

Preliminary decision: United Energy (distribution) 2016–20

We have made a preliminary decision for United Energy Distribution, one of five electricity distribution network operators in Victoria. Our preliminary decision allows United Energy to recover \$1832.3 million (\$nominal) from its customers over five years commencing 1 January 2016.

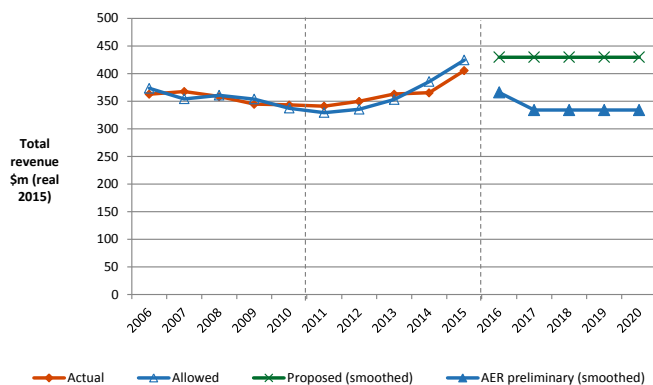
Overview

The Australian Energy Regulator (AER) regulates the revenues of United Energy by setting the annual revenue requirement it may recover from its customers.

Our preliminary decision allows United Energy to recover \$1832.3 million (\$nominal) from its customers over five years commencing 1 January 2016. If we had accepted United Energy's proposal, it would have been permitted to recover \$2315 million (\$nominal) over the 2016–20 regulatory control period. Our preliminary decision is for 20.9 per cent less revenue than United Energy's proposal.

The figure below shows the difference between United Energy's proposed revenue, and what we have allowed for each year of the preliminary decision.

United Energy's past and proposed total revenue and AER preliminary decision revenue allowance (\$million, 2015)



If our final decision (to be made in April 2016) differs from our preliminary decision, any necessary adjustments will be spread across revenues over the remaining years (that is, 2017–20) of the regulatory control period.

The revenue we determine affects the distribution component of a customer's electricity bill. Distribution charges may make up approximately 33 per cent of the bill for one of United Energy's typical residential customers.

Other components of customer bills include the cost of generation, transmission, network charges and retailer costs. The AER does not set retail prices.

Estimated impact on customer bills

Based on the lower distribution charges from our preliminary decision being passed through to customers, we expect average annual electricity bills for residential customers to reduce by \$37 (or –2.2 per cent) in 2016 and a further \$34 (or –2.1 per cent) in 2017. Bills will then remain relatively stable over the rest of the period covered by this decision.

For small business customers, we expect a reduction of \$79 (or –2.2 per cent) in 2016 and a further \$73 (or –2.1 per cent) in 2017. Bills will then remain relatively stable over the rest of the period covered by this decision.

These are only estimates for standard control services, and are based on the data we have about how much energy customers in Victoria use. There are a number of other factors that also affect a customer's electricity bill, such as the wholesale price of electricity and retailer costs. You can read more about what makes up the energy prices on customers' bills at: www.aer.gov.au/Consumers.

Key elements of our decision

We based our assessment of United Energy's proposed revenue on a number of components. These include expenditures to maintain and operate the network, and the return to shareholders on their investment. Together, these determine the revenue United Energy may recover from its customers.

Three components of our preliminary decision drive most of the difference between United Energy's proposed revenue and our preliminary decision: rate of return, operating expenditure (opex) and capital expenditure (capex).

We discuss each of these below.

Rate of return

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

Our preliminary decision sets the allowed rate of return (or 'cost of capital') at 6.12 per cent for 2016. We have not accepted United Energy's proposed 7.38 per cent.

The investment environment has improved since our previous decision in 2010, which was made during the period of uncertainty surrounding the global financial crisis. This improved investment environment translates to lower financing costs necessary to attract efficient investment. We consider that United Energy has sought a rate of return that is higher than necessary given the current investment environment.

We have not accepted the methodology proposed by United Energy to set its rate of return. Instead, we have used the methodology we developed through extensive consultation during our Better Regulation program in 2013. We consider that our approach provides for a rate of return that better reflects the allowed rate of return objective.

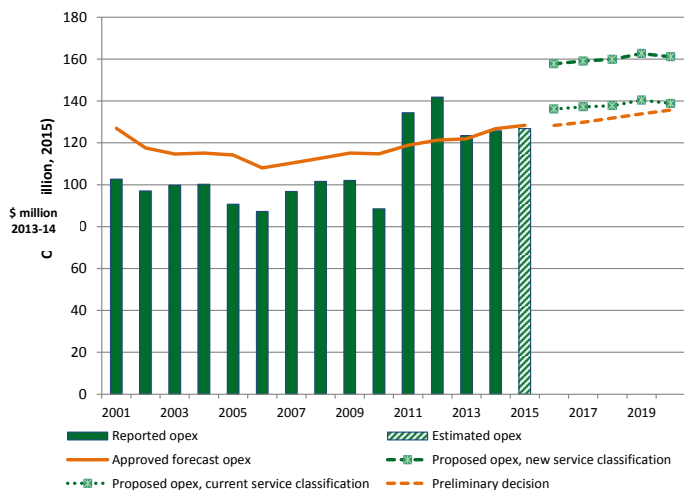
The lower rate of return in this decision will reduce United Energy's average annual revenue requirement compared to the previous regulatory period.

Operating expenditure

Opex includes forecast operating, maintenance and other non-capital costs incurred in the provision of distribution network services. It includes labour and other non-capital costs that United Energy is likely to require during the 2016–20 regulatory control period for the efficient operation of its network.

Our preliminary decision allows United Energy to recover \$659.5 million (\$2015) for opex. This is 16.9 per cent lower than the \$793.8 million United Energy proposed.

AER preliminary decision compared to United Energy's past and proposed opex (\$million, 2015)



The National Electricity Rules require us to be satisfied that the level of opex proposed by United Energy reflects the opex criteria: the costs that a prudent operator—with efficient costs and a realistic expectation of demand and cost inputs—would need to operate its network safely and comply with its obligations and service standards.

In recent years, we have expanded our regulatory toolkit to make greater use of benchmarking—particularly for opex. Benchmarking is a way of determining how well a network business is performing against its peers and over time, and provides valuable information on what is 'best practice'.

Our opex benchmarking results show United Energy has been operating efficiently compared to other service providers in the National Electricity Market. We therefore have used United

Energy's revealed (past actual) costs as the starting point for forecasting efficient opex.

We then assess the prudence and efficiency of forecast cost increases going forward. Overall, we consider that United Energy has proposed more revenue than is required to operate its network prudently and efficiently. That said, we re-allocated opex proposed by United Energy for metering to 'alternative control services', which means these costs will be recovered separately through annual metering charges.

Capital expenditure

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

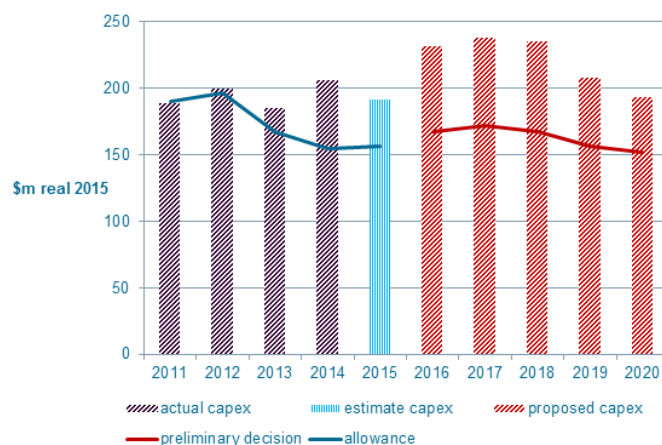
As with opex, we must be satisfied that the level of capex proposed by United Energy reflects the capex criteria: the costs that a prudent operator—with efficient costs and a realistic expectation of demand and cost inputs—would need to operate its network safely and comply with its obligations and service standards.

We have estimated total forecast net capex of \$814.8 million (\$2015) for United Energy's 2016–20 regulatory control period. This is 26.2 per cent lower than the \$1104 million United Energy proposed.

Our capex allowance includes additional expenditure from new safety obligations arising as a result of the recommendations of the 2009 Victorian Bushfire Royal Commission.

The key difference between our substitute capex forecast and United Energy's proposal is lower expenditure on replacement capex, non-network capex and augmentation of the network.

AER preliminary decision compared to United Energy's past and proposed capex (\$million, 2015)



More information about our consultation process

United Energy may submit a revised proposal in response to our preliminary decision by 6 January 2016. Stakeholders may make written submissions on our preliminary decision by the same day, 6 January 2016. Stakeholders may also file submissions on United Energy's revised proposal by 4 February 2016. Our final decision is due for release by the end of April 2016.

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