



Draft Decision

Endeavour Energy 2014–19 electricity distribution determination

July 2018

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Invitation for submissions

Interested parties are invited to make submissions on this draft decision paper by 17 August 2018.

Submissions should be sent to: EndeavourRemittal2014-19@aer.gov.au

Alternatively, submissions can be sent to:

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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
- provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential submissions will be placed on our website. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy (June 2014), which is available on our website.¹

¹ <https://www.aer.gov.au/publications/corporate-documents/accc-and-aer-information-policy-collection-and-disclosure-of-information>

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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):²

“... 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, Endeavour 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 Endeavour Energy’s proposal to recover total revenues of \$4143.4 million (\$, nominal) from consumers over the five-year 2014-19 regulatory control period.³ If this remade draft decision becomes our final decision, the decision will provide consumers with tariff stability and predictability and will maintain distribution network charges at current levels.⁴

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 interests of consumers.

² NEL, s. 7.

³ Endeavour Energy, *Proposal for the Remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018. In consultation with Endeavour Energy, we will continue to update the revenue amount for any new information until our final decision is made (e.g. annual cost of debt updates, actual consumer price index (CPI) and service target performance incentive scheme (STPIS) amounts). <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

⁴ In May 2016, we accepted undertakings given by Endeavour Energy under section 59A of the NEL that set out how network revenues and tariffs will be determined in 2016–17. Endeavour Energy's Network Use of System (NUoS) tariffs in 2016–17 were set as their 2015–16 approved tariffs, adjusted for changes in the CPI. As of May 2017, the Full Federal Court had not yet handed down its decision, so we accepted further undertakings given by Endeavour Energy to establish new interim arrangements to govern the setting of network tariffs in 2017–18. As of March 2018, as the remittal process was not yet settled, we accepted further undertakings from Endeavour Energy for 2018-19. See *Open letter to stakeholders: Electricity network charges in the ACT and NSW from 1 July 2018*, 21 March 2018.

There are a number of factors behind our decision to accept Endeavour Energy's proposal, including:

- 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 3 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 consultation undertaken by Endeavour Energy and the AER
- it will promote price certainty and stability for consumers
- it will provide a timely and certain resolution of Endeavour Energy's distribution determination for the 2014-19 regulatory control period, which will benefit both consumers and Endeavour Energy

Our remade draft decision for the 2014-19 regulatory control period will result in a maximum revenue allowance of \$110 million above the revenue we approved in our 2015 final decision that was set aside by the Australian Competition Tribunal (Tribunal) and will lead to an estimated \$227.1 million being returned to consumers in the next regulatory control period.⁵

We have had to remake our decision following the outcome of limited merits and judicial review processes relating to our 2015 final decision. That decision allowed Endeavour Energy to recover an amount that was \$1258.5 million (\$, nominal) lower than what it proposed at the time. In response, Endeavour Energy sought limited merits review of our decision by the Tribunal.

The Tribunal remitted our decision to us, specifically requiring that we remake our decision in relation to Endeavour Energy's opex forecast and the rate of return with respect to the trailing average approach⁶, and otherwise vary the distribution determination as set out in our April 2015 final decision as we consider appropriate.⁷

On 5 April 2018, Endeavour Energy submitted a new proposal to us to resolve all outstanding issues relating to the decision we need to remake.⁸ It is a total revenue proposal of \$4143.4 million (\$, nominal) for the five-year 2014-19 regulatory control period and is based on:⁹

- our 2015 final decision, including the constituent decisions we made on opex and the rate of return (including the cost of debt)

⁵ The estimated \$227.1 million that is expected to be returned to customers in the 2019-24 regulatory control period is our best estimate at this point in time as we will not know the exact amount until after the 2014-19 regulatory control period.

⁶ See Appendix A for background on our remade decision.

⁷ *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 3, direction 1.

⁸ Endeavour Energy, *Proposal for the Remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

⁹ Ibid.

- the revenue that Endeavour Energy has recovered thus far for the 2014-19 regulatory control period, up to a maximum limit of \$110 million above our April 2015 final decision

We have remade our 2015 final decision in accordance with the NEL and NER. Among other things, this means we have taken into account the revenue and pricing 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 2015 final decision, and what we would generally face in making a distribution determination. As a result, it is likely that this remade draft decision will have limited precedent value. Specifically, we are making the remade draft decision at a time:

- That is four years into the applicable five-year 2014-19 regulatory control period.
- When we have applied interim pricing measures for the 2016-17, 2017-18 and 2018-19 regulatory years by accepting enforceable undertakings to address pricing uncertainties arising from the limited merits and judicial review processes.
- When we have information on Endeavour Energy's actual performance for the first three years of the five-year 2014–19 regulatory control period and updated forecasts for the remaining two years. Since our 2015 final decision, Endeavour Energy has embarked on a reform program that is forecast to reduce its opex to a level consistent with our 2015 decision by 2017-18 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 Endeavour 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 Endeavour Energy recover any additional revenues that result from our remade decision across both the 2014–19 and 2019–24 regulatory control periods).¹⁰
- When we have received Endeavour Energy's revenue proposal for the forthcoming 2019-24 regulatory control period.
- When there is strong support from a range of consumer groups that Endeavour Energy's proposal is in the long-term interests of consumers.

¹⁰ 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.

The novel circumstances we find ourselves in also heightens 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.¹¹

Endeavour 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.¹² Some of the key themes raised by participating stakeholders, which included industry and consumer representatives, were:

- an expedited resolution of the remaking of our 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 concern for consumers

Endeavour Energy also engaged with key energy consumers groups to inform its proposal, including Energy Consumers Australia, Energy Users Association of Australia, Public Interest Advocacy Centre, Western Sydney Regional Organisation of Councils and the AER Consumer Challenge Panel. We also sought written advice from these stakeholders on Endeavour Energy's finalised proposal, where the general consensus was that the proposal is in the long-term interests of Endeavour Energy's customers.¹³

In light of the novel circumstances we are faced with, and the information before us, our remade draft decision is to accept Endeavour 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.

¹¹ 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.

¹² 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>

¹³ The written advice we received from stakeholders on Endeavour Energy's proposal is published on the AER's website. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

1.1 Next steps

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

Table 1-1 Indicative timeline for finalising Endeavour Energy’s determination

Determination process	Indicative date
AER publishes remade draft decision for consultation	20 July 2018
Stakeholder submissions on remade draft decision close	17 August 2018
AER publishes remade final decision	October 2018

1.2 Decisions for other NSW/ACT distribution businesses

We released our 2014-19 remade final decision for Essential Energy on 31 May 2018.¹⁴ We are yet to remake the draft decisions for Ausgrid and Evoenergy, which the Tribunal also remitted to us. For the purpose of progressing the outstanding remittals, we sought stakeholder feedback in late-2017 on an opex Issues Paper and cost of debt Position Paper.¹⁵ We will consider all stakeholder submissions received in response to these papers and engage with the relevant distribution businesses and interested stakeholders to remake the outstanding decisions in due course.

1.3 Structure of this document

This document is structured as follows:

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

¹⁴ AER, *Final Decision Essential Energy 2014-19 electricity distribution determination*, May 2018.
<https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/essential-energy-determination-2014-19-remittal>

¹⁵ 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.

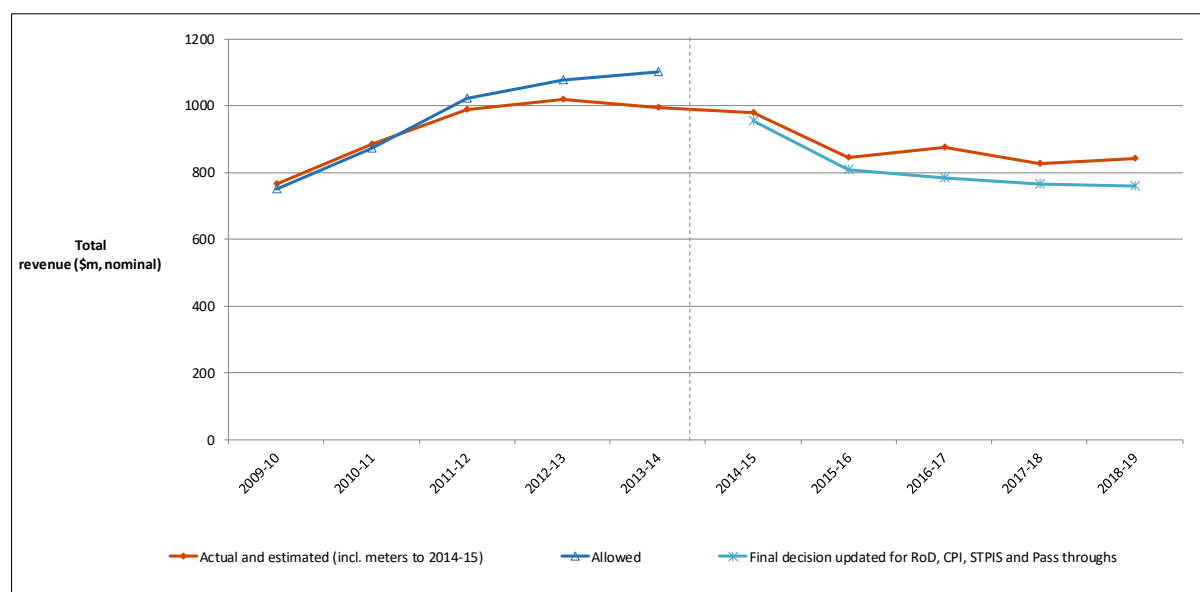
2 Our remade draft decision

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 Endeavour Energy's proposal.¹⁶

This means Endeavour Energy can recover total revenues of \$4143.4 (\$, nominal) from consumers over the 2014–19 regulatory control period.¹⁷ This outcome is \$110 million above the revenue allowance we set in our 2015 final decision. Any additional revenues in excess of this \$110 million limit will be returned to its customers in subsequent regulatory years from 2019–20. The estimated \$227.1 million that is expected to be returned to customers in the next (2019-24) regulatory control period is our best estimate at this point in time as we will not know the exact amount until after the current (2014-19) regulatory control period.

We are satisfied that this remade draft decision, taking into account the RPP, is likely to contribute to the achievement of the NEO to the greatest degree.¹⁸ Figure 2-1 below illustrates our overall decision.

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



Source: AER analysis.

¹⁶ Endeavour Energy, *Proposal for the Remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

¹⁷ Ibid. In consultation with Endeavour Energy, we will continue to update the revenue amount for any new information until our final decision is made (e.g. annual cost of debt updates, actual consumer price index (CPI) and service target performance incentive scheme (STPIS) amounts). <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

¹⁸ NEL, ss. 16(1)(d)(i) and 16(2).

Customers' bills were set by our 2015 final decision and following the Tribunal's decision, by interim pricing measures in 2016–17, 2017–18 and 2018–19.

In the 2014-15 transitional year, distribution network charges reduced, on average, by 1.7 per cent.¹⁹

In 2015-16, distribution network charges fell significantly, reflecting a reduction in Endeavour Energy's real revenues resulting from our 2015 final decision. At the time of our decision, this impact was estimated as a \$106 (5.3 per cent) reduction in the average bill for a residential customer and a \$152 (5.3 per cent) reduction in the bill for a small business customer.²⁰

During 2016-17, 2017-18 and 2018-19, distribution network charges increased by changes in the consumer price index (CPI) in accordance with enforceable undertakings we accepted. The undertakings from Endeavour Energy addressed pricing uncertainties arising from the limited merits and judicial review processes.

¹⁹ AER, *Transitional Decisions: NSW/ACT 2014–15 Factsheet*, April 2014.

https://www.aer.gov.au/system/files/AER%20factsheet%20-%20placeholder%20determinations%20NSWACT_3.PDF

²⁰ AER, *Final Decision Endeavour Energy distribution determination - Fact Sheet*, April 2015. The analysis assumed distribution network charges made up 39 per cent of customers' bills on average. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19/final-decision>

3 Endeavour Energy's proposal

On 5 April 2018, we received Endeavour Energy's proposal for the remaking of the decision pertaining to its revenue determination for the 2014–19 regulatory control period.²¹

It is a total revenue proposal. That is, 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).

In its proposal, Endeavour Energy submits:²²

"We are proposing to adopt the April 2015 Determination as published by the AER, and updating for actual data, where appropriate, for the cost of debt and CPI on the basis that we retain no more than \$110m of revenues... during this regulatory period.

...Specifically, the key aspects of Endeavour Energy's proposal for the remittal:

- Adopt the April 2015 Determination opex and application of the EBSS for the 2014-19 regulatory control period;
- Commit to the application of the revealed cost opex forecasting methodology so that the opex for the 2019-24 regulatory control period will be determined using the AER's opex forecasting model based on our 2017/18 actual opex. The reported actual opex for 2017/18 will be at or below the forecast included in the AER's April 2015 Determination;
- Continued application of the EBSS for the 2019-24 regulatory control period;
- Continued adoption of the capex allowances contained in the April 2015 Determination and continued support for the application of the CESS for the 2014-19 and 2019-24 regulatory control periods;
- Adoption of the AER's 2013 Rate of Return Guideline, including the application of a transition to the trailing average for the 2014-19 and 2019-24 regulatory control periods;
- Retain no more than \$110m of revenues...under the undertakings in 2018/19 dollar terms;
- Return the balance of revenues...under the undertakings; forecast to be \$239.6m in financial year 2018/19 dollar terms on the basis that Endeavour Energy enters into an enforceable undertaking with the AER to set prices for 2018/19 based on the 2017/18 revenues, escalated for CPI. This amount also includes adjustments to reflect an updated CPI forecast as per corrections provided by the AER and in accordance with the findings of the Australian Competition Tribunal of \$12.2m; and
- The amount above to be returned to customers has not considered the outcomes of the STPIS over the current regulatory period. Once the revenue target has been determined by the AER, the outcomes will be incorporated into the balance to be returned in the regulatory proposal for the 2019-24 regulatory control period."

²¹ Endeavour Energy, *Proposal for the Remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

²² Ibid.

Endeavour Energy goes on to explain what it considers its proposal means for customers:²³

- “Acceptance of this proposal will resolve the appeals and dispute between Endeavour Energy and the AER in full thereby providing certainty to customers regarding their current and future prices.
- Guaranteed lower prices for customers. Matters relating to the cost of debt and opex were sent back to the AER by the Australian Competition Tribunal and the Federal Court due to issues with the original decision. We claim that a reasonable valuation of those matters is \$543.8m in \$2018/19, \$176.5m for unfunded actual opex and \$367.3m for debt based on actual market data.
- If this proposal is accepted the net benefit to customers could be considered to be as high as \$433.8m in \$2018/19 after the retention of \$110m of revenues is deducted.
- This proposal locks in our public commitment to ensuring savings in annual opex of 20% are passed on to consumers. In our Directions Paper released in August last year we committed to achieving opex outcomes in line with the AER’s April 2015 Determination by the 2017/18 financial year.
- Our proposal reinforces our commitment to an incentive based regulatory regime that provides financial disciplines and rewards to further drive improvements in operating costs and capital investments that will ultimately be passed on to consumers.
- Adoption of the 2013 Rate of Return Guideline as applied by the AER, including adoption of a gamma of 0.4, provides certainty for customers and ensures that trailing average cost of debt approach is applied, helping insulate customers from the short-term price impacts of debt cost movements compared to the rate of on the day approach.
- This proposal removes all anticipated contention regarding the cost of capital and the opex allowance for the next regulatory period, leaving only the issue of the necessary capital expenditure to support efficient customer outcomes to be agreed. This is expected to provide customers with confidence of stable and efficient regulatory outcomes.
- The proposed CPI adjusted undertaking and the reduction in revenues for the next regulatory period of \$239.6m in \$2018/19 to account for the undertaking in place over this current regulatory period will ensure price stability to customers in line with the revenue smoothing participant derogations lodged by Endeavour Energy.
- Retention of a portion of the...[revenue]...reduces the benefit of the other matters within the proposal by \$110m in \$2018/19 and will allow Endeavour Energy to resolve the outstanding matters without further points of dispute and provide certainty for customers for the remainder of this and the next regulatory period...”

Endeavour Energy engaged with consumer groups on a draft version of its proposal prior to submitting its finalised proposal to the AER. The next section summarises the stakeholder comments we received on Endeavour Energy’s finalised proposal.

²³ Ibid.

4 Stakeholders' views on the proposal

Following early discussions between Endeavour Energy and our staff on the key aspects of the decisions the Tribunal has required us to remake, Endeavour Energy engaged with consumer groups on a near-final version of its proposal.

Subsequent to receipt of Endeavour Energy's finalised proposal, we sought the views of consumer groups on the finalised proposal. We received written responses from:

- Energy Consumers Australia (ECA)
- Energy Users Association of Australia (EUAA)
- Public Interest Advocacy Centre (PIAC)
- Western Sydney Regional Organisation of Councils (WSROC)
- AER Consumer Challenge Panel, Sub-panel 10 (CCP10)

The general consensus of these consumer groups is that Endeavour Energy's proposal for the 2014-19 regulatory control period is in the long-term interests of its customers. The written responses we received are available on our website. Excerpts are provided below.

4.1 Energy Consumers Australia

In its response to the AER on Endeavour Energy's proposal, ECA submitted:²⁴

"Having considered the proposal, Energy Consumers Australia (ECA) accepts the proposal is in the long-term interest of consumers, as it will mean consumers do not pay any more than is necessary for the energy network services they require from Endeavour during 2014-2019.

...Endeavour is proposing to retain \$110 million in additional revenue above the AER's original 2015 determination. In our view, the proposed increase in allowed revenue represents a reasonable decision, in the long-term interests of consumers, to allow compensation for the costs Endeavour has incurred in its progress to achieve the AER's benchmark expenditure levels by the final year of the current determination period.

Following engagement with Endeavour at senior levels, we are also aware of its expectation that when \$239.6 million of revenue...in the current period is returned between financial years 2020 and 2024, Endeavour's consumers will see real network price decreases of 1% per year, for five years. ECA supports this approach because of consumers' preference for price stability.

...Our view is that Endeavour Energy has engaged in a positive and open way in developing its proposal for the re-making of the 2014-19 revenue determination decision. We also welcome Endeavour's position that networks must operate their businesses 'through the constraints of affordability'."

²⁴ Energy Consumers Australia, *Support for Endeavour Energy's 2014-19 Remittal Proposal*, 16 April 2018. <https://www.aer.gov.au/system/files/ECA%20-%20Letter%20to%20AER%20on%20Endeavour%20Energy%202014-19%20proposal%20-%20April%202018.pdf>

4.2 Energy Users Association of Australia

In its response to the AER on Endeavour Energy's proposal, EUAA submitted:²⁵

"We would like to acknowledge the approach Endeavour Energy has taken in this remittals process, particularly its focus on the affordability pressures facing all energy consumers. We are pleased to see the specific details of the proposal – and that acceptance will resolve the long running appeals and dispute between Endeavour and the AER.

Following examination of Endeavour Energy's proposed package of measures outlined in the letter of 5th April 2018, the EUAA has concluded that the overall package of measures proposed is in the long-term interests of consumers."

4.3 Public Interest Advocacy Centre

In its response to the AER on Endeavour Energy's proposal, PIAC submitted:²⁶

"PIAC supports Endeavour Energy's proposal to accept the AER's 2015 final determination and retain some...revenue with a limit of \$110 million across the period.

PIAC supports the approach Endeavour Energy has taken to stakeholder engagement about the remitted decisions for the 2014-19 period. Endeavour Energy has engaged with the AER, Consumer Challenge Panel and consumer advocates in making its remittal proposal. This built on Endeavour Energy's extended consumer engagement program for their 2019-24 proposal, which PIAC considers has been positive.

In PIAC's view, Endeavour Energy's proposal is in the long-term interests of consumers. By proposing to accept the regulator's 2015 final determination, Endeavour Energy will ensure that their customers do not face the increase in bills associated with the opex allowance and rate of return originally sought by Endeavour Energy.

Furthermore, the prompt resolution of this process, and the removal of the potential for judicial review of the AER's re-made decision by Endeavour Energy, is in consumers' interests.

On balance, PIAC considers it reasonable for Endeavour Energy to recover a maximum of \$110 million over the revenue allowance set in the 2015 final determination, on the basis that this appears to be a lower cost than the revenue forgone by Endeavour Energy on opex and rate of return."

²⁵ Energy Users Association of Australia, *Re: Endeavour Energy - Determination 2014-19 – Remittal*, 16 April 2018.
<https://www.aer.gov.au/system/files/EUAA%20-%20Letter%20to%20AER%20on%20Endeavour%20Energy%202014-19%20proposal%20-%20April%202018.pdf>

²⁶ Public Interest Advocacy Centre, *Endeavour Energy Remittal Proposal*, 12 April 2018.
<https://www.aer.gov.au/system/files/PIAC%20-%20Letter%20to%20AER%20on%20Endeavour%20Energy%202014-19%20proposal%20-%20April%202018.pdf>

4.4 Western Sydney Regional Organisation of Councils

In its response to the AER on Endeavour Energy’s proposal, WSROC submitted:²⁷

“WSROC views the finalised Remittal Proposal from Endeavour Energy as a positive response to addressing the outstanding regulatory issues pertaining to the 2014-2019 Determination. Notwithstanding the need to have a safe & reliable network; investing for customer & economic growth, and enabling customers’ choices, the issue of affordability and a degree of certainty are vital concerns to WSROC. This proposal attempts to address these concerns and if accepted by the AER will provide some certainty to customers with respect to current and future prices.”

4.5 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 its response to the AER on Endeavour Energy’s proposal, CCP10 submitted:²⁸

“Endeavour has had an engagement program with consumer groups about its proposal. The proposal has been disclosed by Endeavour and discussed with consumer groups in the following meetings:

Stakeholder Group	Dates
Bilateral discussions CCP10, ECA and PIAC	November 2017- January 2018
CCP10	17 January 2018
Endeavour’s Customer Advisory Group (CAG), CCP10 and AER deep dive	16 March 2018
Teleconference with all groups	28 March 2018
WSROC	4-5 April 2018
Energy Users Association Australia	5-9 April 2018
NCOSS	4-5 April 2018

...CCP10 confirms that Endeavour was very receptive to comments from consumer groups and that it has taken steps to incorporate the feedback in the final proposal and infographic.

...Endeavour’s proposal for resolving its regulatory allowance for 2014-19, following the remittal of that determination to the AER by the Federal Court, is supported by CCP10. We commend Endeavour on its 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 Endeavour proposal is in the long-term interest of Endeavour’s customers. We understand this involves Endeavour

²⁷ Western Sydney Regional Organisation of Councils, *Proposal For The Remittal Of The Endeavour Energy 2014–2019 Determination*, 17 April 2018. <https://www.aer.gov.au/system/files/WSROC%20-%20Letter%20to%20AER%20on%20Endeavour%20Energy%202014-19%20proposal%20-%20April%202018.pdf>

²⁸ Consumer Challenge Panel, *Endeavour Energy 2014–19 revenue allowance remittal proposal*, 10 April 2018. <https://www.aer.gov.au/system/files/CCP10%20-%20Letter%20to%20AER%20on%20Endeavour%20Energy%202014-19%20proposal%20-%20April%202018.pdf>

retaining up to \$110m in revenue...that would otherwise be returned to consumers, but this needs to be considered in the context of the overall proposal. Consumers will benefit from:

- the certainty provided by the 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
- on an ongoing basis from the reductions in operating expenditure that Endeavour has achieved and
- the continuation of reduction in network prices since 2012.

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

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 degree²⁹
- consider Endeavour Energy's proposal, as well as each of the consumer groups' letters on the proposal

5.1 Our approach

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.³⁰

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

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 from those we faced when we made our April 2015 final decision, and what we would generally face in making a distribution determination. As a result, it is likely that this remade draft decision will have limited precedent value.

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

- that is four years into the applicable five-year 2014-19 regulatory control period

²⁹ NEL, ss. 16(1)(d)(i) and 16(2).

³⁰ Ibid.

- when we have applied interim pricing measures for the 2016-17, 2017-18 and 2018-19 regulatory years by accepting enforceable undertakings to address pricing uncertainties arising from the limited merits and judicial review processes
- when we have had a number of Tribunal and Federal Court processes, since the Tribunal’s decision on Endeavour Energy, that have considered and clarified the law in relation to ‘efficient financing costs’ and the determination of the cost of debt
- when we have information on Endeavour Energy’s actual performance for the first three years of the five-year 2014–19 regulatory control period and updated forecasts for the remaining two years
- when our decision has the potential to create significant retail price fluctuations if it differs materially from our 2015 final decision³¹
- when we have received Endeavour Energy’s revenue proposal for the forthcoming 2019-24 regulatory control period
- when there is strong support from a range of consumer groups that Endeavour Energy’s proposal is in the long-term interests of consumers

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 Endeavour Energy’s network that is in the long-term interests 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.³²

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

“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.

³¹ Recognising that this prospect is to some extent alleviated by the rule made by the AEMC on 1 August 2017 that allows us to let Endeavour Energy recover any additional revenues that result from our decision across both 2014–19 and 2019–24 regulatory control periods. See 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.

³² 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].

³³ AER, *Final Decision, Endeavour Energy distribution determination 2015–16 to 2018–19, Overview*, April 2015, pp. 46–47.

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 2016:³⁴

“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 Endeavour Energy’s proposal, we note that there are potentially a range of possible outcomes that may meet the Tribunal’s directions.

5.2 Assessment of Endeavour Energy’s proposal

As set out in section 3, Endeavour Energy’s proposal for a revenue allowance for the 2014-19 regulatory control period is summarised as follows:³⁵

“We are proposing to adopt the April 2015 Determination as published by the AER, and updating for actual data, where appropriate, for the cost of debt and CPI on the basis that we retain no more than \$110m of revenues...during this regulatory period.

...Acceptance of this proposal will resolve the appeals and dispute between Endeavour Energy and the AER in full thereby providing certainty to customers regarding their current and future prices.”

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

³⁵ Endeavour Energy, *Proposal for the Remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

In light of the novel circumstances we are faced with, and the information before us, we are satisfied that accepting Endeavour 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.

Key reasons for our decision to accept Endeavour 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 discussed in sections 5.3.1 and 5.3.2, respectively. This result also aligns with Endeavour Energy's proposal that is in part premised on the revenue allowance set in our 2015 final decision. In summary:

- Endeavour Energy is undertaking reforms so that by 2017-18 it will continue to provide safe and reliable electricity services to its consumers while incurring opex in line with the opex forecasts set out in our 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 heightens 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.³⁶ 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 Endeavour Energy (particularly in light of its 2019-24 regulatory proposal which has now been submitted to the AER).³⁷

If this remade draft decision becomes our final decision, it will resolve 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 and is one of the primary reasons we accepted the enforceable undertakings that Endeavour Energy gave to us to govern prices for the 2016–17, 2017–18 and 2018–19 regulatory years.³⁸ 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 Endeavour

³⁶ 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.

³⁷ 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. Also, section 4 of this decision summarises the views of consumer groups on the Endeavour Energy remittal proposal and they have expressed similar views on this matter.

³⁸ See AER, *Open letter to stakeholders: Electricity network charges in the ACT and NSW from 1 July 2017*, 19 April 2017; and *Open letter to stakeholders: Electricity network charges in the ACT and NSW from 1 July 2018*, 21 March 2018.

Energy to recover any additional revenues that result from remaking our decision, across both the 2014–19 and 2019–24 regulatory control periods.³⁹

To that end, we agree with the following statement of the AEMC in its rule determination:⁴⁰

“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, given the novel circumstances for this decision, a maximum revenue allowance of \$110 million above that set in our 2015 final decision is likely to contribute to the achievement of the NEO to the greatest degree. In support of this, Endeavour Energy noted in its proposal that this:⁴¹

“...will allow Endeavour Energy to resolve the outstanding matters without further points of dispute and provide certainty for customers for the remainder of this and the next regulatory period.”

In coming to this maximum revenue allowance, we have considered the following factors:

- It represents an outcome that quantifies and appropriately balances the risk and uncertainty of a protracted decision process 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.
- It is within 3 per cent of the total revenues Endeavour 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.
- It provides greater certainty and price stability for customers for the remainder of this and over the next regulatory period.⁴²

We have given weight to the expressions of support from the ECA, EUAA, PIAC, WSROC and CCP10 in respect of Endeavour Energy’s proposal. Notably, given the circumstances, each of these stakeholders considers that this maximum revenue allowance results in an outcome that is in the long-term interests of Endeavour Energy’s customers.⁴³ For example, the CCP10 stated:⁴⁴

³⁹ 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.

⁴⁰ 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.

⁴¹ *Ibid.*

⁴² *Ibid.*

⁴³ Energy Consumers Australia, *Support for Endeavour Energy’s 2014-19 Remittal Proposal*, 16 April 2018; Energy Users

“A feature of the proposal is that the revenue effects will be smoothed over the 2019-24 period and within a CPI-1% price path leading to price stability for Endeavour’s consumers. In order to achieve this proposal, Endeavour has chosen not to re-open contentious matters following the Federal Court decision.”

The variations to our control mechanism constituent decision that we have made in order to give effect to the maximum revenue allowance is discussed in section 5.4.1.

Overall, we consider that Endeavour 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 Endeavour Energy’s network that is in the long-term interests of consumers. In other words, the long-term interests of consumers are served by us identifying how the level of electricity supply services delivered by Endeavour Energy so far during the 2014-19 regulatory control period may be done at least cost to the consumer.

As the Tribunal has previously stated:⁴⁵

“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.”

Endeavour Energy’s proposal as accepted in this draft decision:

- is effectively \$491 million less than its January 2015 revised regulatory proposal on the issues of opex and the cost of debt
- represents a reduction in its opex of around 18 per cent relative to its January 2015 revised regulatory proposal (n.b. Endeavour Energy has incurred significant redundancy costs in the first three years of the 2014-19 regulatory period to downsize its workforce and achieve this lower level of opex.)

We note that Endeavour Energy has made the commitment that its actual opex for 2017-18 (which will be at or below our 2015 final decision) will form the base year for its opex forecast for the 2019-24 regulatory control period.⁴⁶

Association of Australia, *Re: Endeavour Energy - Determination 2014-19 – Remittal*, 16 April 2018; Public Interest Advocacy Centre, *Endeavour Energy Remittal Proposal*, 12 April 2018; Western Sydney Regional Organisation of Councils, *Proposal For The Remittal Of The Endeavour Energy 2014–2019 Determination*, 17 April 2018; Consumer Challenge Panel, *Endeavour Energy 2014–19 revenue allowance remittal proposal*, 10 April 2018.

⁴⁴ Consumer Challenge Panel, *Endeavour Energy 2014–19 revenue allowance remittal proposal*, 10 April 2018.

⁴⁵ *Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3, [15].

⁴⁶ Endeavour Energy, *Proposal for the Remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

We also note that, 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. The \$110 million cap that Endeavour Energy has proposed is not subject to this reconciliation.

5.3 Remaking the operational expenditure 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 Endeavour Energy are as follows:⁴⁷

- “(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 Endeavour’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.”

In the context of the Endeavour Energy decision, the Tribunal also noted that:⁴⁸

“The AER’s reconsideration in relation to opex will involve, at least in part, a ‘bottom up’ analysis of the VM [vegetation management] Expenditure and a review of its approach to the Redundancy Expenditure. The extent to which the determination ‘opens up’ the more general opex allowance for the AER is a matter for the AER to determine. Indeed, for the reasons given in the PIAC-Ausgrid Decision, the Tribunal’s determination on the Endeavour application enables the AER to revisit such of the other topics it addressed in the Endeavour Final Decision as it considers appropriate to give effect to s 16(1)(c) and (d) of the NEL.”

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

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.

⁴⁷ *Applications by Public Interest Advocacy Centre Ltd and Endeavour 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 Tribunal (No 2)* [2017] FCAFC 79, [738]-[784].

⁴⁸ *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2, para 76.

5.3.1 Operational expenditure constituent decision

Operational 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.

In the April 2015 final decision, we estimated total forecast opex over the 2014-19 period of \$1218.3 million (\$2013–14) (Table 5-1). This was \$247.3 million lower than Endeavour Energy's revised proposal of \$1465.6 million.⁴⁹

In our 2015 final decision, we found Endeavour Energy’s 2012-13 base year opex to not be materially inefficient and a reasonable basis for forecasting opex for the 2014-19 regulatory period. The key difference between our substitute estimate and Endeavour Energy’s proposed opex related to its proposed step-change for vegetation management.⁵⁰ Endeavour Energy considered its revealed opex (i.e. the 2012-13 base year) did not reflect the full cost of complying with its existing regulatory standards. It proposed an increase in opex that reflected increased costs associated with meeting its existing standards, and increased overhead expenditure that was allocated to vegetation management as a result of this proposed cost increase.

We considered there was not sufficient evidence that Endeavour Energy required an additional increase in opex to meet its existing regulatory obligations, and that our estimate of base opex was sufficient for Endeavour Energy to meet all of its existing regulatory obligations, including for vegetation management. In reaching this view we relied, in part, on our benchmarking analysis.

As noted in section 3, Endeavour Energy’s remittal revenue proposal implicitly retains the efficient opex forecast we provided for in our April 2015 final decision. We have re-examined our 2015 opex forecast in light of the Tribunal’s directions 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.⁵¹

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

2014-15	2015–16	2016–17	2017–18	2018–19	Total
235.8	239.5	243.3	247.5	252.3	1218.3

Source: AER analysis.

Note: Excludes debt raising costs.

⁴⁹ AER Endeavour Energy distribution determination 2015–16 to 2018–19 April 2015

⁵⁰ Endeavour Energy also proposed a step-change for redundancy costs related to capital efficiencies under the capital prioritisation and efficiency program. We did not accept the cost as a step-change. Endeavour Energy appealed this decision to the Tribunal.

⁵¹ These opex amounts exclude debt raising costs.

5.3.1.1 Reasons for our decision

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 Endeavour Energy's opex forecast was not in error. However, the Tribunal determined that we erred in our approach to using benchmarking in arriving at our substitute estimate. 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 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 because opex is largely recurrent and stable at a total level between years and regulatory periods. This is known as the 'revealed cost approach'. So long as we do not identify any material inefficiency in a distributor's revealed costs, or a change in the costs associated with the business' operating environment,⁵² our preference is to rely on these costs in assessing the distributor's proposed opex forecast, and if necessary, in determining a substitute estimate.⁵³

In remaking our opex decision, we have primarily relied on Endeavour Energy's actual costs over the first three years of the 2014-19 regulatory control period, and its cost estimates for the remainder of the period. This information was not available to us at the time of our original decision or the Tribunal and Federal Court decisions.

Given that our 2015 final decision found Endeavour Energy's 2012-13 base year opex to not be materially inefficient and a reasonable basis for forecasting opex for the 2014-19 regulatory period, for the remittal we have compared Endeavour Energy's actual and target opex over 2014-19 to its 2012-13 opex.

Endeavour Energy's opex in the first three years of the regulatory period was greater than its level of opex in 2012-13, and greater than our 2015 final decision opex forecast. This was driven primarily by an increase in vegetation management costs to achieve compliance with existing regulatory standards, and an increase in redundancy costs associated with a restructuring program to downsize its workforce.⁵⁴

Since 2015-16, Endeavour Energy's opex has declined and is forecast to decrease significantly more in 2017-18 and 2018-19. Endeavour Energy's opex targets for these two

⁵² Step-changes provide for increases where this is not the case.

⁵³ AER, *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p.22.

⁵⁴ AER data requests. Endeavour Energy, *Regulatory Proposal 1 July 2019 to 30 June 2024*, p.163-164.

years are below its 2012-13 opex level and are consistent with our 2015 final decision opex forecast. Endeavour Energy has noted that it will be able to sustain the opex level achieved by 2017-18 into the 2019-24 regulatory period, and has proposed its 2017-18 opex level (based on our 2017-18 forecast) as the base year for its 2019-24 opex forecast.⁵⁵

Endeavour Energy appears to have responded to the strong incentives imposed by our regulatory regime, including the use of economic benchmarking. The revealed costs and opex target data indicate that our 2015 final decision opex forecast, which forms the basis of Endeavour Energy's overall proposal, represents an efficient and sustainable level of opex that reasonably reflects the opex criteria.

Having regard to the Tribunal's directions, and to cross-check our revealed costs and opex targets analysis, we have tested the efficiency of Endeavour Energy's 2017-18 and 2018-19 opex targets with two supplementary tools:

- Additional economic benchmarking modelling of Endeavour Energy's actual opex for 2016-17 and its opex targets for 2017-18 and 2018-19. This shows that Endeavour Energy's opex targets represent an improvement in opex productivity relative to the level it achieved in 2012-13, and a significant improvement relative to the other networks' scores in 2016.
- Category level cost analysis that examines the underlying reasons for the forecast reduction in Endeavour Energy's opex relative to 2012-13. This shows that Endeavour Energy is forecast to offset higher costs in vegetation management and redundancies with decreases in other cost areas (i.e. emergency services costs, maintenance costs and other total overhead costs), such that it will be able to fund improved regulatory compliance with vegetation management standards and reforms to lower labour costs while decreasing its opex over the period.

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

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

Revealed costs and opex targets

This section examines Endeavour Energy's revealed costs between 2012-13 (its proposed base year for its 2014-19 revenue proposal), 2016-17 (the most recent year for which actual cost data is available), and 2017-18 and 2018-19 (its opex targets for the remainder of the regulatory control period).

As outlined in our Expenditure Assessment Forecast Guideline, our preferred approach for forecasting opex is to use the revealed cost approach.⁵⁶ 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

⁵⁵ Endeavour Energy, *Proposal for the remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018, p. 3.

⁵⁶ AER, *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p.31.

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 2014-19 regulatory control period given that our opex forecasts were significantly below the businesses' actual costs at the start of the period.⁵⁷ Given the timing of the remittal process, we now have the opportunity to consider the revealed costs that Endeavour Energy has incurred during the 2014-19 regulatory control period and its opex targets for the remainder of the period when remaking our opex forecast.

Figure 5-1 shows Endeavour Energy's actual opex up to 2016-17 and its opex targets for 2017-18 and 2018-19. Endeavour Energy's actual opex in the first three years of the regulatory period was greater than its opex in 2012-13, and \$159.1 million (\$2013-14) greater than our April 2015 final decision opex forecast. This was driven primarily by an increase in vegetation management costs to achieve compliance with existing regulatory standards, and an increase in redundancy costs associated with downsizing its workforce under its 'Endeavour 2020' efficiency transformation program. Endeavour Energy reports that since 2012 it has reduced its workforce by almost 1000 FTEs.⁵⁸

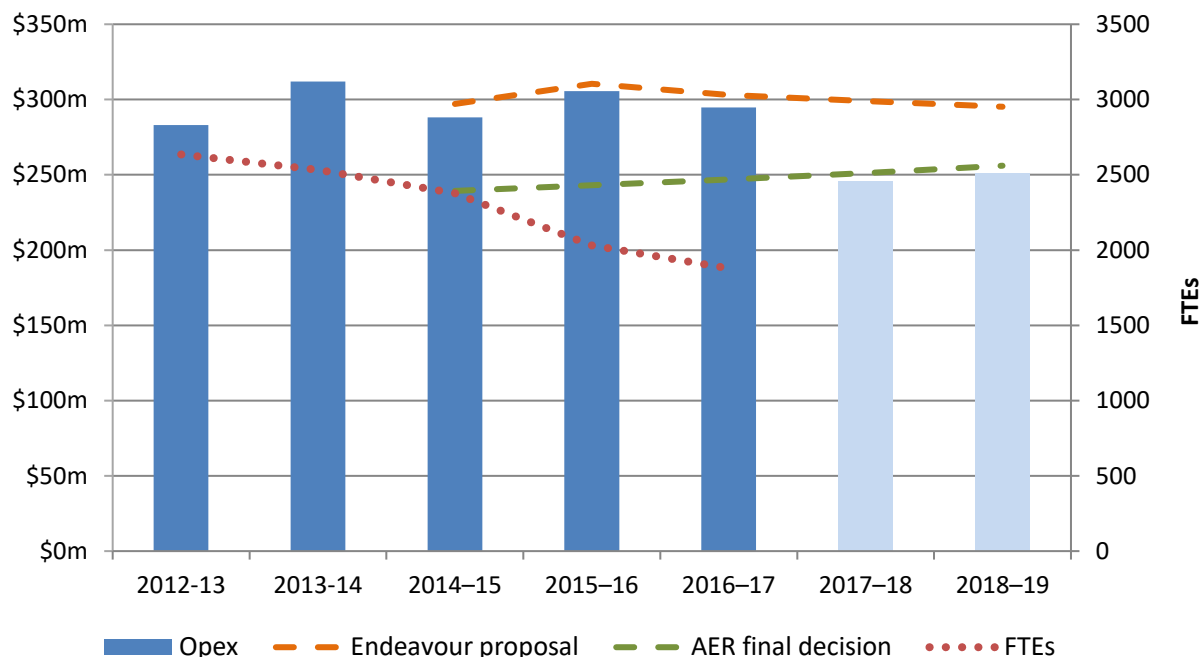
Between 2015-16 and 2016-17, Endeavour Energy's actual opex declined by 3.7 per cent. It is forecast to decrease by a further 19.9 per cent between 2016-17 and 2017-18, then increase by 1.9 per cent between 2017-18 and 2018-19. Endeavour Energy's opex forecasts for 2017-18 and 2018-19 are below its 2012-13 opex (by 15.1 per cent and 12.9 per cent, respectively) and consistent with our 2015 final decision opex forecast.

⁵⁷ 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>

⁵⁸ Endeavour Energy, *Regulatory Proposal 1 July 2019 to 30 June 2024*, pp.163-164.

Figure 5-1 Endeavour Energy's actual and target opex, AER forecast opex in 2015 final decision, including movements in FTEs (\$2013-14)



Source: AER 2015 final decision; Annual RINs and 2019-24 Reset RINs; Endeavour 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 remittal proposal, Endeavour Energy states that since 2012, it has improved its efficiency under the ‘Endeavour 2020’ efficiency program:⁵⁹

“Since 2012, we have cut our workforce by almost 1,000 FTEs without compromising safety or reliability, and generated total savings of \$891m (real FY18) through to February 2018. Endeavour Energy continues to build on its history of focused reform and measurable, sustained efficiency improvements. Our final year opex in 2018/19 represents a reduction in our annual opex of 20 per cent in real 2018/19 dollar terms over the current regulatory period.”⁶⁰

Endeavour Energy further notes that it will be able to sustain the level of cost savings in opex achieved by 2017-18 into the next 2019-24 regulatory period.

“In our 2017 Directions Paper, which sets out key aspects of our 2019-24 regulatory proposal, we committed to locking in opex savings arising from achieving at least the AER allowed opex for the 2017/18 financial year...[such that]...the opex for the 2019-24 regulatory control period will be determined using the AER’s opex forecasting model based on our 2017/18 actual opex.”⁶¹

⁵⁹ Endeavour Energy, *Regulatory Proposal 1 July 2019 to 30 June 2024*, p.163 notes that “Endeavour 2020 was an organisation-wide efficiency transformation program for the 2014-19 period”. The program was implemented following the AER’s 2014-19 determination and in advance of the partial 99-year lease of the business to private investors. Endeavour Energy conducted a review of its operations to identify cost improvement opportunities in order to reduce the shareholder funded opex to the lowest amount possible.

⁶⁰ Endeavour Energy, *Proposal for the remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018, p.2.

⁶¹ Ibid, p.4.

Endeavour Energy states that the implementation of its efficiency program will allow it to operate a safe and reliable network that meets its regulatory requirements, at a level of opex that is consistent with our 2015 final decision and that is sustainable over the 2019-24 regulatory period.

In the following sections, we test this finding with additional benchmarking and bottom-up analysis.

Benchmarking analysis

The Tribunal directed us to use a broader range of modelling and benchmarking against Australian businesses.⁶² This was in the context of the approach taken in our April 2015 final decisions, which applied a specific benchmarking technique (the Cobb Douglas-SFA econometric model) as a tool for determining the level of efficient base opex for our forecast.

Whilst we are mindful of the Tribunal's findings, it is not practical for us to now review and revise our economic benchmarking techniques to apply them in remaking this opex decision. The benchmarking techniques and data we utilised in our 2015 final decisions 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 Endeavour 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 set aside decisions in a timely manner and recognised that revisiting our benchmarking would not be possible without further delaying the remaking of our opex decisions.⁶³

We now also have available to us a range of revealed cost data – Endeavour Energy's actual opex for the first three years of the 2014-19 period and its opex targets for the remaining years – which was not available to us at the time of our 2015 final decision or the Tribunal and Court decisions. We have relied primarily on this data in remaking our opex decision.

To address the Tribunal's direction in this context, we have used benchmarking analysis updated with new data beyond the SFA model, and applied it to test the efficiency of Endeavour Energy's 2017-18 and 2018-19 opex targets.⁶⁴

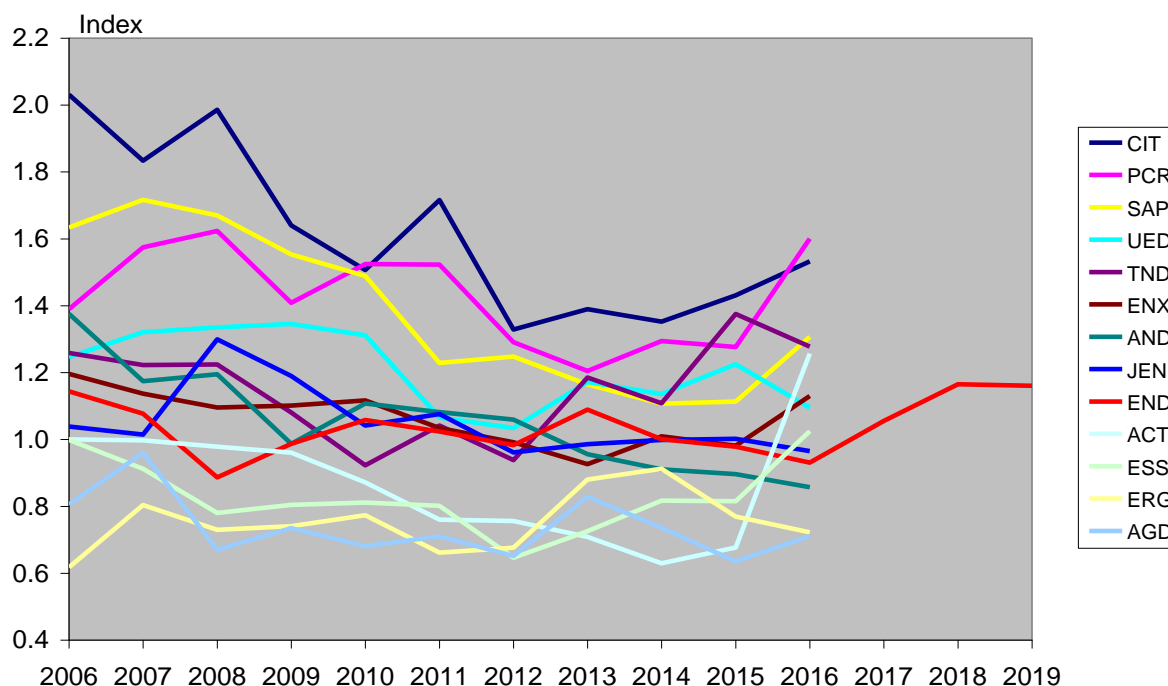
⁶² *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3, direction 1(a).

⁶³ Consumer stakeholders have expressed support for ongoing use of benchmarking and we are committed to refining our benchmarking tools.

⁶⁴ See Economic Insights Memorandum, 16 July 2018, 'Assessment of Endeavour Energy's proposed base year opex', available on the AER website. More detail about these economic benchmarking techniques are set out in the AER's annual benchmarking report – Electricity distribution network service providers, November 2017, and the Economic Insights memo. <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/annual-benchmarking-report-2017>

Figure 5-2 compares Endeavour Energy's opex Multi-lateral Partial Factor Productivity (MPFP) (the red line), based on its actual opex for 2016-17 and forecasts for 2017-18 and 2018-19, to the business' own productivity and that of other networks in 2015-16 and earlier.

Figure 5-2 Distribution Network Service Provider Opex Multi-lateral Partial Factor Productivity for FY2006–16, with Endeavour Energy forecast to FY2019



Source: Economic Insights Memorandum, 16 July 2018, Assessment of Endeavour Energy's proposed base year opex

Note: A given year (i.e. 2016) represents the financial year (i.e. 2015-16).

Figure 5-2 shows that Endeavour Energy's opex productivity increasing in 2016-17 and 2017-18, then stabilising in 2018-19. These results show that Endeavour Energy's target opex for 2017-18 and 2018-19 represents a large improvement in opex productivity relative to the network's 2012-13 level. It also represents a significant improvement relative to other network scores from 2015-16 (i.e. Endeavour Energy improves from 10th place in 2015-16 to 6th place in 2018-19).

These results support our view that Endeavour Energy's opex targets in 2017-18 and 2018-19 are not materially inefficient.

We note that Figure 5-2 shows a decline in Endeavour Energy's opex MPFP from 2013-14 to 2015-16. Analysis undertaken for our 2017 annual benchmarking report showed that this decrease was attributable, in part, to redundancy costs incurred by the business as part of a restructuring program designed to reduce the size of the workforce and achieve longer-term productivity gains. The analysis found that in 2015-16, for example, approximately 9.5 per cent of Endeavour Energy's total opex was attributable to redundancy costs, and that these costs decreased its opex MPFP score by approximately 11 per cent that year.⁶⁵ The

⁶⁵ See Economic Insights' DNSPs Report 31 October 2017 memo. <https://www.aer.gov.au/networks-pipelines/guidelines->

subsequent increase in Endeavour Energy's opex productivity since 2015-16 is attributable, in part, to a decrease in redundancy costs and the realisation of labour costs savings.

Opex category analysis

The Tribunal and Court did not specify the form of bottom-up assessment we need to undertake in remaking our opex decisions. The Court stated that the form and scope of any 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 (e.g. 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.

The revealed costs and opex target analysis, and the benchmarking results, indicate that Endeavour Energy's opex targets for 2017-18 and 2018-19 are likely to not be materially inefficient and are sustainable. Consequently, we have undertaken a limited form of bottom-up analysis that examines some of the underlying drivers of the forecast reductions in opex between 2012-13 and 2017-18 as an additional test of the efficiency of Endeavour Energy's opex targets.⁶⁶

Figure 5-3 shows the breakdown of Endeavour Energy's major opex cost categories using actual opex up to 2016-17 and forecasts for 2017-18 and 2018-19. From 2012-13 (the base year of our 2015 final decision) to the end of the 2017-18 financial year, total opex is forecast to decrease by approximately 12.1 per cent (\$2012-13). This decrease is driven by reductions in cost categories, which are forecast to include:

- emergency services costs – reduced by 17.7 per cent
- maintenance costs – reduced by 22.1 per cent
- total overheads (including redundancies) – reduced by 18.8 per cent

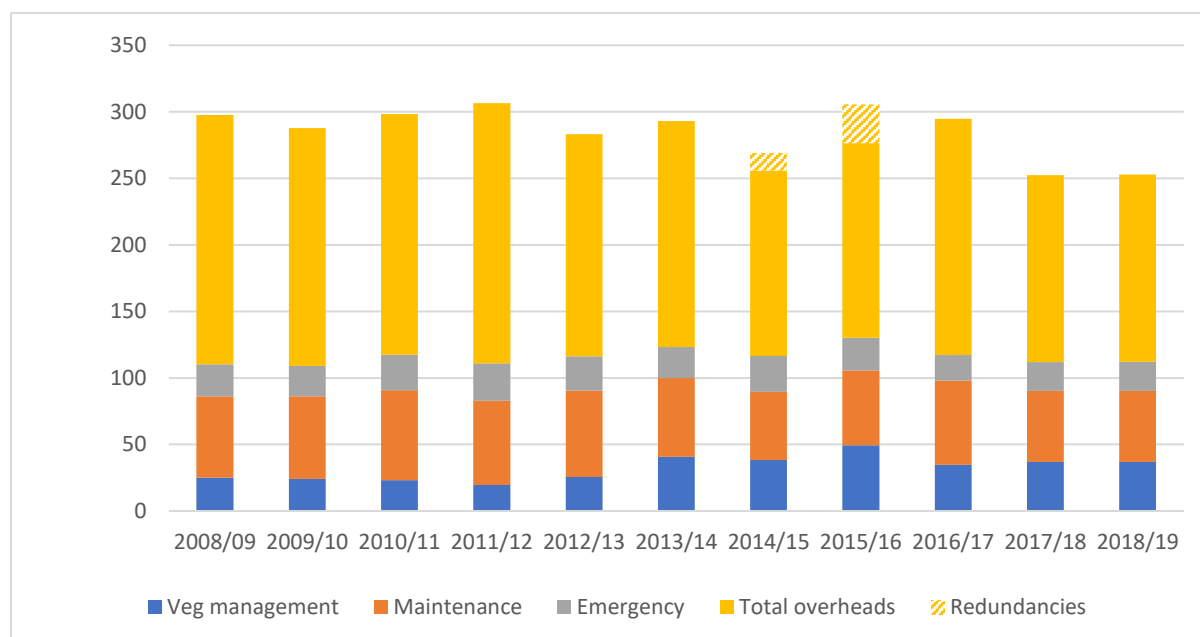
Over the same period, vegetation management costs are forecast to increase by 31.0 per cent.⁶⁷

schemes-models-reviews/annual-benchmarking-report-2017

⁶⁶ 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 and ACT remittal roundtable (16 August 2017) summary note*, August 2017.

⁶⁷ Similar magnitudes of changes in costs categories are forecast when comparing changes in costs between 2012-13 and 2018-19.

Figure 5-3 Endeavour Energy's opex cost breakdown (\$million, 2013-14)



Source: Category Analysis RINs, 2019-24 Reset RINs and AER data request.

Note: Redundancy costs are a subcategory of Total Overheads. Endeavour Energy reports it has/will incur redundancy costs in each year of the current regulatory period (2014-19). Redundancy costs for 2014-15 and 2015-16 are shown as a proportion of Total Overheads in those years. Redundancy costs for 2016-17, 2017-18 and 2018-19 are currently not publicly available so have been included in Total Overheads for those years and are not shown separately.

The observed increase in vegetation management costs over the 2014-19 period has been driven by Endeavour Energy's actions to improve compliance with its existing regulatory standards.

In 2015, Endeavour Energy proposed 2012-13 as its base year for forecasting opex for the 2014-19 regulatory period, while noting that that year's opex did not reflect the full cost of complying with its existing standards, in particular those relating to vegetation management.⁶⁸ It stated that it faced increases in vegetation management costs over the 2014-19 regulatory period to improve compliance with standards and proposed a step-change to cover the higher costs.⁶⁹

In our 2015 final decision, we found there was insufficient evidence that Endeavour Energy required an increase in opex to meet its existing regulatory obligations and determined that its 2012-13 base opex was sufficient for it to meet its existing obligations.⁷⁰

Since 2015, Endeavour Energy has noted that it has been able to reduce its opex over the 2014-19 period despite facing additional cost pressures, including from the need to:⁷¹

“increase...vegetation management costs by more than \$10.0 million annually (real, 2018-19) to ensure compliance with the required safety standards.”

⁶⁸ Endeavour Energy, *Revised Regulatory Proposal – 1 July 2015 to 30 June 2019*, pp. 78-79

⁶⁹ *Ibid*, pp. 79, 87 and 88.

⁷⁰ AER, *Final Decision – Endeavour Energy distribution determination 2015–16 to 2018–19*, April 2015, pp. 34-36.

⁷¹ Endeavour Energy, *Regulatory Proposal 1 July 2019 to 30 June 2024*, p.164.

Endeavour Energy goes on to note that it has been able to meet these costs and achieve compliance with its vegetation management requirements while reducing its overall opex to the AER's final year opex allowance for the 2014-19 regulatory control period.⁷²

Figure 5-3 also shows significant redundancy costs in 2014-15 and 2015-16. Endeavour Energy reports it incurred similar levels of redundancy costs in 2016-17 and forecasts that these costs will decrease significantly in the last two years of the regulatory period.⁷³ As with vegetation management costs, Endeavour Energy proposed a step-change for redundancy costs in its 2015 revenue proposal.⁷⁴ It stated that an increase in labour redundancy costs — needed to finance the downsizing of its workforce as it reduced its capex under the capital prioritisation and efficiency program — created a step-up in its opex compared to its 2012-13 base year.

In our 2015 final decision, we did not accept the step-change for redundancy costs on the basis that Endeavour Energy's restructure of its workforce was likely only needed because it was not operating as efficiently as it could.⁷⁵ In support of this, we noted that while Endeavour Energy had begun efficiency improvements, it had higher than efficient labour costs because it had too many staff and had engaged permanent staff in preference to contractors over the 2009-14 period.⁷⁶ These staff became stranded labour due to the restrictions on involuntary redundancies imposed by Endeavour Energy's enterprise bargaining agreement.⁷⁷ These views were informed by a review conducted by Deloitte Access Economics.⁷⁸

More recently in its proposal for the 2014-19 regulatory control period, Endeavour Energy has highlighted the success of its 'Endeavour 2020' efficiency transformation program in improving the efficiency of its workforce and achieving a sustainable level of opex consistent with our 2015 final decision:

"...through the Endeavour 2020 initiatives we have reduced our FTEs, in excess of the AER's opex allowance, from 369 to zero. Since 2012, we have reduced our workforce by almost 1,000 FTEs to make our business more efficient."⁷⁹

"Reducing our FTEs has resulted in higher opex amounts in the earlier years of the 2014-19 period. The short-term cost increases, particularly in 2015-16, are associated with exiting staff and restructuring which was required to deliver longer-term opex savings. The benefits of these are forecast to be realised in the 2017-18 opex which is \$64.1 million (real, 2018-19)

⁷² Ibid.

⁷³ Redundancy costs are a component of total overhead costs. Redundancy costs are shown separately in Figure 5.3 in 2014-15 and 2015-16. For 2016-17, 2017-18 and 2018-19 these costs have been included in Total Overheads and are not shown separately.

⁷⁴ Endeavour Energy, *Regulatory Proposal 1 July 2015 to 30 June 2019*, p. 88.

⁷⁵ AER, *Final Decision – Endeavour Energy distribution determination 2015–16 to 2018–19, Attachment 7 – Operating Expenditure*, April 2015, p. 241.

⁷⁶ Ibid. pp. 7-25.

⁷⁷ Ibid.

⁷⁸ Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis*, November 2014, pp. i-v; Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis: addendum to 2014 report*, April 2015, pp. ii–vii.

⁷⁹ Endeavour Energy, *Regulatory Proposal 1 July 2019 to 30 June 2024*, p. 164-165.

below our opex in the 2013-14 year. As 2017-18 is our base year for forecasting purposes, these benefits will continue to be passed through to customers over the 2019-24 period.”⁸⁰

Endeavour Energy has achieved significant efficiencies in its labour force, which has enabled it to reduce FTEs substantially.⁸¹ It forecasts that it will be able to achieve further labour force efficiencies and cost savings in 2017-18 and 2018-19 and maintain these over the 2019-24 regulatory period.

Further, as with vegetation management costs, Endeavour Energy has noted that it has been able to manage the increase in redundancy costs associated with its efficiency program over the 2014-19 period while reducing its overall opex to an efficient level that is consistent with our 2015 final decision.

“The Endeavour 2020 program has achieved its objective of transitioning our opex to the AER’s final year opex allowance for the 2014-19 period. Through our transformative efficiency programs we have managed to reduce our costs in real terms while managing the above additional cost pressures.”⁸²

Since our 2015 final decision, Endeavour Energy has been able to offset increases in vegetation management and redundancy costs through efficiencies that have generated decreases in other cost areas (i.e. emergency services costs, maintenance costs and total overhead costs). This has allowed it to meet its regulatory obligations and the costs of transforming its business while decreasing its overall opex to a level consistent with the opex criteria.

These reforms to Endeavour Energy’s opex cost categories and labour costs generally provide further supporting evidence, in addition to economic benchmarking, that its opex targets for 2017-18 and 2018-19 are not materially inefficient and are consistent with the opex criteria.

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 its network.⁸³ 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.

Endeavour 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.

⁸⁰ Ibid.

⁸¹ Endeavour Energy, *Proposal for the remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018, pp. 2-4.

⁸² Endeavour Energy, *Regulatory Proposal 1 July 2019 to 30 June 2024*, p.165.

⁸³ The term ‘network service provider’ relates to service providers that provide gas and electricity transmission and distribution services.

Since our 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 2015 final decision, the revenue outcome of our new approach is approximately the same as in that decision.⁸⁴ Endeavour Energy's proposal is consistent with our new approach to determining the return on debt.

The revised rate of return allowance for this draft decision is set out in Table 5-2. These numbers reflect our 2015 final decision with respect to the return on equity and the gearing ratio and a revenue neutral transition calculated using partially updated debt yield data from the Reserve Bank of Australia (RBA)⁸⁵ and fully updated data from Bloomberg. The RBA data has been updated for the pre 5 June 2018 RBA revisions only, due to the unique circumstances described in section 5.3.2.5. They also reflect the debt averaging periods we determined to use in our 2015 final decision.

Table 5-2 Endeavour Energy draft decision return on debt and return on capital (\$million, 2013-14) and percentage debt portfolio rate of return⁸⁶

	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	212.9	217.9	217.7	214.7	210.4	1073.7
Draft decision return on capital	367.7	378.9	382.3	381.2	378.5	1888.7

⁸⁴ We note a very small change in revenue occurs due to the use of the most recent debt yield data available.

⁸⁵ Reserve Bank of Australia, Letter to AER, *Revisions to statistical table F3*, 4 July 2018. <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-rate-of-return-guideline/draft-decision>

⁸⁶ These numbers reflect the final decision including annual debt updates using data prior to the 5 June 2018 RBA update.

5.3.2.1 The NER requirements

We must determine a rate of return such that it achieves the allowed rate of return objective (ARORO).⁸⁷ 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).⁸⁸ 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.⁸⁹ The RPP are relevant because we must take them into account in exercising this type of decision-making power.⁹⁰ We must also take into account any interrelationships between our remade debt decision and any other related component of a distribution determination.⁹¹

5.3.2.2 The Tribunal's decision

On 26 February 2016, the Tribunal handed down its decisions.⁹² 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.⁹³ 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 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 the value of imputation credits (gamma).⁹⁴

⁸⁷ NER ss. 6.5.2(b), 6A.6.2(b).

⁸⁸ NER ss. 6.5.2(c), 6A.6.2(c).

⁸⁹ NEL, ss. 7 and 16(1)(d).

⁹⁰ 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).

⁹¹ NEL, s. 16(1)(c).

⁹² *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 Endeavour Energy* [2016] ACompT 3; *Application by ActewAGL Distribution* [2016] ACompT 4.

⁹³ *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 Endeavour 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).

⁹⁴ *Australian Energy Regulator v Australian Competition Tribunal (No 3)* [2017] FCAFC 80.

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.
- 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.

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 Endeavour Energy should be interpreted.⁹⁵ 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 decision⁹⁶
- the decisions of the Australian Competition Tribunal for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd⁹⁷

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 Endeavour 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

⁹⁵ See eg *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3 at [295].

⁹⁶ *Application by SA Power Networks* [2016] ACompT 11; *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3.

⁹⁷ *Application by ActewAGL Distribution* [2017] ACompT 2.

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'.⁹⁸ We consider these decisions support our ex ante interpretation of efficient financing costs. These decisions and our view on them are covered in further detail in our debt Position Paper on our remitted debt decisions.⁹⁹

On 18 January 2018, the Full Federal Court handed down its decision on *SA Power Networks v Australian Competition Tribunal*.¹⁰⁰ This was a review brought by SA Power Networks from a decision of the Tribunal.¹⁰¹ The Full Federal Court noted that the Court had not had the benefit of hearing a number of issues in relation to Endeavour 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 Endeavour 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 Federal Court decision also supports our new revenue neutral debt transition approach which we propose to apply in this remitted debt decision.

⁹⁸ Ibid.

⁹⁹ 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.

¹⁰⁰ *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3.

¹⁰¹ *Application by SA Power Networks* [2016] ACompT 11.

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 updated Bloomberg debt series data and partially updated RBA debt data (as available prior to 5 June 2018).¹⁰² The RBA has made three changes to its yield curve estimates over the relevant period and Bloomberg has removed a period of data from publication. Given the timing of the third RBA update and the remittal process discussed further below, we have used data reflecting the Bloomberg update and the first two RBA updates in making this draft decision.

The most recent round of RBA data updates were published on 5 June 2018, and involved a back-casting of yield curve estimates covering the 2014-19 period.¹⁰³ We understand a primary driver of the update was to reflect improvements in the methodology used by the RBA to convert bonds issued in US dollars into Australian dollar-equivalent terms.

We consider that, on balance, it would not be in the long-term interests of consumers to apply the 5 June 2018 RBA debt update at this juncture, given the particular circumstances before us.

As noted in section 5.1.1, the approach we have applied in remaking this draft decision has necessarily been influenced by the novel circumstances that we face now. They are materially different from those that we faced when we made our April 2015 final decision, and what we would generally face in making a distribution determination. For example, this is highlighted by the fact that we are four years into the applicable five-year 2014-19 regulatory control period. In fact, under a separate process, we have already started publically consulting on Endeavour Energy's 2019-24 regulatory proposal. In this respect, we also note that the recently updated RBA data has not been applied in any other decisions covering the 2014-19 regulatory period, including Essential Energy's remade final decision.

Stakeholders have told us they would like regulatory certainty and resolving the outstanding remittals in a timely manner will provide this certainty. Certainty is of benefit to both consumers and the network businesses and, therefore, will contribute to the NEO. To a large degree, this explains the concerted effort by all parties during pre-lodgement discussions – in all the remittals – to agree the key financial parameters which, in turn, could be developed into a proposal by the relevant network business – in this case, Endeavour Energy – and put

¹⁰² We note that while our application of a revenue neutral transition to a trailing average is mathematically the same as our 2015 final decision, our reasoning has changed and is entirely based on the reasoning as set out in our APA VTS final decision.

¹⁰³ Reserve Bank of Australia, Letter to AER, *Revisions to statistical table F3*, 4 July 2018. <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-rate-of-return-guideline/draft-decision>

to us for consideration and further stakeholder consultation under the regulatory determination process.

The consultation process on Endeavour Energy's proposal occurred in good faith, based on the best available information at the time. We note that the most recent RBA data update released on 5 June 2018 occurred after a period in which substantial pre-lodgement engagement on the key financial parameters of Endeavour Energy's proposal had already taken place with its key stakeholders, including consumer groups and our officers.

In summary, given the novel circumstances, the late timing of the 5 June 2018 RBA data update, the good faith in which parties have sought resolution of the remittal, and the broad stakeholder support for Endeavour Energy's proposal, on balance, we consider that not applying the most up to date RBA data (as updated on 5 June 2018) to this remade draft decision is the outcome that contributes to the NEO to the greatest degree. We will consider all stakeholder submissions received on this issue, and other issues more generally, before publishing our final decision later this year.

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.¹⁰⁴ 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 Paper¹⁰⁵ 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 Endeavour Energy from changing the debt estimation methodology.

¹⁰⁴ 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.

¹⁰⁵ Ibid.

We rely on the reasoning in our APA VTS decision in making this draft decision for Endeavour Energy, as set out in Attachment 3 of our APA VTS determination.¹⁰⁶ 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.¹⁰⁷

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 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 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 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.

¹⁰⁶ 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.

¹⁰⁷ 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.

5.4 Other aspects of the 2015 final decision to be varied

5.4.1 Control mechanism

The control mechanism was not a subject of Endeavour Energy's appeal of our April 2015 final decision. However, if this remade draft decision becomes our final decision, the 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.”

This remade draft decision is \$110 million above our 2015 final decision. In order to effect the additional \$110 million in our control mechanism formula, we must vary the control mechanism as set out in our Framework and Approach paper for Endeavour Energy's 2014-19 revenue determination and adopted in our 2015 final decision.¹⁰⁸

This remade draft decision removes the following requirement from our 2015 final decision on the form of control mechanism:¹⁰⁹

“In proposing variations to the amount and structure of DUoS charges, Endeavour 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 mechanism formula is necessary given the material and unforeseen (novel) change in circumstances since our 2015 final decision.¹¹⁰ The variation will allow us to track Endeavour Energy's revenue relative to our 2015 final decision through the DUoS 'unders' and 'overs' accounts. If this remade draft decision becomes our final decision, this will enable us to implement the decision while maintaining the operation of the unders and overs accounts across the 2014–19 and 2019–24 regulatory control periods.

¹⁰⁸ AER, *Stage 1 Framework and approach paper – Ausgrid, Endeavour Energy and Endeavour Energy, Attachment 2 Control mechanisms*, March 2013, p.43. Available at: <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/Endeavour-energy-determination-2014-19/aer-position>

¹⁰⁹ AER, *Final decision Endeavour Energy distribution determination: 2015–16 to 2018–19, Attachment 14 - Control mechanism*, April 2015, p.18.

¹¹⁰ NER, cl. 6.12.3(c)(1).

This is consistent with the requirements of the NER as it would minimise administrative costs and reduce uncertainty.¹¹¹

If this remade draft decision becomes our final decision, we will ensure Endeavour Energy earns no more than the amount set out in the 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 Endeavour 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 Endeavour Energy's standard control services in the 2019–24 regulatory control period.¹¹² At this stage, we are likely to maintain the general properties of the control mechanism from our 2015 final decision, including the unders and overs accounts. With this in mind, if this remade draft decision becomes our final decision, we consider there are several options for enforcing the decision through the control mechanism for the 2019–24 regulatory control period. Any amounts recovered above that allowed in the decision will be returned to customers in the next (2019-24) regulatory control period and determined as part of Endeavour Energy's 2019-24 distribution determination.

5.4.2 Inflation error adjustment

In the course of its review of our decisions of the Victorian electricity distributors and ActewAGL's gas decision, the Tribunal identified an error in how inflation was estimated.¹¹³ The Tribunal made note of the error in its decision and left it to the AER to determine how best to address the error.¹¹⁴ The error affected not only the decisions under that review, but the 2015 final decisions for the NSW distributors. The error had not been picked up during the review of the 2015 NSW decisions.

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 \$8.85 million (\$2013-14, nominal) compared to our 2015 final decision.

On 15 December 2017, we notified Endeavour 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.¹¹⁵ In its 5 April 2018 proposal, Endeavour Energy accepted the application of the downward revenue adjustment, which it estimated to be \$12.2 million (\$2018-19, nominal).¹¹⁶

¹¹¹ NER, cl. 6.2.5(c)(2) and (3).

¹¹² AER, *Framework and approach Ausgrid, Endeavour Energy and Endeavour Energy: Regulatory control period commencing 1 July 2019*, July 2017, pp. 41 and 52–54.

¹¹³ File Nos: ACT 3, 4, 5, 6, 7, 8 of 2016: <http://www.competitiontribunal.gov.au/current-matters/tribunal-documents>

¹¹⁴ For example, see ACT, Application by ActewAGL Distribution [2017] ACompT 2, 17 October 2017, p i-iii.

¹¹⁵ AER, *Proposed correction to an inflation calculation error impacting Endeavour Energy distribution determination 2014-19*, 15 December 2017. <https://www.aer.gov.au/system/files/DORIS%20-%20D17-178606%20AER%20letter%20proposed%20inflation%20correction-Endeavour%20En....pdf>

¹¹⁶ Endeavour Energy, *Proposal for the Remittal of the Endeavour Energy 2014-19 Determination*, 5 April 2018, p. 3. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/endeavour-energy-determination-2014-19-remittal/proposal>

5.4.3 Minor corrections to our 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.¹¹⁷ If this remade draft decision becomes our final decision, and as part of the decision for Endeavour Energy, we will refer and give effect to that open letter published on our website. The letter sets out our proposed correction for the following errors in our 2015 final decision:

1. Inaccurate description of metering in Appendix A to the Overview

- In April 2015, the AER made its 2014-19 distribution determination for Endeavour Energy. Shortly after, in May 2015, the AER agreed with Endeavour Energy that the distribution determination contained an inaccurate description of metering services classification in Appendix A to the Overview of that determination. This description did not align with the (accurate) description in Attachment 16 (alternative control services) of the same determination. The AER also agreed with Endeavour Energy that it would be inappropriate to revoke and substitute the determination to correct the error at that time, and that we would amend the error once any appeal in relation to our distribution determination was resolved.
- In practice, throughout this regulatory period we have been applying the correct classification of metering services as reflected in Attachment 16 of the 2014-19 determination through the enforceable undertakings and annual pricing proposal processes. Accordingly, there is no residual error to correct. We consider this matter is now resolved and closed.

2. Inaccurate public lighting prices

- In practice, throughout this regulatory period we have been applying correct public lighting prices through the enforceable undertakings and annual pricing proposal processes. Accordingly, there is no residual error to correct. We consider this matter is now resolved and closed.

3. Parameter missing for control mechanism

- This matter has now been superseded by the proposed approach to resolving this remittal for Endeavour Energy. Please refer to section 5.4.1.

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

¹¹⁷ AER, *AER letter to Endeavour Energy about correcting errors in Endeavour Energy distribution determination 2015–16 to 2018–19*, 20 May 2015.
<https://www.aer.gov.au/system/files/Letter%20from%20AER%20to%20Endeavour%20Energy%20about%20correcting%20errors%20in%20distribution%20determination%20-%2020%20May%202015.pdf>

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.

2015 final decisions for the 2014-19 regulatory control period

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, Endeavour 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 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 on:¹¹⁸

- Opex (and for Evoenergy, the implications of this for the Service Target Performance Incentive Scheme):¹¹⁹ 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.¹²⁰ In particular, the Tribunal considered that we relied too heavily on the results of a single benchmarking model to derive our alternative opex forecasts.¹²¹
- 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.¹²²

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.¹²³ However, following the Tribunal's decision and our subsequent

¹¹⁸ *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 Endeavour Energy* [2016] ACompT 3; *Application by ActewAGL Distribution* [2016] ACompT 4.

¹¹⁹ 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.

¹²⁰ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1.

¹²¹ *Ibid.*

¹²² *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 Endeavour Energy* [2016] ACompT 3, direction 1 (b); *Application by ActewAGL Distribution* [2016] ACompT 4, direction 1 (b).

¹²³ 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 determinations. Subsequently, we approved each of the distributors' 2014–15 pricing proposals.

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 2016–17.¹²⁴ 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 2015-16.¹²⁵

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 2017–18.¹²⁶ 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 2016–17.¹²⁷ 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 recover such differences over both the 2014–19 and 2019-24 regulatory control periods.¹²⁸ 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.

¹²⁴ Ausgrid, *Ausgrid enforceable undertaking*, May 2016. Endeavour Energy, *Endeavour Energy enforceable undertaking*, May 2016. ActewAGL, *ActewAGL enforceable undertaking*, May 2016. Endeavour Energy, *Endeavour Energy enforceable undertaking*, May 2016.

¹²⁵ 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.

¹²⁶ Ausgrid, *Ausgrid enforceable undertaking*, May 2017. Endeavour Energy, *Endeavour Energy enforceable undertaking*, March 2017. ActewAGL, *ActewAGL enforceable undertaking*, May 2017. Endeavour Energy, *Endeavour Energy enforceable undertaking*, May 2017.

¹²⁷ 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.

¹²⁸ 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*.

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:¹²⁹

- “(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 Endeavour’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.”

¹²⁹ *Applications by Public Interest Advocacy Centre Ltd and Endeavour 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 Tribunal (No 2)* [2017] FCAFC 79, [738]-[784].