Consumer
Challenge
Panel

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Dear Sebastian

Endeavour Energy 19-24 draft revenue allowance proposal

On 30 August 2018 Andrew Schille, General Manager Regulation & Corporate Affairs of Endeavour Energy (Endeavour), wrote to you proposing that Endeavour's 2019-24 capex forecast be reduced from $2.16 billion to $1.7 billion for its 2019-24 revenue proposal. This being among other changes to its initial revenue proposal that was lodged with the AER on 30th April 2018.

CCP10 commends Endeavour for its attempts to resolve the issues raised by customers about its capex proposal. We agree with Endeavour that it is preferable to progress these issues now and not to leave them unresolved until after the AER's Draft decision, consequently we support the reduction in capex proposed by Endeavour Energy for 2019-21, while noting that it is at the 'upper end' of our cost expectations.

Endeavour has actively engaged with consumer groups including ECA, PIAC and ourselves about the 30 August 2018 proposal and the changes to its initial revenue proposal. Whilst the timing has not been ideal, CCP10 commends Endeavour for the revision of its proposal and it's openness to constructively consider consumer feedback, some of which has been 'robust.'

Context for revised proposal

Given that the proposal has been presented as the most recent development in a lengthy process that has included remaking aspects of the 2014-19 regulatory decision and engagement on a number of aspects of the 2019-24 proposal, we think that there is value in recapping some of the context for this revised proposal.

In our comments at the AER's Public Forum on 3 July 2018 and in our written submission to the AER's Issues Paper dated 8 August 2018, CCP10 was critical of aspects of Endeavour's initial 2019-24 revenue proposal for several reasons including its change to the capital contributions policy, the very high capex proposal, the high labour growth forecasts, the lack of a trend opex productivity improvement and Endeavour's refusal to accept the 2018 WACC Guideline being applicable to its 2019-24 revenue proposal. We concluded that its draft revenue proposal was not capable of acceptance and that it did not reflect the feedback that Endeavour had received from consumer groups during extensive engagement on the Proposal, including from the "deep dive" sessions that were conducted during the additional time that the AER approved, to allow for further consumer engagement (31st January 2018 to 30th April 2018). This is acknowledged by Endeavour in its letter of 30 August.

In our written submission to the AER dated 8 August 2018 we made the following specific comments:

- On capex: *"Despite the strong case for investment to meet the energy demands of new residential and commercial development in the Endeavour area, CCP10 is strongly of the opinion that Endeavour Energy has not made a reasonable case in justifying this significant increase in expenditure above that required for the current period. We believe there is a strong case for significantly reduced investment, even to the order of 20%, as a result of addressing the opportunities noted in this report. We believe such reductions in investment will have only minimal impact on the performance of the network and delivery of services."*

- On capital contributions: *"On that basis, the justification for the change in the contributions policy and the demonstration that the connections process in Endeavour is becoming more efficient is rejected."*

- On DM initiatives: "*For NSW distribution businesses, the proportion of DMIA underspent is significant as shown in chart 12*.*"*

- On overheads: "*As with operating costs, we would expect to see ongoing productivity benefits reducing the 'back-office' costs and overheads, especially after the significant IT spend ($31M, 34%) overspend in 2014-19." And ....."These figures show that overheads are a very large proportion of opex, particularly for Endeavour Energy. We suggest that it is reasonable for consumers to expect reductions in* *overheads over time because of expectations of ongoing efficiency improvements and the business objectives of improving affordability or maintaining service standards.*"

- On IT investment: "*We see investment in information technology as requiring a clear positive impact on business efficiency, capability, compliance or service to customers. It is difficult to identify a poor IT investment, as its replacement or remediation is buried deep in terms such as 'upgrade', 'compliance' or 'refresh'*...and "*In the current 2014-19 period, Endeavour plan to overspend the allowance of $90M for IT expenditure by 34%."*

- On step changes: "*The meaning of this seems uncertain but appears to imply that Endeavour may seek to significantly change its approach to step changes during the course of the review. However, the costs listed clearly do not meet the requirements for acceptance as step changes. They are vaguely specified and costed without supporting information. While Endeavour has stated that it is "absorbing all step changes as a productivity improvement" (Proposal, p176) this equates to only 0.7% of opex over 2019-24*."

- On increased wages and salaries: "*Endeavour Energy is projecting a significantly higher rate of growth in real wages than the other businesses - a cumulative increase of 12% over the 6 years to 2023-24 real wages and salaries compared to 8% and 7% for Ausgrid and Essential, respectively. Furthermore, neither Endeavour nor Ausgrid offset rising wages with assumed productivity improvements*."

- On opex productivity: "*Aside from the fundamental high-level perspective CCP10 believes a trend productivity assumption can be supported by:*

    1. *a closer examination of the data available to the AER on productivity trends,*
    2. *reference to broader economy-wide trends, and*
    3. *inclusion of the expectation that businesses will seek productivity offsets in negotiating real wage increases."*

- On EBSS: "*CCP10 is strongly of the opinion that the expected value of EBSS should be zero and if not, positive expected value should be built into cash flows." We emphasise that the EBSS was intended to equalise incentives over time and not to create bonuses for utilities. We* *are concerned that "soft" assumptions on productivity mean that the expected value for EBSS is positive, not zero and consequently inconsistent with the long term interests of consumers*."

- On WACC: "*Endeavour has used the current approach and parameter values while arguing against application of the 2018 guideline*."

We also referred to the fact that Endeavour was continuing to engage with its customers in the following statement:

> "*The Endeavour Energy 30th April 2018 proposal is not capable of being accepted. We recognise that discussion and some engagement has occurred since the proposal was lodged and since the public forum that is likely to bring the proposal closer to being able to be accepted, from a consumer perspective*."

The following comments summarise our perspective on the current status concerning issues of most interest to CCP10 relating to Endeavour Energy's 2019-24 regulatory proposal.

1. **Capex**

CCP10 believes that the amended $1.7 billion capex forecast in the 30 August 2018 Proposal (the Endeavour Proposal) has:

- made a fair case supporting growth rates, and tempered the speculative 'out years'
- reasonably explained the fact that augex is 'more expensive' per unit as fringe capacity is used up
- accepted increased risk in moderating repex triggers
- held non-system expenses (including IT) at relatively low rates
- maintained stable network performance and operational indicators
- not articulated their approach to reducing unit costs in augmentation and
- been able to use rapid growth in customer numbers to drive falling 'per customer' indicators.

Overall, whilst being at the 'upper end' of our cost expectations, we believe the amended Endeavour Proposal sets out an acceptable case for capital investment at $1.7 billion and has responded constructively to consumer input.

2. **Capital contributions**

Endeavour has listened to consumers and has reversed its policy so that it will maintain higher developer contribution rates. CCP10 supports this change being effective from 1 January 2019 rather than 1 July 2019. This was an issue that was very strongly argued by all customer representatives other than developers.

3. **DM initiatives**

CCP10 is disappointed that Endeavour has significantly underspent its DMIA in the current period. We also believe that the 2019-24 proposal remains an unrealised opportunity for Endeavour to be at the forefront nationally on initiatives related to demand management and efficient energy developments and in a higher growth environment than other Australian electricity distribution networks.

We are aware that Endeavour has made some effort to make their DAPR more accessible and informative, going some way to supporting DR interest and CCP10 supports this initiative.

4. **Overheads**

We agree with Endeavour’s observation that some stakeholders will have differing views about how the $1.7billion should be allocated to projects and categories. CCP10 is concerned that Table 1 in Endeavour’s amended proposal continues to have capitalised overheads constant at $400m. We believe that this is a missed opportunity to more aggressively reduce overheads and back office costs.

5. **IT investment**

The IT investment proposed by Endeavour is not the highest among the NSW distributors. However we remain of the view that Endeavour’s IT expenditure does not fully capitalise the benefits of their additional expenditure in IT from 14 – 19. Further we believe that IT expenditure should support opex productivity.

6. **Step changes**

Endeavour has identified costs totalling $9.5 m per annum that it did not propose as step changes. We welcome Endeavour’s commitment not to include any step changes in its proposal. However, CCP10 rejects Endeavour’s claim that this exclusion represents an implied productivity factor of 1% per annum. We doubt that many of the step changes identified would meet the requirements for a step change; i.e. they would not warrant treatment as new, significant, exogenously imposed costs that are beyond the purview of standard business operating costs.

7. **Increased wages and salaries**

CCP16 has separately welcomed Endeavour’s advice in its proposal that it will revise its wages proposal to be consistent with the AER’s wages parameter estimates, these views align with those of CCP10.

8. **Opex productivity**

CCP10 welcomes the recent AER announcement of a review into their approach to forecasting operating expenditure productivity growth. As other networks such as Essential, EQ and TasNetworks have shown, productivity improvements are consistent with an incentive base regulatory structure. Economic regulation is designed to replicate what would be the outcome in a workably competitive market. A workably competitive market requires firms to continually improve productivity or else there is a high risk they will go out of business. The efficiency frontier is continually moving out. We consider that requiring electricity networks to also achieve productivity improvements is not an unreasonable regulatory requirement. CCP10 notes that the results of the AER's opex review will apply to the Endeavour 19-24 revenue determination. We note also Endeavour's support for the AER's detailed opex review. CCP10 expects the AER's draft decision to include a placeholder for the results of the productivity review.

CCP10 does however take issue with Endeavour's assertion in the amended Endeavour Proposal that its "*forecasts already include explicit efficiencies*." We anticipate the AER and stakeholders will respond to these claims as part of the upcoming productivity review. We offer the following initial observations about the examples referred to by Endeavour:

- "*The opex cost to serve customers is approximately $30 lower in the forecast period than it is in the current period*." However this reflects opex gains in the current regulatory period and not opex gains in 2019-24.

- "*Our decision to exclude positive step changes is effectively an implied productivity factor of 1 per cent per annum)".* As discussed above; first we do not accept that all the expenses cited would meet the threshold to be categorised as a step change. Secondly, the estimated costs are untested. Before accepting the claim the estimated costs would need to be tested. Third, the estimates are in nominal terms with no time profile. To compare the estimates to forecasts of real opex we need a time profile to deflate them. Finally the "step changes" do not amount to the amount claimed.

- "*Our decision to not escalate materials and fuel costs in our opex forecast is a forecast efficiency*." However Endeavour has increased these costs in line with inflation. Neither they nor other DNSPs who use this common assumption have previously argued that this reflects anything other than expected increases in unit costs.

- "*Our decision to retain our opex forecast whilst at the same time reducing our capital forecast and absorbing any opex costs increases*". In response to this we observe to the extent that:
  1. the asset base is growing to reflect growth in customers and demand, this is reflected in the specific adjustments in opex for growth in sales/customers and
  2. the RAB is growing due to repex (replacement of old

assets with new assets) there is no basis for assuming opex should increase - indeed if the average age of assets is coming down or asset quality is improving opex should reduce.

• "*Our decision to accept the AER's real labour forecast (using AER's historic method) also represents an efficiency forecast*." This is incorrect and the AER has confirmed that the AER's approach to real labour costs **does not include** within it assumed labour productivity improvements separate from the assumption on trend productivity improvements and so this statement is incorrect.

9. EBSS

CCP10 supports the ongoing application of the EBSS to Endeavour provided that the opex forecast includes ongoing productivity. We note that this issue will also be resolved as part of the AER's productivity review, and reflects constructive application of EBSS by Endeavour

10. WACC

CCP10 welcomes Endeavour's commitment to accept the prevailing Rate of return Guideline and expects the AER's draft decision to include a WACC calculated in accordance with the AER's draft 2018 Guideline.

Conclusion

CCP10 commends Endeavour for its efforts to resolve the issues raised by customers about its capex proposal. We agree with Endeavour that it is preferable to progress these issues now and not to leave them unresolved until after the AER's Draft decision.

As we have set out above, capex is not the only area where CCP10 has concerns with Endeavour's initial 2019-24 proposal. However, we believe that the amended $1.7 billion forecast is more likely to be capable of acceptance as being in the long-term interests of consumers.

CCP10 can confirm that we have made relevant checks to ensure that to the best of our knowledge, this document does not contain any confidential material or material that is commercial in confidence. This document can be published on the AER website.

Yours sincerely

Louise Benjamin, Eric Groom, Mark Henley and Mike Swanston.