

<sup>72</sup> The RPP that are directly relevant to remaking our debt decision are set out at NEL, ss. 7A(2), 7A(3), 7A(5), 7A(6) and 16(2).

<sup>73</sup> NEL, s. 16(1)(c).

### 5.3.2.2 The Tribunal's decision

On 26 February 2016, the Tribunal handed down its decisions.<sup>74</sup> The Tribunal instructed us to remake the constituent decision on the return on debt in relation to the introduction of the trailing average in accordance with the Tribunal's reasons for its decisions without giving a clear clarification of the directions for the remittal.<sup>75</sup> The Tribunal found us in error in our definition of a benchmark efficient entity as a 'regulated' entity. The Tribunal also found us in error in our construction of NER rule 6.5.2(k)(4), based on the information available to the Tribunal at that time.

### 5.3.2.3 Judicial Review

On 24 March 2016, we applied to the Federal Court for judicial review of the Tribunal's decisions on the value of imputation credits (gamma), the return on debt and opex. On 24 May 2017, the Court dismissed our appeals on the return on debt and opex and upheld the Tribunal's decisions in relation to these issues. It upheld the AER's appeal in relation to gamma.<sup>76</sup>

We have carefully considered the full reasoning of the Court in considering what to do to achieve the ARORO, NEO and RPP in this decision. Of relevance, in relation to the Court's decision:

- the Court clarified that a benchmark efficient entity is not necessarily either regulated or unregulated
- the important characteristic of a benchmark efficient entity is that it has a similar degree of risk to the service provider with respect to the provision of its regulated services
- a change in debt estimation methodology does not necessarily result in any impacts for a benchmark efficient entity

In relation to both the decisions of the Tribunal and Court, we also make the following observations:

- The decisions of the Tribunal and Court were not focussed on the interpretation of 'efficient financing costs' in the ARORO. We consider this to be an important factor (and which we discuss in further detail under section 5.3.3).
- Neither decision removes the requirement to apply a debt methodology that we consider will achieve the relevant legislative objectives for each of the respective service providers affected by the remittals.
- Neither decision requires the use of a trailing average methodology for determining the cost of debt in this remittal.

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<sup>74</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1; *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2; *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3; *Application by ActewAGL Distribution* [2016] ACompT 4.

<sup>75</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1, direction 1(b); *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2, direction 1(b); *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1(b); *Application by ActewAGL Distribution* [2016] ACompT 4, direction 1(b); *Application by Jemena Gas Networks (NSW) Ltd* [2016] ACompT 5, direction 1(a).

<sup>76</sup> *Australian Energy Regulator v Australian Competition Tribunal (No 3)* [2017] FCAFC 80.

In subsequent decisions involving other parties, the Tribunal and Full Federal Court have made various findings and comments which are also relevant to these matters. In particular, both the Tribunal and Federal Court have made comments about our new approach to estimating the return on debt that help to clarify how the Tribunal's decision for Essential Energy should be interpreted.<sup>77</sup> This is discussed in more detail below.

#### 5.3.2.4 Other relevant legal processes

Other legal decisions that we have had regard to in our remade draft decision are:

- the decision of the Australian Competition Tribunal for SA Power Networks and the subsequent decision of the Full Federal Court on the appeal of this decision<sup>78</sup>
- the decisions of the Australian Competition Tribunal for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd<sup>79</sup>

The decisions of the Tribunal for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd are particularly important as they are directly concerned with the application of our new approach to estimating the return on debt.

After the Tribunal handed down its decisions for Essential Energy, we reconsidered our approach to debt estimation methodology. The new approach, which we adopted in our decisions for ActewAGL (Gas) Distribution and Jemena Electricity Networks, does not rely upon a conceptualisation of a benchmark efficient entity as a regulated entity. It recognises that different service providers may have a different benchmark efficient entity. The new approach also does not rely on a change in methodology impacting a benchmark efficient entity to justify our revenue neutral transition. Our new approach does not rely upon an assessment of historical financing practices. Instead, it considers the efficient financing costs (being the costs of equity and debt) in a forward looking manner. Our new approach was subject to review by the Tribunal.

The Tribunal upheld our new approach. It explained more clearly how each of the Tribunal's and Court's decisions should be read together consistently. It provided clarification for the earlier Tribunal's decision on the directions of the Tribunal for the remittal that were previously unclear to us. We consider these decisions support a revenue neutral transition when moving to a trailing average methodology based on our new approach, or the continuance of an on-the-day methodology for determining the cost of debt, to achieve the NEO.

An important aspect of the decisions for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd is the consideration in those decisions of the interpretation of the 'allowed rate of return objective' (or ARORO) and the meaning of 'efficient financing costs'.<sup>80</sup> We consider these decisions support our ex ante interpretation of efficient financing costs. These

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<sup>77</sup> See eg *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3 at [295].

<sup>78</sup> *Application by SA Power Networks* [2016] ACompT 11; *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3.

<sup>79</sup> *Application by ActewAGL Distribution* [2017] ACompT 2.

<sup>80</sup> *Application by ActewAGL Distribution* [2017] ACompT 2.

decisions and our view on them are covered in further detail in our debt Position Paper on our remitted debt decisions.<sup>81</sup>

On 18 January 2018, the Full Federal Court handed down its decision on *SA Power Networks v Australian Competition Tribunal*.<sup>82</sup> This was a review brought by SA Power Networks from a decision of the Tribunal.<sup>83</sup>

The Full Federal Court noted that the Court had not had the benefit of hearing a number of issues in relation to Essential Energy's review, that had been subsequently put to it in *SA Power Networks vs Australian Competition Tribunal*. In particular, the Court stated:

We would add that the present proceeding has raised a number of issues that were not advanced by the parties in *AER v Australian Competition Tribunal* [ie the Essential Energy case]. The Full Court's observation at [572] of *AER v Australian Competition Tribunal* that there were no impacts in the form of hedging contracts that needed to be unwound was made in the context of the facts of that case and the submissions that were advanced by the parties at that time. No wider consideration of the possible "impacts" of a change in methodology to estimate the return on debt was advanced or addressed. We do not regard *AER v Australian Competition Tribunal* as in any way confining the "impacts" to which the AER might have regard when applying r 6.5.2(k)(4).

We consider this Full Court decision handed down on 18 January 2018 also supports our new revenue neutral debt transition approach which we propose to apply in this remitted debt decision.

### 5.3.2.5 Our approach to debt in this remitted debt decision

In remaking our debt decision, we are moving to a trailing average approach to estimating the return on debt from our previous on-the-day methodology. We will apply a revenue neutral transition in moving to this methodology. As noted by the Tribunal in its decision for ActewAGL (Gas) distribution and Jemena Electricity Networks Ltd, our revenue neutral transition is effectively a combination of the on-the-day methodology and trailing average methodology.

The only change in application we are making in comparison to our April 2015 final decision is in undertaking our calculations to use the most updated debt series data available for the periods from the RBA and Bloomberg.<sup>84</sup> The RBA made two changes to its yield curve estimates over the relevant period and Bloomberg has removed a period of data from publication.

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<sup>81</sup> AER, *Position paper– Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

<sup>82</sup> *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3.

<sup>83</sup> *Application by SA Power Networks* [2016] ACompT 11.

<sup>84</sup> We note that while our application of a revenue neutral transition to a trailing average is mathematically the same as our final decision, our reasoning has changed and is entirely based on the reasoning as set out in our APA VTS final decision.

### 5.3.2.6 Stakeholder submissions on our cost of debt Position Paper

On 21 December 2017, we published a cost of debt Position Paper.<sup>85</sup> It set out our proposed approach to our remitted debt decision. On 22 January 2018, we published links to the decision of the Full Federal Court in *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3 and invited interested parties to comment on the decision and/or our view that it supported our proposed position to the remitted debt decisions in their submissions to our debt Position Paper. All parties to the Tribunal litigation were notified of the debt Position Paper and the Full Court's decision via email on 21 December 2017 and 22 January 2018, respectively.

In response to the debt Position Paper, we received submissions from CCP10, Evoenergy, Jemena Gas Networks, PIAC and ECA. We have had regard to these submissions in making this remade draft decision.

### 5.3.2.7 Reasons for our draft decision

For the reasons set out in our debt Position Paper on our remitted debt decisions and in our APA VTS final decision, we consider a revenue neutral transition to a trailing average debt estimation methodology will lead to an allowed rate of return that will achieve the ARORO and contribute to the achievement of the NEO to the greatest degree. This rate of return will both reflect ex ante efficient financing costs and result in an approximately zero NPV investment outcome which is important to achieving efficient investment incentives. A revenue neutral transition will also substantially eliminate any wealth impact on Essential Energy from changing the debt estimation methodology.

We rely on the reasoning in our APA VTS decision in making this draft decision for Essential Energy, as set out in Attachment 3 of our APA VTS determination.<sup>86</sup> This includes an explanation of how our approach has changed in response to relevant legal decisions. We also rely on our explanation and reasoning as set out in the debt Position Paper on our remitted debt decisions in making this draft decision.<sup>87</sup>

As set out above, we have used the most up to date debt data from the RBA and Bloomberg for estimating the cost of debt over the relevant averaging periods. We note that the RBA has updated its cost of debt data and back-cast this twice since our original April 2015 final decision. Bloomberg has also removed some data from publication. We consider that by using the most updated debt data, our cost of debt estimates will be better estimates of the efficient cost of debt than if we used the earlier data from Bloomberg and the RBA.

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<sup>85</sup> AER, *Position paper– Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

<sup>86</sup> AER, *Final Decision APA VTS gas access arrangement 2018 to 2022, Attachment 3 - Rate of return*, November 2017; Available at: <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/apa-victorian-transmission-system-access-arrangement-2018-22/final-decision>

This decision discusses and applies substantively identical provisions for rate of return as those applicable to electricity distribution.

<sup>87</sup> AER, *Position paper– Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

In relation to the timing of the initial debt averaging period (for the commencement of the trailing average), we have used the initial averaging period set out in our April 2015 final decision for the introduction of the trailing average. As such, we have not adopted PIAC's submission to use prevailing rates closer to the commencement of the 2015-16 regulatory year when estimating the return on debt for the NSW electricity distributors. We also have used the debt averaging periods for the later years of the regulatory control period, as set out in our April 2015 final decision, because we consider these will lead to a rate of return that achieves the ARORO and contribute to the achievement of the NEO. All averaging periods were chosen in advance of their commencement and we consider their use should result in an ex ante efficient return on debt allowance. We consider choosing averaging periods after the periods have finished (or post commencement) is generally inappropriate due to the potential incentive on various stakeholders to advocate for averaging periods that give particular results.

We also consider our overall approach will lead to an overall allowed rate of return that will achieve the ARORO and contribute to achieving the NEO because:

- the return on equity we determined in our April 2015 final decision was upheld on appeal as was the gearing ratio and we consider these values remain appropriate
- our combination of the yield from two debt series we used to estimate the return on debt in the April 2015 final decision, a simple average of yields estimated from the Bloomberg and RBA yield curves, was upheld on appeal in the Tribunal and we consider remains appropriate
- we consider the overall allowed rate of return estimated using our return on debt, return on equity and gearing estimates will result in an allowed rate of return that will achieve the ARORO and contribute to achieving the NEO

As noted earlier, we have had regard to the submissions on our debt Position Paper in making this remade draft decision.

## **5.4 Other aspects of the final decision to be varied**

### **5.4.1 Control mechanism**

The control mechanism was not a subject of Essential Energy's appeal of our April 2015 final decision. However, this remade draft decision has implications for the operation of the control mechanism for the 2014–19 and 2019–24 regulatory control periods. As noted above, the Tribunal's directions that we are to comply with in remaking our decision includes:

- (d) the AER is to consider, and to the extent to which it considers appropriate to vary the Final Decision in such other respects as the AER considers appropriate having regard to s 16(1)(d) of the National Electricity Law in the light of such variations as are made to the Final Decision by reason of (a)-(c) hereof.

As we discussed in section 5.2, this draft decision enables Essential Energy to recover the revenue allowances under our April 2015 final decision, plus additional revenue capped at \$100 million. In order to accommodate the \$100 million cap in our control mechanism formula, we must vary the control mechanism as set out in our Framework and Approach

paper for Essential Energy's 2014–19 revenue determination and adopted in our April 2015 final decision.<sup>88</sup>

This remade draft decision removes the following requirement from our April 2015 final decision on the form of control mechanism:<sup>89</sup>

In proposing variations to the amount and structure of DUoS charges, Essential Energy is to achieve an expected zero balance on their DUoS unders and overs accounts in each forecast year in its annual pricing proposals in the 2015–19 regulatory control period.

In making this variation, we note that clause 6.12.3 of the NER states:

(c) The form of the control mechanisms must be as set out in the relevant framework and approach paper.

(c1) The formulae that give effect to the control mechanisms referred to in paragraph (c) must be as set out in the relevant framework and approach paper unless the AER considers that unforeseen circumstances justify departing from the formulae as set out in that paper.

We consider this variation to the control formula is necessary given the material and unforeseen change in circumstances since our April 2015 final decision (as set out in section 5.1.1).<sup>90</sup> The variation will allow us to track Essential Energy's revenue relative to our April 2015 final decision through the DUoS 'unders' and 'overs' accounts. This will enable us to implement the \$100 million cap while maintaining the operation of the unders and overs accounts across the 2014–19 and 2019–24 regulatory control periods. This is consistent with the requirements of the NER as it would minimise administrative costs and reduce uncertainty.<sup>91</sup>

We will ensure Essential Energy earns no more than the \$100 million cap from this remade draft decision through the design of the control mechanism for standard control services for the 2019–24 regulatory control period. This is because we will not know what Essential Energy's actual revenue for the 2014–19 regulatory control period will be until after this regulatory control period expires.

A revenue cap will continue to apply to Essential Energy's standard control services in the 2019–24 regulatory control period.<sup>92</sup> At this stage, we are likely to maintain the general properties of the control mechanism from our April 2015 final decision, including the unders and overs accounts. With this in mind, we consider there are several options for enforcing the \$100 million cap through the control mechanism for the 2019–24 regulatory control period. However, the exact design by which we will implement this returning of any revenue

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<sup>88</sup> AER, *Stage 1 Framework and approach paper – Ausgrid, Endeavour Energy and Essential Energy, Attachment 2 Control mechanisms*, March 2013, p.43. Available at: <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19/aer-position>

<sup>89</sup> AER, *Final decision Essential Energy distribution determination: 2015–16 to 2018–19, Attachment 14 - Control mechanism*, April 2015, p.18.

<sup>90</sup> NER, cl. 6.12.3(c)(1).

<sup>91</sup> NER, cl. 6.2.5(c)(2) and (3).

<sup>92</sup> AER, *Framework and approach Ausgrid, Endeavour Energy and Essential Energy: Regulatory control period commencing 1 July 2019*, July 2017, pp. 41 and 52–54.



that breaches the \$100 million cap is a matter which we will need to consult upon and assess as part of Essential Energy's upcoming distribution determination.

### 5.4.2 Inflation error adjustment

In the LMR of Victorian Electricity and ACT Gas decisions, and subsequent to our April 2015 final decision for Essential Energy, the Tribunal became aware of an inflation estimation error impacting each of our determinations on review in this process.<sup>93</sup> The Tribunal noted the error in each of its decisions and stated it left it to us to determine the appropriate response to our error.<sup>94</sup> This was not an issue that was raised in the NSW Tribunal decision and we have discretion as to whether to correct this error in our remade determinations.

The error identified by the Tribunal is embedded in our April 2015 final decision for Essential Energy. The error results from an incorrect geometric average calculation undertaken on the annual inflation rates; resulting in an incorrect (lower) inflation rate of 2.38 per cent instead of 2.42 per cent. Correcting the error would result in a downward revenue adjustment of approximately \$10.75 million (\$, nominal) compared to our April 2015 final decision.

On 15 December 2017, we notified Essential Energy (and other NSW and ACT distribution businesses) in writing, stating that we were considering whether it is appropriate to correct the affected determinations when remaking our decisions.<sup>95</sup> This date is well after a period in which substantial pre-lodgement engagement on the key financial parameters of Essential Energy's 30 November 2017 proposal had already taken place with its key stakeholders, including consumer groups and our officers. As a consequence of this timing, the broad consumer support for its proposal and the good faith in which Essential Energy sought early resolution of all outstanding remittal-related matters, we consider it is appropriate to use our discretion in this instance and not apply the inflation estimation error correction in our remade draft decision for Essential Energy's 2014-19 regulatory control period.

### 5.4.3 Minor corrections to our April 2015 final decisions

On 20 May 2015, we published an open letter notifying our intention to correct several errors in our April 2015 final decision once any appeal to that decision is resolved.<sup>96</sup> As part of this remade draft decision for Essential Energy, we now refer and give effect to that open letter published on our website. It sets out our proposed correction for the following errors in our April 2015 final decision:

1. inaccurate description of metering in Appendix A to the Overview
2. inaccurate public lighting prices

<sup>93</sup> File Nos: ACT 3, 4, 5, 6, 7, 8 of 2016: <http://www.competitiontribunal.gov.au/current-matters/tribunal-documents>

<sup>94</sup> For example, see ACT, Application by ActewAGL Distribution [2017] ACompT 2, 17 October 2017, p i-iii.

<sup>95</sup> AER, *Proposed correction to an inflation calculation error impacting Essential Energy distribution determination 2014-19*, 17 December 2017. Available at: <https://www.aer.gov.au/system/files/DORIS%20-%20D17-178607%20AER%20letter%20proposed%20inflation%20correction-Essential%2015....pdf>

<sup>96</sup> AER, *AER letter to Essential Energy about correcting errors in Essential Energy distribution determination 2015-16 to 2018-19*, 20 May 2015. Available at: <https://www.aer.gov.au/system/files/Letter%20from%20AER%20to%20Essential%20Energy%20about%20correcting%20errors%20in%20distribution%20determination%20-%2020%20May%202015.pdf>

### 3. parameter missing for control mechanism

To ensure the relevant legal documents accurately reflect our decisions, the correction set out in the open letter shall form part of our remade draft decision for Essential Energy's remitted determination and supersede the errors we had identified in our April 2015 final decision.

# Appendix A

## Background on our remade draft decision

The AER is required to determine the revenue allowance for distributors under the National Electricity Rules (NER).

As part of the transitional arrangements for major changes to national rules for the regulation of distributors made in November 2012, the Australian Energy Market Commission (AEMC) deferred the full regulatory determination process for NSW and ACT distributors' 2014-19 regulatory control period. On 16 April 2014, as part of the transitional arrangements, we determined a placeholder revenue allowance for the 2014-15 transitional regulatory control period.

In May 2014, we received the NSW and ACT distributors' regulatory proposals for the 2014-19 regulatory control period, after which the full determination process commenced. We assessed the revenue allowances for the whole 2014-19 regulatory control period, and trued up any difference between the placeholder revenue allowance and revenue requirement for the transitional year.

## Original final decisions for 2014-19

On 30 April 2015, we published final decisions for the 2014–19 NSW and ACT electricity distribution determinations. In these decisions:

- We did not accept the distributors' proposed opex forecasts, and instead substituted our own alternative opex forecasts. We found the actual opex incurred by Ausgrid, Essential Energy and Evoenergy (formerly ActewAGL) in their proposed base year of 2012-13 was materially greater than what a prudent and efficient network service provider would incur in delivering safe and reliable network services to customers, and therefore these revealed costs could not be used as a basis to forecast opex for the 2014-19 regulatory control period. In the case of Endeavour Energy, we did not find any evidence of material inefficiency in the actual opex it incurred in its proposed base year, but if the proposed significant opex increase for vegetation management costs were included, then we would not be satisfied that the total forecast opex would reasonably reflect the opex criteria.
- We did not accept the distributors' proposed method for estimating allowed returns on debt. In relation to the debt transition, we did not accept the distributors' proposal to immediately use a trailing historical average. Instead, we used a transition that started from an on-the-day based estimate of the cost of debt and transitioned this to a trailing average over ten years.

## Limited merits review

On 17 July 2015, the distributors sought limited merits review (LMR) of our final decisions by the Australian Competition Tribunal (Tribunal). The Public Interest Advocacy Centre (PIAC) also applied for review of our NSW final decisions. Additionally, the Commonwealth Minister

for the Environment and Energy intervened. The key areas under review were opex, the cost of debt and the value of imputation credits (gamma).

On 26 February 2016, the Tribunal handed down its decisions. It remitted our decisions to us to be remade, in accordance with its orders:<sup>97</sup>

- Opex (and for Evoenergy, the implications of this for the Service Target Performance Incentive Scheme):<sup>98</sup> the Tribunal found it was open to us not to accept the distributors' opex forecasts, but had a number of concerns with how we derived our alternative opex forecasts.<sup>99</sup> In particular, the Tribunal considered that we relied too heavily on the results of a single benchmarking model to derive our alternative opex forecasts.<sup>100</sup>
- Cost of debt: the Tribunal instructed us to remake the constituent decision on return on debt in relation to the introduction of the trailing average in accordance with the Tribunal's reasons for its decisions without giving a clear clarification of the directions for the remittal.<sup>101</sup>

## Judicial review

On 24 March 2016, we applied to the Full Federal Court (Court) for judicial review of the Tribunal's decisions on the value of imputation credits (gamma), return on debt and opex. The crux of our argument was that the Tribunal misinterpreted the scope of the reviewable errors in s 71C of the National Electricity Law (NEL).

On 24 May 2017, the Court dismissed our appeal and upheld the Tribunal's decision in relation to opex and cost of debt. It upheld the AER's appeal in relation to gamma — by consent, following the Court's decision, the parties agreed that paragraph 1(c) of the Tribunal's direction to the AER be set aside (together with consequential reference to paragraph (d)).

## Undertakings provided by distributors

During the time the appeal processes were underway, all of the distributors submitted their annual pricing proposals consistent with our final decisions for the 2015–16 regulatory year, which we approved.<sup>102</sup> However, following the Tribunal's decision and our subsequent

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<sup>97</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1; *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2; *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3; *Application by ActewAGL Distribution* [2016] ACompT 4.

<sup>98</sup> The Tribunal upheld the distributors' challenges to the AER's allowances for returns on debt, the value it set for gamma (which was later set aside by the Federal Court in judicial review) and Evoenergy's (formerly ActewAGL) Service Target Performance Incentive Schemes.

<sup>99</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1.

<sup>100</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1.

<sup>101</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1, direction 1 (b); *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2, direction 1 (b); *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1 (b); *Application by ActewAGL Distribution* [2016] ACompT 4, direction 1 (b).

<sup>102</sup> In May 2014, the NSW/ACT distributors had submitted to us their 2014–15 annual pricing proposals for their respective networks. We assessed these proposals for compliance with Part 1 of the NER and our 2014–15 placeholder distribution

judicial review application, there was considerable uncertainty regarding the effect of the Tribunal's decision on pricing and non-price matters, undermining stability and transparency for consumers, retailers and the distributors.

We addressed this uncertainty in May 2016 by accepting enforceable undertakings given by the distributors under section 59A of the NEL that set out how network revenues and tariffs will be determined in 2016–17.<sup>103</sup> ActewAGL, Ausgrid, Endeavour Energy and Essential Energy's Network Use of System (NUoS) Tariffs in 2016–17 were set as their 2015–16 approved tariffs, adjusted to include changes in the consumer price index (CPI) in 2015-16.<sup>104</sup>

As of May 2017, the Court had not yet handed down its decision, so we accepted further undertakings given by the distributors to establish new interim arrangements to govern the setting of network tariffs in 2017–18.<sup>105</sup> ActewAGL, Ausgrid and Endeavour Energy's NUoS Tariffs in 2017–18 were also set as their 2015–16 approved tariffs, adjusted to include changes in the CPI in 2015–16 and 2016–17.<sup>106</sup> Essential Energy undertook to continue to apply the terms of, including the price path determined in, our April 2015 final decision, for 2017–18 and 2018–19, and to account for and give effect to the new tariff structure statements from 1 July 2017.

The effect of these undertakings is that the revenues recovered by the distributors during 2016–17 and 2017–18 are likely to differ from that which they are entitled to recover after we remake our decisions. On 1 August 2017, the AEMC made a rule that allows us to let the distributors to recover such differences over both the 2014–19 and 2019-24 regulatory control periods.<sup>107</sup> The intent is to minimise the potential for significant fluctuations in retail prices that consumers may experience from one period to the next. The rule allows us to make revenue adjustments to smooth revenue across, or allocate it between, these regulatory control periods. Such adjustments are given effect through the pricing proposal and distribution determination processes.

## The remittal task – remaking our decisions for 2014-19

Following the Court's decision, the Tribunal's directions that we are to comply with in remaking the decision are as follows:<sup>108</sup>

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determinations. Subsequently, we approved each of the distributors' 2014–15 pricing proposals.

<sup>103</sup> Ausgrid, *Ausgrid enforceable undertaking*, May 2016. Endeavour Energy, *Endeavour Energy enforceable undertaking*, May 2016. ActewAGL, *ActewAGL enforceable undertaking*, May 2016. Essential Energy, *Essential Energy enforceable undertaking*, May 2016.

<sup>104</sup> Network Use of System (NUoS) Tariffs traditionally include distribution use of system tariffs and transmission use of system (TUOS) tariffs. We included TUOS tariffs in the undertakings to ensure price stability and predictability.

<sup>105</sup> Ausgrid, *Ausgrid enforceable undertaking*, May 2017. Endeavour Energy, *Endeavour Energy enforceable undertaking*, March 2017. ActewAGL, *ActewAGL enforceable undertaking*, May 2017. Essential Energy, *Essential Energy enforceable undertaking*, May 2017.

<sup>106</sup> These enforceable undertakings also obliged the ACT and NSW distributors to continue to provide network services consistent with the non-price terms and conditions of their 2015–19 electricity distribution determinations.

<sup>107</sup> AEMC, *Participant derogation - NSW DNSPs revenue smoothing, Rule Determination*, 1 August 2017; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6*.

<sup>108</sup> *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1. Note direction (c) is omitted following the Court's decision in relation to gamma: *Australian Energy Regulator v Australian Competition*

- (a) the AER is to make the constituent decision on opex under r 6.12.1(4) of the National Electricity Rules in accordance with these reasons for decision including assessing whether the forecast opex proposed by the applicant reasonably reflects each of the operating expenditure criteria in r 6.5.6(c) of the National Electricity Rules including using a broader range of modelling, and benchmarking against Australian businesses, and including a “bottom up” review of Essential’s forecast operating expenditure;
- (b) the AER is to make the constituent decision on return on debt in relation to the introduction of the trailing average approach in accordance with these reasons for decision;
- ...
- (d) the AER is to consider, and to the extent to which it considers appropriate to vary the Final Decision in such other respects as the AER considers appropriate having regard to s 16(1)(d) of the National Electricity Law in the light of such variations as are made to the Final Decision by reason of (a)–(c) hereof.

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*Tribunal (No 3) [2017] FCAFC 80, [738]-[784].*