

Consumer
Challenge
Panel

CCP10 Response to AER Draft Decision

**Essential Energy 2014-19 Electricity Distribution Determination
(remitted decision)**

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Submitted to: EssentialRemittal2014-19@aer.gov.au

CCP10 is Louise Benjamin, Eric Groom, Mark Henley, Mike Swanston

Section 1. Summary of Response

The Draft Decision from the Australian Energy Regulator (AER) to accept the Essential Energy proposal for the remitted 2014-19 regulatory period is supported by the Consumer Challenge Panel, through subpanel 10 (CCP10).

In their draft decision the AER says:

“Our remade draft decision is to accept Essential Energy’s proposal to recover total revenues of \$5,102.9 million (\$, nominal) from consumers over the five-year 2014-19 regulatory control period. This equates to our 30 April 2015 final decision with additional revenues of \$100 million and will maintain distribution network charges at the current levels.” The current levels relating to March 2018.

Central to the AER’s decision is their consideration that:

“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.”

Support for the draft decision by CCP10 should come as no surprise to Essential Energy, consumer groups and the AER since we have engaged actively with all of these parties in the lead up to Essential Energy lodging their proposal for the remitted decision for 2014-19.

Prior to making its draft decision, the AER sought advice from CCP10 and some key consumer groups, we said:

“CCP10 supports Essential’s proposal for resolving its regulatory allowance for 2014-19 following the remittal of that determination to the AER by the Federal Court. We commend Essential on its genuine and transparent consumer engagement on its proposal and on the way it has listened to that feedback and reflected it in its revised proposal. CCP10 believes that the Essential proposal is in the long-term interests of Essential’s customers.”

We maintain this perspective now that the proposal has been formally lodged and is under consideration by the AER.

Submissions have also been made to the AER remitted decision issues paper dealing with operating expenditure and the position paper on debt decisions. Consistent with the arguments that we have presented in these two papers, we support the AER’s draft decisions regarding operating costs and debt as presented in the Essential Energy remade draft decision for 2014-19.

Section 2. Behind the Draft Decision

In expanding on our support for the draft decision, we think it is appropriate to make comment on three aspects of the decision-making process to date, these aspects being:

1. the unique circumstances that have led to this draft decision being made
2. the application of “AER 2.0”
3. why we think the draft decision is in the long-term interests of consumers.

2.1 Unique Circumstances

In the draft decision the AER refers to “*the novel circumstances*” that they faced in “*making this remade draft decision.*”

We concur with the AER’s observation about the novel/unique circumstances associated with this draft decision. We think there is merit in briefly recapping a history of the allowed revenue for 2014-19 for Essential Energy because it helps to understand the important question of benefit to customers as well as providing a base for reflection on the aspects of the decision process that are likely to be useful in a changing energy market and consequently a changing regulatory environment for Australian energy network businesses.

The original regulatory proposals for New South Wales electricity distribution businesses for 2014-19 were coordinated by Networks New South Wales who sought common ground for all three New South Wales electricity distribution businesses which at the time were all government owned, though the spectre of (at least partial) privatisation loomed large.

These proposals were also the first lodged under the then newly revised rules for network regulation which were finalised by the AEMC in late 2012 at a time of considerable political sensitivity about high energy prices and at a time when network costs were regarded as the major factor pushing up prices for both household and business customers. The AER had also undertaken a comprehensive consideration of the implications of the newly revised rules and consulted extensively on the development of a number of guidelines under their “Better Regulation” process. The Consumer Challenge Panel was also established in 2013 with the very first subpanel established to consider the New South Wales and ACT electricity distribution 2014-19 proposals.

The revised rules and Better Regulation process meant that the New South Wales network businesses were delayed from what would have been the standard timeframe in lodging their 2014-19 proposals, so a placeholder revenue decision was made for the first year of the regulatory period.

In April 2015 the AER published final decisions for the New South Wales electricity distribution businesses as well as ActewAGL (now Evoenergy), the electricity distribution business for the Australian Capital Territory. These decisions were for reductions from what was sought by the network businesses of the order of 30% and included release of benchmarking data, which had been actively considered during the Better Regulation process. The development and application of benchmarking data had also been a recommendation from the Productivity Commission’s review of energy network pricing that was released in May 2013.

Essential Energy, along with Endeavour Energy and Ausgrid, the other two electricity distribution businesses that had been part of Networks New South Wales sought merits review of the AER's final decisions. The Public Interest Advocacy Centre (PIAC) also challenged the AER's NSW final decisions arguing that the AER had been lenient in its final determinations and could have made better decisions that were more in the long-term interest of consumers. The Commonwealth Minister also intervened in the Australian Competition Tribunal hearings of the merits review application. The Tribunal then announced their decisions, relevant to Essential Energy, in February 2016, remitting the decisions to be remade by the AER with particular reference to return on debt, aspects of operating expenditure and the value of dividend imputation credits for taxation considerations, gamma.

The AER responded the following month seeking judicial review of the Tribunal's decisions in the Australian Federal Court.

In February 2016 the Federal Court upheld the AER's appeal regarding gamma and dismissed the AER's appeal regarding the cost of debt and operating expenditures, meaning that the AER was required to remake the 2014-19 revenue decision for Essential Energy, as well as other New South Wales and ACT network businesses. Each of these will be the subject of separate processes to remake their regulatory determinations.

What this means for Essential Energy customers is that there has not been an accepted revenue allowance for Essential Energy for the entirety of the 2014-19 regulatory period creating uncertainty for customers and the risk of higher future prices, should decision making processes result in Essential Energy being allowed to collect more revenue than it has collected under the various interim pricing arrangements for the duration of 2014-19 period. To the best of our knowledge this level of pricing uncertainty based on a protracted energy regulatory process is unprecedented in Australia.

Heightened political sensitivity about electricity prices, new rules for regulation, growing and enhanced consumer engagement and protracted legal appeals processes on top of changing technologies and global financial markets still 'settling' after the global financial crisis all occurring together have created a very complex and unique set of circumstances that have weighed heavily on all stakeholders.

In short, the Australian Competition Tribunal has remitted the original decision back to the AER to remake the decision for Essential Energy, (and other New South Wales and ACT energy network businesses) for 2014-19. For Essential Energy the AER is required to remake the decision with regard to operating costs forecasts and the rate of return with reference to the trailing average approach "*and otherwise vary the distribution determinations as set out in our April 2015 final decision as we consider appropriate.*"

While this means that the preferable timeliness of the decision cannot be met, the AER is in the unusual position of being able to remake the decision with revealed costs for much of the regulatory period. Knowing the costs incurred by Essential Energy from 2014 to the end of the 2017 calendar year provides an unusual amount of knowledge for all parties about actual costs. This means that the AER is well placed to be able to comply with the Tribunal's directions, meaning that they can appropriately "*vary the distribution determinations as set out in our April 2015 final decision.*" So there is an upside to the protracted timelines for making

the final 2014-19 decision through the application of hindsight rather than the usual and more difficult reliance on foresight for revenue determination.

2.2 AER 2.0

On 28 July 2017 in a speech to an Energy Networks Australia (ENA) conference in Brisbane, AER Chair, Paula Conboy, talked about a better way for undertaking network regulation, committing the regulator to being part of what she described as “AER 2.0.” This approach is understood to be more open than in the past with the expectation of early, clear and direct communication between key stakeholders including the regulator and network businesses to deal with matters as they arise. An open and constructive environment for dealing with network regulatory issues can minimise the risk, real or perceived, that are associated with the Commonwealth Government’s decision to remove access to Limited Merits Review, during 2017.

The remitted decisions for the 2014-19 period have provided some of the earliest opportunities to apply “AER 2.0”, and to apply them in a situation where there is no clear precedent or guide due to the unique nature of the situation.

On 16 August 2017 a stakeholder Roundtable was convened by the AER to discuss options for resolving issues associated with the remitted decisions, both Essential Energy and CCP10 were participants in this Roundtable. We consider the Roundtable to have been held in good spirit and with a genuine interest in enabling the transition to significantly more efficient businesses and to adequate revenue for the network businesses.

Prior to this August meeting, Essential Energy had been actively engaging with consumers and consumer interest groups from across their substantial geographic region, with a focus on consulting on important consumer and network business issues for the 2019-24 revenue proposal. We observe that Essential Energy built on the substantial consumer engagement work that was in progress to also consult on key aspects of the 2014 -19 remitted decision.

Essential Energy expressed interest in seeking prompt resolution of the remitted decision, preferably before the 2019-24 regulatory proposal was considered, as this would provide greater clarity for the business and provide greater certainty to customers including the opportunity to maintain stable prices for consumers. As a result of their willingness to seek prompt resolution of the 2014-19 revenue allowance and to openly discuss the issues at hand with consumer groups and the regulator, Essential Energy lodged a proposal for the remade 2014-19 revenue allowance on 30 November 2017, the first network business to make a written proposal to the AER for a remitted decision.

CCP10 has observed very high levels of engagement between Essential Energy, consumer groups and the regulator in developing a sensible proposal for the remitted decision, a process we regard as having been an excellent example of how “AER 2.0” should work.

Consumer Engagement

While we will address the consumer engagement undertaken by Essential Energy in more detail in responding to their 2019-24 revenue proposal, we think it’s appropriate to make a couple of observations in the context of the remitted decision.

A starting point for considering Essential Energy’s current consumer engagement is to revisit the AER’s original final decision to the 2014-19 regulatory period. The AER concluded their consideration of Essential Energy’s consumer engagement by saying:

“We consider that the primary purpose of consumer engagement is for consumers to have a meaningful opportunity to engage in Essential Energy’s processes. In particular, we consider that consumers should be provided with the opportunity to help shape Essential Energy’s proposal and the services it offers. Our view is that Essential Energy has not provided consumers with sufficient opportunity to influence its processes.”

Our advice about Essential Energy’s consumer engagement associated with remitted decision is that they have consulted as widely as practical given short timeframes and the unique circumstances and have built on the considerable goodwill that has been generated through their consumer engagement activities particularly during the last 18 months. Essential Energy has made considerable advances in the quality of their consumer engagement in the short time since the AER’s original 2014-19 final determination. This business led progress on consumer engagement that has been genuinely two way and has led to confidence of key consumer groups in accepting Essential Energy’s remitted 2014-19 proposal.

The consumer engagement undertaken for the remitted decision is summarised below.

Stakeholder Group	Dates
Consumer Challenge Panel 10 (CCP10)	10 November
Energy Consumers Australia	8 November and 15 November
Public Interest Advocacy Centre	10 November
Essential Energy’s Customer Advocacy Group (CAG)	15 November
Energy Users Association Australia	16 November
Roundtable with all groups	23 November

Table 1. Essential Energy consumer engagement regarding 2014-19 remittal

2.3 Best Interests of Customers

On page 17 of the draft decision, the AER says:

“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.”

We strongly agree that a regulated determination is greater than the sum of its constituent parts recognising that some constituent parts warrant consideration as well.

2.3.1. Allowed Revenue

The AER’s draft decision to allow Essential Energy to collect \$5102.9 million(\$, nominal) over the five years, 2014-19, corresponds to allowing revenue equal to the April 2015 final decision plus \$100 million.

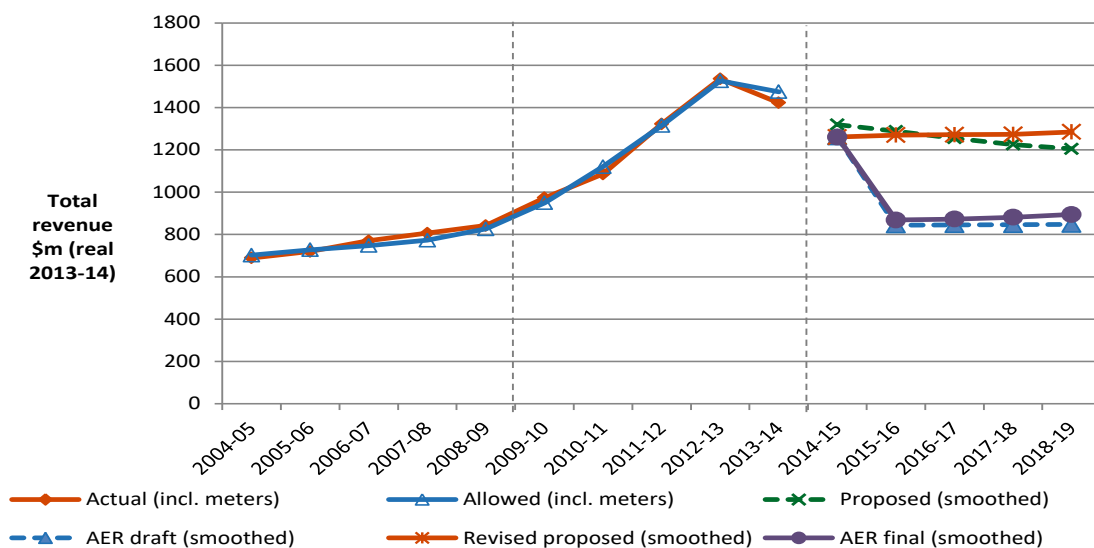
In considering why we believe this is in the best interests of customers it is important to re-read the April 2015 final decision, which was that:

“Essential Energy can recover \$3826.1 million (\$ nominal) from consumers over the 2015–19 regulatory control period. Figure 1 below illustrates our overall decision.”

Essential Energy’s proposal was for \$5545.7 million (\$ nominal) over the 2015-19 regulatory control period, so the AER decision was for a revenue allowance which was 31% less than the revenue sought.

Note that this decision is for a four-year period, since the 2014-15 financial year was the subject of a placeholder decision. The Figure 1 referred to in this decision follows:

Figure 1. Essential Energy's past total revenue, proposed total revenue and AER total revenue allowance (\$ million, 2013–14)



Source: AER analysis.

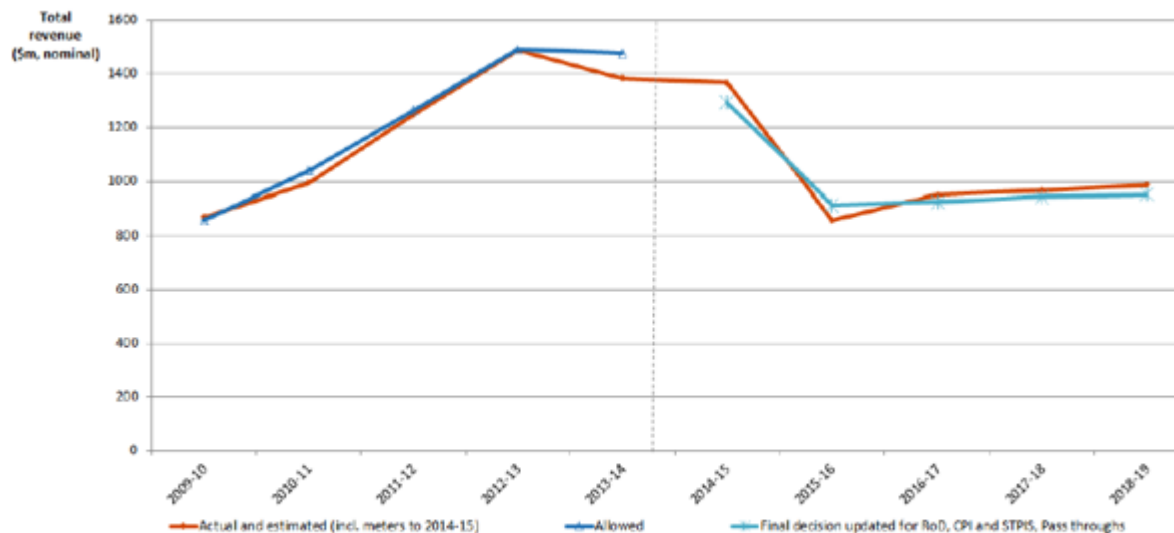
This figure gives a graphical representation of the significant gap between the AER’s final decision (smoothed and shown as dark blue dots) and the Essential Energy revised proposal (smoothed and shown as brown “x”) for 2014-19.

It is worth comparing the gap between the 2015 final determination and Essential Energy’s proposal in Figure 1 with the minimal difference between the AER’s draft determination and Essential Energy’s proposed revenue shown in Figure 2-1 which is taken from the 2018 remitted draft decision and is shown below as Figure 2.

The current alignment between the AER and Essential Energy positions is encouraging from a consumer perspective. The efforts made by Essential Energy to move from their original and revised revenue proposal to the remitted decision proposal represents considerable savings

for customers over the 2014-19 period as well as providing for a more efficient business that will provide ongoing, long-term benefits to consumers through lower cost structures for the business.

Figure 2. Essential Energy’s past total revenue and AER draft decision total revenue allowance (\$million, nominal)



Source: AER analysis.

These two graphs reflect the disappearing gap between Essential Energy and the regulator regarding revenue to be collected from consumers and represents the significant benefit that end consumers are saving over the regulatory period, compared to the original (2013 lodged) Essential Energy proposal.

There has been a 35% reduction in the distribution component of bills being paid by an indicative Essential Energy customer between the first and last year of the 2014-19 regulatory period. This represents a significant transition to efficiency by Essential Energy, meaning benefits for customers.

2.3.2. Reduced Operating Costs

One of the major issues under consideration through the appeals and now remitted decision process has involved the operating costs allowance for the 2014-19 period.

We agree that there was general agreement that the 2009-14 revenue allowance sought by Essential Energy and other New South Wales distribution businesses was inefficient so a significant part of the 2014-19 regulatory period was to improve efficiency of operations for Essential Energy which meant allowing for a transition path from less efficient to more efficient.

In the remade Draft Decision, the AER provides some analysis of operating costs, they say.

“Since 2012–13 (our April 2015 final decision base year), there have been reductions across all of its major cost categories. Since 2012-13, it has made the following opex reductions:

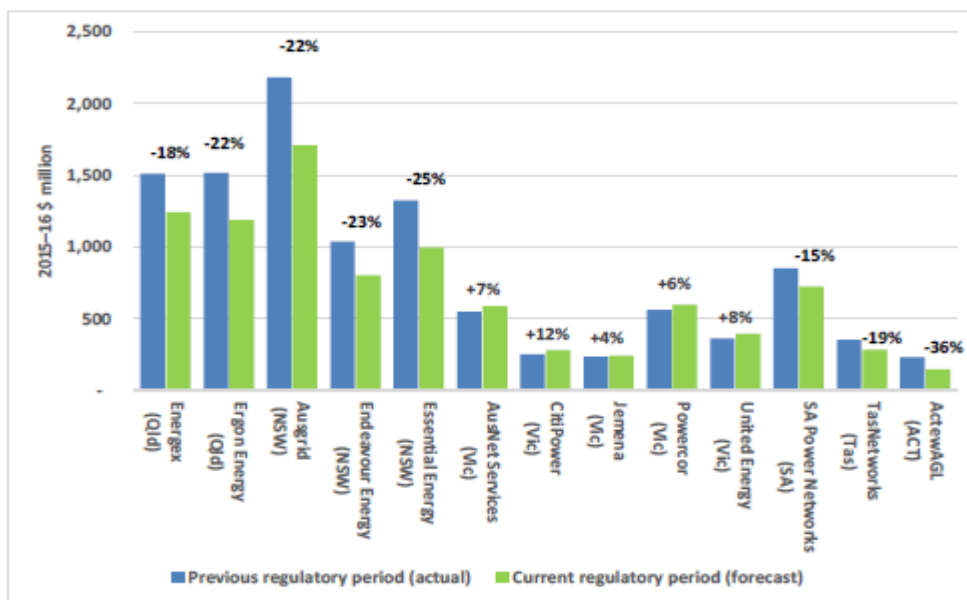
- *vegetation management (excluding allocated overheads) reduced by 28 per cent*

- maintenance costs reduced by 33 per cent
- total overheads reduced by 38 per cent
- emergency services costs reduced by 37 per cent.”

These are major cost reductions by Essential Energy and reflect significant savings for consumers, in aggregate and for a vast majority of individual customers.

We note that staffing costs was a major issue considered by CCP1 in their advice concerning the original regulatory proposals for 2014-19 from all three New South Wales electricity distribution businesses. CCP10 supports the general principle enunciated by CCP1 that consumers should pay for efficient staffing costs with any additional payroll commitments met by the owner and have stated this view and provided further commentary in our submission to the AER Issues Paper: “Remitted decisions for NSW/ACT 2014-19 electricity distribution determinations operating expenditure.”

Figure 3. Forecast change in electricity network revenues from previous to current regulatory period, by DNSP



Source: AER Benchmarking report 2017

One of the implications of reduced operating costs is shown in Figure 3 displaying the forecast change in Australian electricity network revenues from previous to current regulatory periods. All the reductions are significant for each New South Wales network business, the percentage reduction is greatest for Essential Energy, reflecting the significant efforts of the businesses made to improve efficiency and achieve the NEO.

2.3.3. Timeliness of Decision

Predictability and certainty coupled with lower prices are critical issues for electricity customers. While the 2014-19 regulatory process has dragged on for an unprecedented length of time, speedy resolution of Essential Energy’s 2014-19 revenue allowance is in the best interests of consumers so Essential Energy’s concise proposal and the AER’s prompt

response with this draft decision both reflect increased goodwill and benefit to consumers through prompt resolution from this point of time.

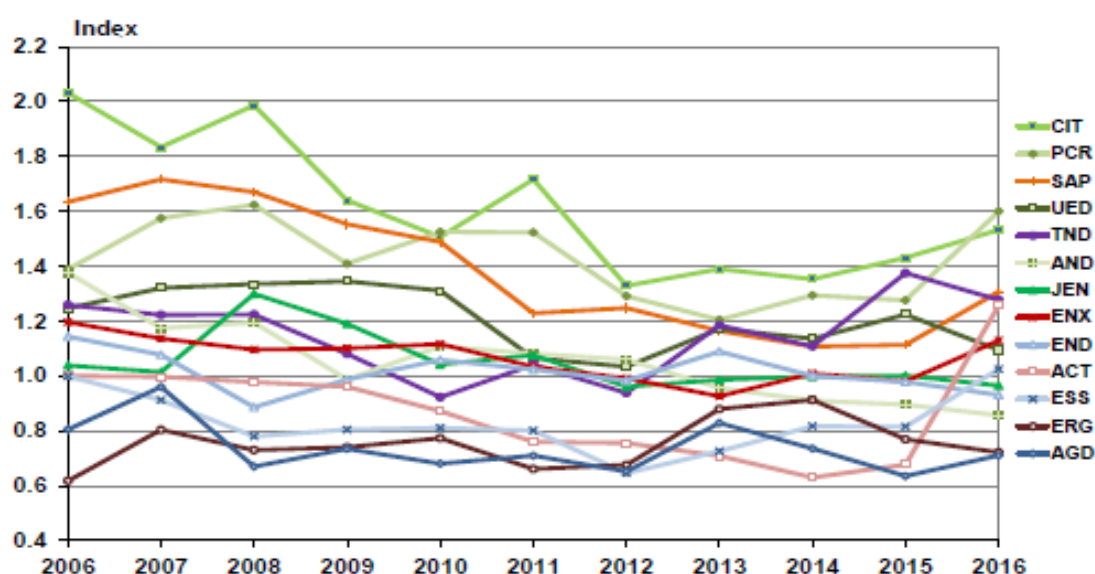
Prompt finalisation of the 2014-19 allowance also provides a sound basis for finalising the 2019-24 revenue allowance including smooth transition between the two regulatory periods, which is also of benefit to customers.

2.3.4. Reduced Transaction Costs

Failure to promptly resolve the 2014-19 allowance would also mean that there is a likelihood of additional costs from further consultant reports, reduced capacity for efficient network management along with the potential for further legal challenge, all of which would be additional costs that would end up being paid by consumers. The risk of future costs through an unresolved regulatory allowance is an additional burden for consumers, who will benefit from prompt and sensible resolution.

2.3.5. Improved Efficiency

Figure 4. Opex multilateral partial factor productivity (MPFP), 2006–16



Source: AER Benchmarking report 2017

The key outcome of the substantial efforts made by Essential Energy to reduce their operating costs has been for an observable improvement in opex multilateral partial factor productivity. Shown in Figure 4, this is an improvement in effectiveness of use of the network with Essential Energy moving from the worst performed Australian distribution business in 2012 to approaching ‘middle of the pack’ by 2016. These are improvements that have provided a customer benefit during the 2014-19 control period and will lead to ongoing customer benefits during subsequent regulatory periods.

2.3.6. Improved Goodwill

Electricity network businesses, like any business, operate within a societal setting. A business like Essential Energy operates across a wide range of local and regional communities. Maintaining a “social licence to operate” is important for consumers, the communities in which

they live or do business and the network business. While it is difficult to put a dollar value on the value of improved goodwill for a network business, this is important and of benefit to both Essential Energy, in this case and their customers.

In a paper that CCP10 presented to the AER Board in response to the Framework and Approach for NSW / ACT distribution businesses for the 2019-24 period, we commented on the range of potential benefits for network businesses from clear communication and shared objectives, we said:

“ ... there is a range of rewards that companies can potentially be looking for, we summarise these under the following 4 headings:

- 1. Reputation, including being seen to be ‘decent’ members of society / social license to operate.*
- 2. Saved money and time*
- 3. Efficiency in regulatory process*
- 4. Increased financial return.*

These are not necessarily sequential, but a reward with more monetary value may be considered to have ‘higher strength.’ Two points to bear in mind are that:

- The nature and importance of the financial rewards may vary depending on ownership and management/investor objectives*
- Financial rewards for investors are not limited to the penalties/rewards through annual revenues.*

For example, reputational incentives may translate into financial incentives, depending on ownership and corporate objectives. Many listed firms pursue ‘triple bottom line objectives’ because they believe it is both the right thing to do and that it is good for shareholder value and long term returns. ... Government-owned firms do not face the same financial incentives (through market value) but avoidance of adverse public comment may be more important for a government-owned business.”

We wish to reiterate that there is a range of benefits to network businesses as well as consumers from expedient resolution of regulated matters.

The AER’s draft decision, which is to accept Essential Energy’s proposed revenue for 2014-19, enhances goodwill and strengthens the social licence to operate which is a further benefit for consumers.

In a similar manner, the improved trust of Essential Energy that we have observed from consumer advocacy groups is also a consumer benefit, and bodes well for an efficient and quicker resolution of the 2019-24 revenue proposal.

2.3.7. NEO Achieved

Compared to the original AER decision for 2014-19, the draft decision allows for an extra \$100m in revenue to be collected by Essential Energy. The consumer benefit from this regulatory bargain includes:

- 35% reduction in the distribution component of bills being paid between the first and last year of the 2014-19 period
- 25% reduction in total revenue for 2014-19, compared to 2009-14
- maintenance costs reduced by 33 per cent
- total overheads reduced by 38 per cent
- emergency services costs reduced by 37 per cent
- the above savings carried forward into 2019-24
- more stable pricing
- improved efficiency of the Essential network
- improved goodwill

A dollar value for these benefits has not been calculated, but we conservatively estimate the total saving for consumers for the remade 2014-19 decision to be well over a billion dollars compared to the initial proposal; savings that will be retained for future periods

In summary, we agree with AER's analysis:

"... our view is that the \$100 million, as part of Essential Energy's overall proposal, which incorporates significant cost reductions in opex to date, will contribute to price stability for its consumers and result in an outcome that is likely to contribute to the achievement of the NEO to the greatest degree."

Regulatory judgment has been carefully exercised and has involved assessing the decision as a whole in unique circumstances, with the National Energy Objective being achieved.

Section 3. Concluding Observations

In our letter to the AER regarding our initial thoughts about the Essential Energy proposal to finalise the 2014-19 decision, we made the following statement that we think is worth repeating.

"Finally, we laud the clarity and brevity of the Essential 2014-19 revenue allowance remittal proposal. We commend Essential for showing leadership in the resolution of the 2014-19 revenue determinations. Consumers were not well served by the regulatory impasse between the AER and the NSW/ACT businesses around the 2014-19 determinations."

CCP10 supports the AER's draft decision for the remitted Essential Energy 2014-19 revenue allowance.