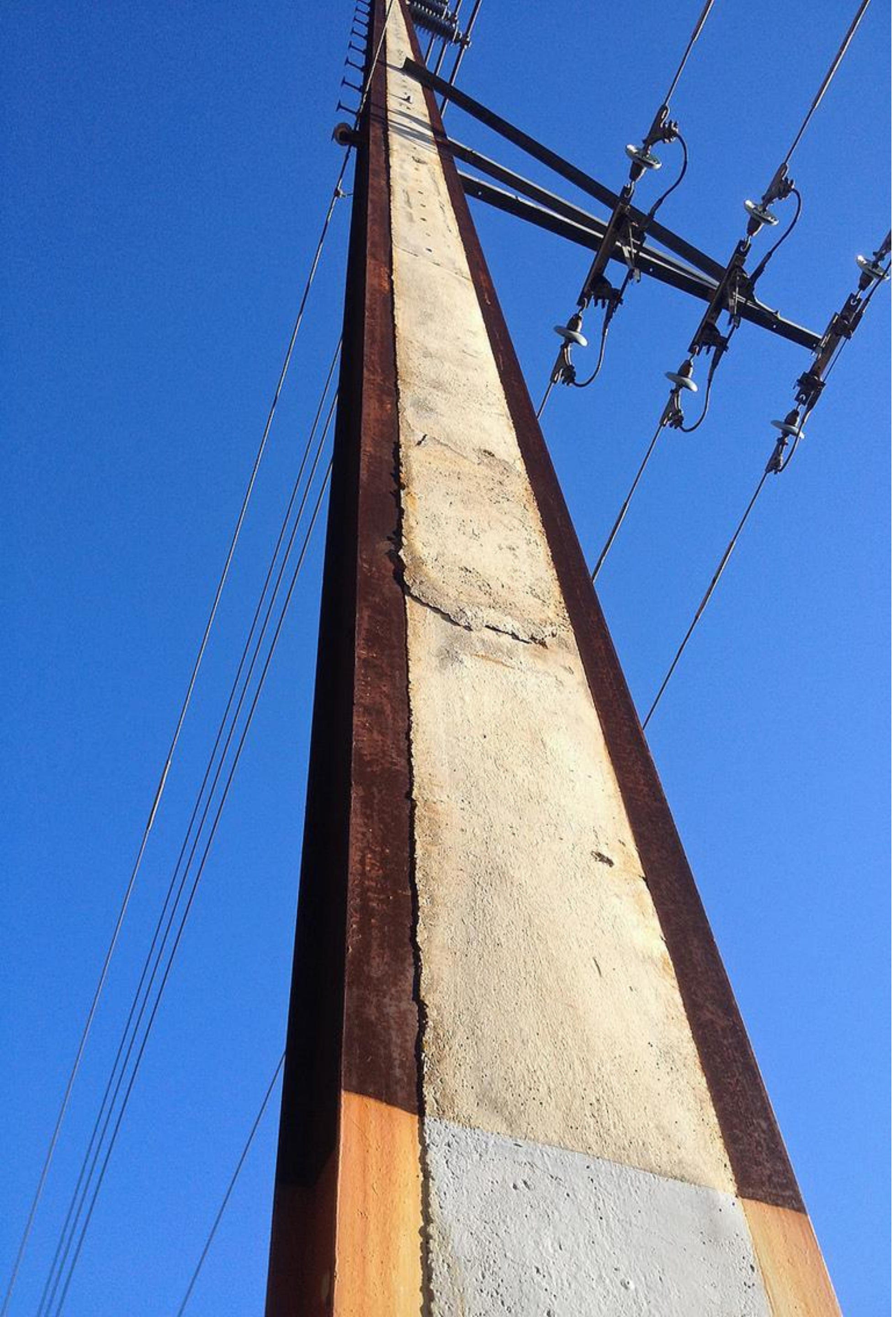


Consumer
Challenge
Panel

SA Power Networks
2020-25 Distribution Determination

AER Public Forum

Consumer Challenge Panel

30 October 2019

CCP14
Mark Grenning
Mike Swanston

http://cakecrushonthetown.blogspot.com/2017/09/stobie-poles-with-adelaide-matt.html

Our role as a Consumer Challenge Panel…

- We advise the AER on:
  i. Whether the network businesses’ proposals are in the long-term interests of consumers, *and*
  ii. The effectiveness of network businesses’ engagement activities with their customers –
      i. who, how, when and what issues EQ engaged with its customers on,
      ii. how this engagement has influenced the revenue proposal,
      iii. do consumers agree with the revenue proposal, and
      iv. is there a process for ongoing review of CE/continuous improvement
- We consider this role in the context of the National Electricity Objective (NEO)
- Emphasis on “challenge” to both the network and the AER
- Aim of getting to a proposal that is “capable of acceptance”

The AER is guided by the NEO

National Energy Objective (NEO):

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

Therefore, we consider:

- How prudent and efficient is proposed capex/opex expenditure?
- How will costs be allocated to different consumer groups?
- How does the proposal reflect the changing electricity market and long-term issues?

CCP scope in the AER building blocks

The 'in scope' capex/opex items account for ~ 35-40% of SAPN's proposed revenue

In scope	Out of scope
✓ Proposed capex in period	✘ Rate of return – AER binding guideline in December 2018
✓ Proposed opex in period	✘ Opex productivity – AER decision March 2019 for 0.5%/yr
✓ Application of incentive schemes	✘ Taxation allowance – AER decision in December 2018 (*but we do comment here because of SAPN's late submission*)
✓ Tariff Structure Statement	✘ Regulatory depreciation
✓ Consumer engagement	

Consumer Challenge Panel

What we will cover today

1. Some opening comments on the Draft Decision
2. Revenue and prices
   I. How the Draft Decision differs from SAPN's Reg Proposals
   II. The importance of a lower WACC to the outcome
   III. SAPN efficiency over time
3. Taxation
4. Operating Expenditure (Opex)
5. Customer Engagement
6. Capital expenditure (Capex)
7. Looking forward
   I. Our expectations for the revised proposal
   II. Broader issues for the future

Some opening comments

1. Agree with the Draft Decision
2. Even with the AER reductions in capex and opex, it is factors outside of SAPN’s control – particularly lower WACC - that are driving the price outcomes
3. Without these external factors - especially WACC - SAPN’s prices would have increased in 2020-25
4. Low WACCs are the nature of a long term investment – the cycle of returns which consumers also face
5. It brings more focus on drivers of price that are within SAPN’s control - control of opex and capex to ensure that it is prudent and efficient
6. We remain unconvinced by SAPN’s argument that “there is no room for improvement”
7. What is SAPN doing to prepare for the inevitable change in the interest rate cycle in the future?
8. Now up to SAPN to provide the evidence the AER requires to justify additional capex and opex expenditure; “the fish that John West rejects?
9. Strong consumer engagement, but was the affordability message heard?

Revenue and prices
Taxation
Opex

Draft Decision compared to the proposal

Real $2020	Current 2015-20	Forecast Period 2020-25			Draft Decision % Change	
	Forecast	Draft Plan August 18	Reg Proposal Jan 19	AER Draft Decision	From current period	From Jan 2019 Reg Proposal
Total Revenue	3,882	3,893	3,915	3,630	-6%	-7%
Capex (excl equity raising costs and net of contributions and disposals)	1,682	1,836	1,720	1,247	-26%	-27%
Opex (exc Debt Raising Costs)	1,315	1,468	1,530	1,466	11%	-4%
RAB (at end of period)	4,393	4,641	4,478	4,039	-8%	-10%
Nominal WACC %	6.15%	5.55%	5.43%	4.70%		

Data supplied by SAPN

From our April Forum presentation –

SAPN's proposed price falls are due to AER WACC and tax decisions and not SAPN's actions to reduce opex and capex

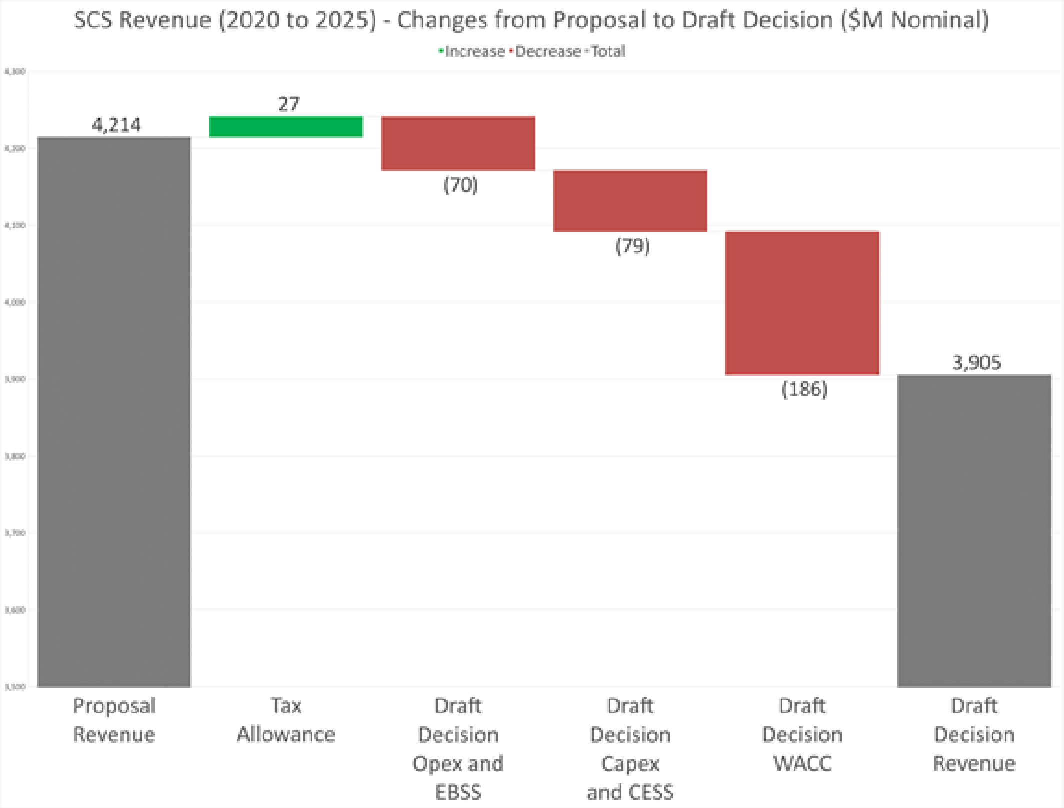
Nominal Price change on 1 July 2020 (per customer)	Residential		Small to medium business (20 MWh/pa)	
As proposed	- $40	- 7%	- $111	- 5%
Adopting 2015-20 WACC parameters, RfR and tax allowance methodology	+ $11	+ 2%	+ $75	+ 4%

Nominal Price increase on 1 July 2024 from 30 June 2020 (per customer)	Residential		Small to medium business (20 MWh/pa)	
As proposed	- $5	- 1%	+ $49	+ 2%
Adopting 2015-20 WACC parameters, RfR and tax allowance methodology	+ $49	+ 8%	+ $250	+ 12%

Data supplied by SAPN

Without these external influences, prices would have increased

Draft Decision shows continued dominance of these external influences that prevent price increases



- Over half the reduction in revenue in the DD was WACC/opex productivity related
- The DD has only strengthened our conclusion from April that without these external influences – WACC, opex productivity and tax – SAPN prices would have increased even with the DD reduction in capex and opex (excl 0.5%)
- And SAPN will no doubt seek a reduction in those cuts in its revised proposal

Graph supplied by SAPN

An example of the impact of WACC on DMOs

	Total Bill 2020-21 to 2024-25		Annual impact on customer bill	
	SAPN proposed WACC - 5.43%	Draft Decision WACC (av 4.70%)	SAPN proposed WACC (5.43%)	Draft Decision WACC (av 4.7%)
Residential	$2,648	$2,460	+ 0.1%	- 0.6%
Small business	$11,800	$10,963	+ 0.1%	- 0.5%

Data supplied by SAPN

Some comments on WACC – AFR 9 October 2019

Spark: revenue cap will stifle investment

James Fernyhough

Spark Infrastructure has claimed it will not be able to invest sufficiently in its South Australian electricity network assets after the Australian Energy Regulator refused to grant SA Power Networks its requested maximum revenue.

On Tuesday the AER refused to grant SA Power Networks, which is 49 per cent owned by Spark, the full $4215 million it had requested to charge customers between 2020 and 2025.

Instead it set the upper limit at $3905 million, more than $300 million below the requested limit. The AER's decision is provisional, with a final call due on April 30, 2020.

The decision provided for a weighted average cost of capital of 4.95 per cent, which incorporates a regulated equity return of 4.98 per cent.

Spark insisted this was insufficient not just for its own network, but for all electricity networks.

Spark managing director Rick Francis said it was disappointing that the AER had "not acted on the clear message it has received from the investment community in relation to the market's rate of return expectations".

"In our view, the rate of return is insufficient to ensure the long-term sustainability and reliability of Australia's electricity infrastructure," he said.

"This jeopardises achievement of Australia's environment and energy policy objectives. Our country needs critical investment in networks to facilitate the economy's efficient transition to a renewable future, and the integration of distributed energy resources enabling consumer choice and delivering the lowest-cost system."

In August, Mr Francis said current regulated equity returns were making it unviable to invest in other networks including the NSW-South Australian electricity interconnector, which would be built by another one of Spark's part-owned companies, Transgrid. He said it would also affect upgrades being considered to Queensland and Victoria.

"I'd love to invest but my investors tell me I need to achieve a certain return on their capital and I'm just a custodian of that capital," Mr Francis said at the time.

"There is an economic reality that we have to live in. When the Treasurer runs around and says we want people to invest and reinvest, absolutely we are there. But we need the investment climate and the policy settings that enable that investment," he said.

The NSW-South Australia interconnector would protect the renewables-heavy South Australian network from periods when neither solar nor wind provide sufficient power with easier access to NSW's coal-generated electricity, while giving NSW easier access to South Australia's renewable energy when supply is plentiful.

Explaining its decision not to grant SA Power Networks the full amount, the AER said: "This draft decision finds a significant difference between what SA Power Networks proposes and what we consider efficient spending on capex, especially regarding the need for future investment.

"Our decision to allow SA Power Networks lower amounts of money to spend in this regard reflects what we consider a reasonable forecast of the spending required to deliver safe and reliable electricity services over the next five years.

"SA Power Networks has provided some justification and supporting evidence for its proposed capex investment. However, there are gaps in this information which prevent us from supporting its proposal," the regulator said.

• Matthew Stevens Analysis p26

I'd love to invest but my investors tell me I need to achieve a certain return on their capital and I'm just a custodian of that capital.

Rick Francis (above), Spark managing director

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But investment in networks is a long-term story

SAPN historical WACC

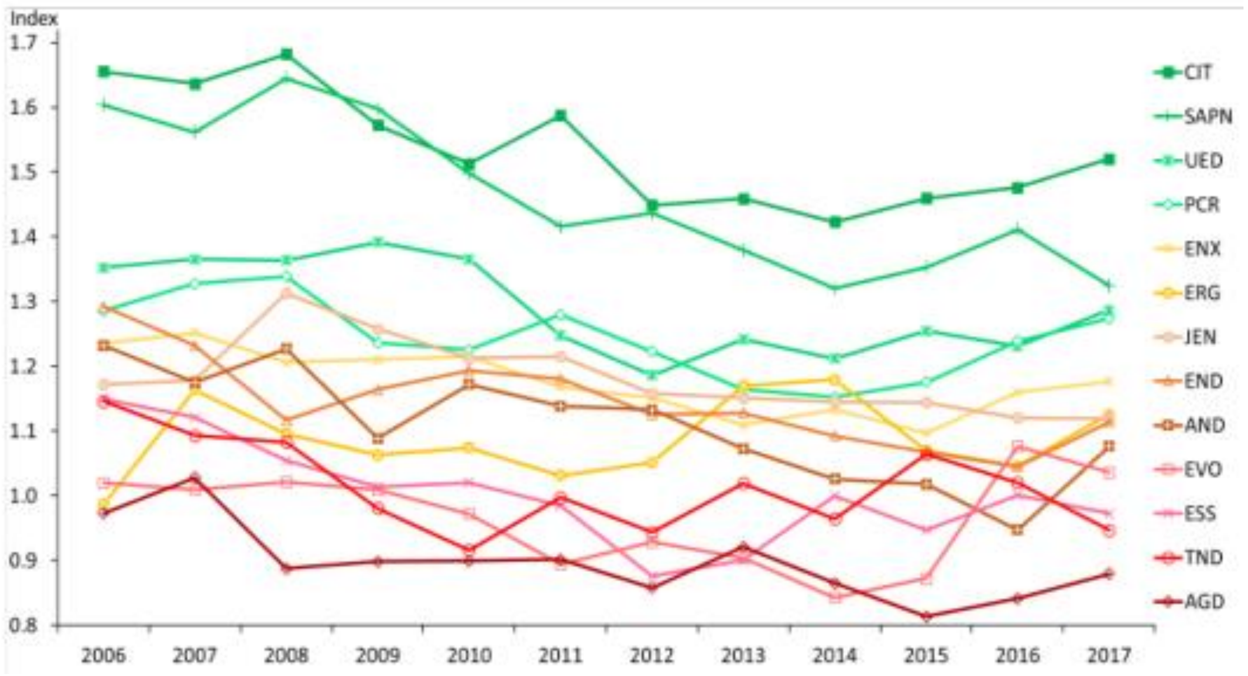
2005-10	8.90%
2010-15	9.76%
2015-16	5.28%
2016-17	5.31%
2017-18	5.29%
2018-19	5.22%
2019-20	5.14%
Draft Decision 2020-25	4.95%

Data supplied by AER

- Electricity consumers also have expectations about higher returns but they now have to accept 1.25% on their 5 year term deposit
- Key foundation of the 'regulatory contract' between consumers, networks and the regulator is networks' acceptance of WACC cycles is part of the price they pay for consumers bearing stranded asset risk
- But if the WACC is too low (and it is likely to go lower by April 2020) why does SAPN want more capex?
  - Yes it has regulatory/license obligations
  - So debate is around the prudent and efficient level of expenditure

SAPN is relatively good but is that good enough? – multi-factor productivity

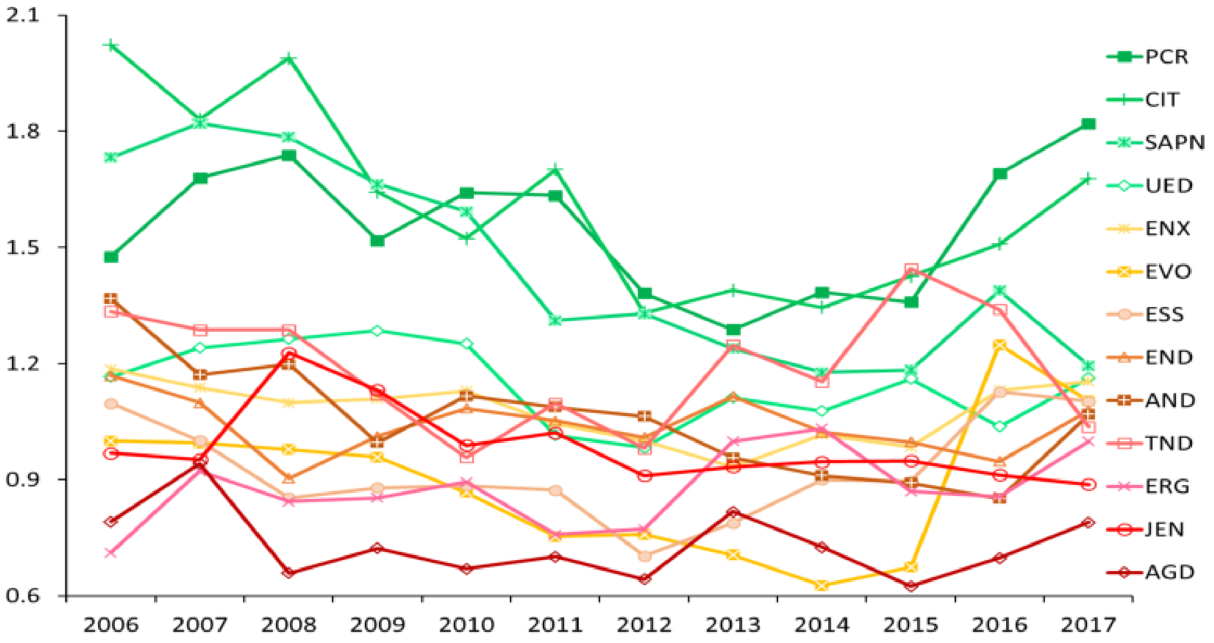
Figure 3 Multilateral total factor productivity by individual DNSP, 2006–17



- SAPN argues that because it perform well on AER benchmarking measures that there is little or no scope for productivity improvement
- Not the case in a workably competitive market – standing still can mean going out the back door
- SAPN in long term decline in total factor productivity
- Look forward to seeing 2018 results next month

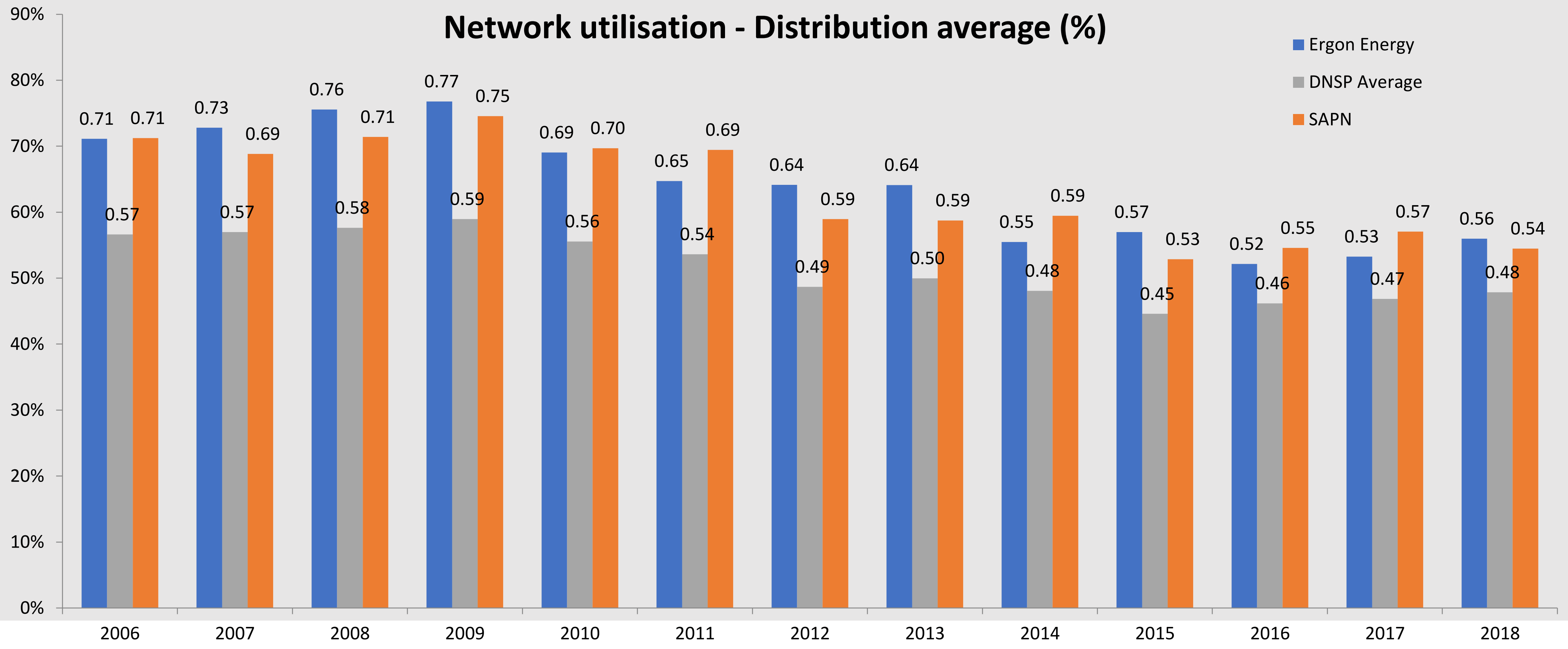
SAPN is relatively good but is that good enough? – opex productivity

Figure 4.3 DNSP opex multilateral partial factor productivity indexes, 2006–17



- Again for opex, SAPN's productivity has been in long run decline
- Yes there are reasons eg veg management, extreme weather, GSL payments DER etc
- Yes despite this decline it is still "realtively" efficient, but efficiency should be an absolute not a relative concept
- Previous CCP commentary recommending the AER review the current 0.75 benchmark for the "not materially inefficient" opex – all networks can get to that, so it loses its relevance

Asset utilisation has fallen over time



Taxation

- Agree with the AER's Draft Decision – application of the tax review
  - Allow immediate expensing for some capex; SL for existing assets and DV for most assets after 30 June 2020
  - $154m under old method becomes $38m under new method
- Significant source of above WACC returns for SAPN in current and previous period as Benchmark Efficient Entity tax allowance based on no immediate expensing - fine in an incentive regulation framework
- Now the Benchmark Efficient Entity for 2020-25 has immediate expensing - but SAPN wants to decrease the opening Tax Asset Base to reflect past immediate expensing – and increase the tax allowance from $38m to $53m
- AER correctly rejected this attempt at double dipping from consumers
  - Consumers want the benefits of paying more in the past
  - Decision reflects efficient costs of the BEE – and NEO
- We understand there has been no formal consultation with the SAPN CCP on this matter – we support it occurring

SAPN Opex

1. This was an issue we highlighted in the April Forum
2. SAPN have acknowledged the 0.5% productivity improvement
3. We agree with the AER's alternative estimate driven by its analysis of the step and trend components
   - that is an application of the their standard approaches for the various components and concluded step change costs were over estimated
4. We are pleased to see that the AER has moved away from the previous practice of forecasting real unit labour costs as the average of the AER and network forecasts to simply the more historically accurate AER Deloitte forecast

Capital investment and customer engagement

Customer and stakeholder engagement

- Engagement sessions were very well run, with excellent documentation and received positively by stakeholders.
- SA Power Networks began an extensive consumer engagement in early 2017 and learnt the following key customer expectations:
  - *Keeping prices down;*
  - *A safe and reliable network; and*
  - *Transitioning to a new energy future*

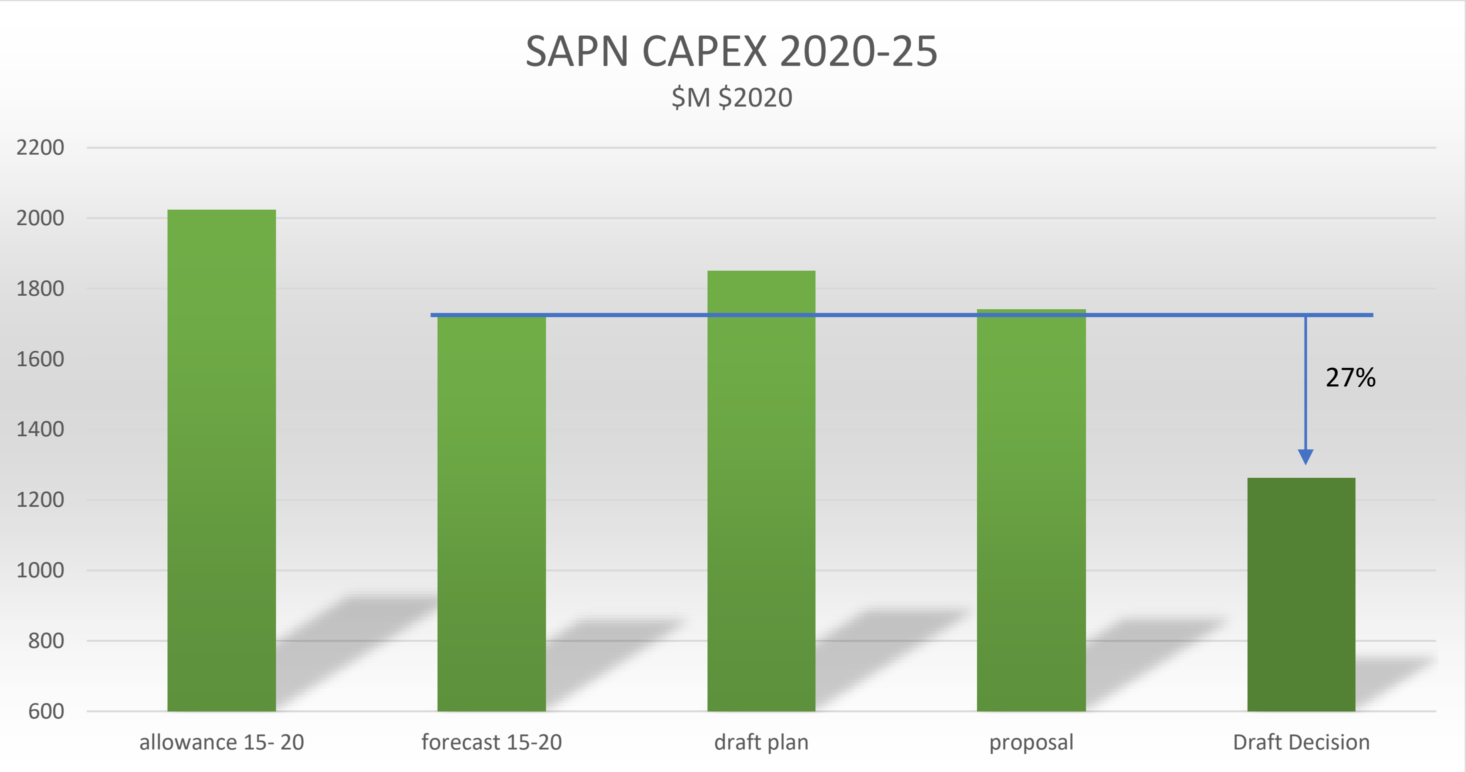
But …

- Based on its observations of consumer feedback, CCP14 believes that this 'steady as she goes' approach is no longer what consumers are expecting. While it is likely to maintain current service levels and performance, it does not adequately reflect the changing view of customers who are demanding lower energy prices underpinned by a trust that the utility is *doing everything in its power to perform more efficiently, find new ways of managing risk and to 'work with less'* wherever reasonably possible.
- Savings focus supported by CCP14, ECA, SA Government

Capital investment allowances (CAPEX)

Reductions in the Draft Dec:

- Replacement -20.2%
- DER – 30%
- Augmentation -29%
- ICT – 31%
- Fleet -32%
- Other non-network -28%

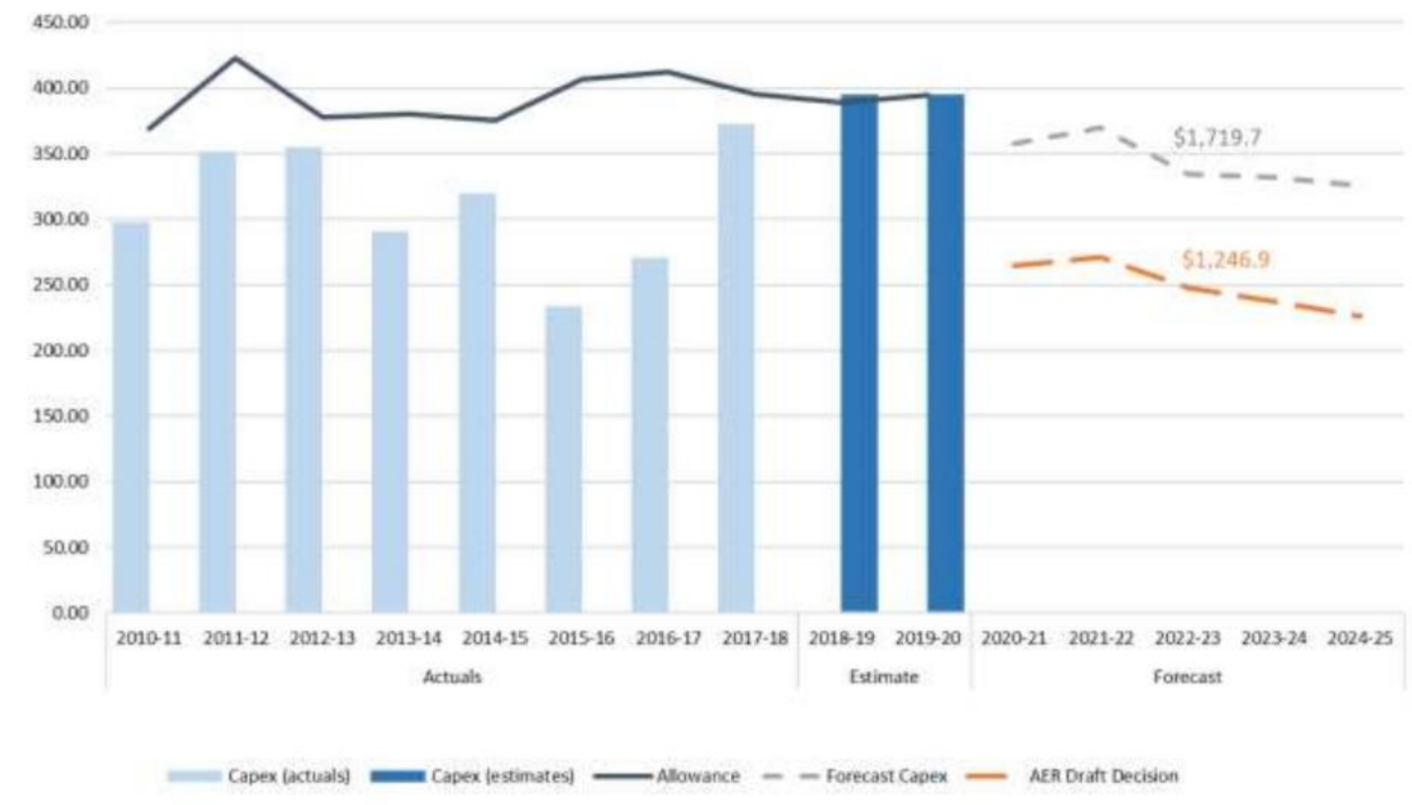


Capital investment allowances (CAPEX)

SAPN has a history of under-spending capex:

- Lower demand growth
- Delaying asset replacement
- Storm events diverted resources

Figure 5.1 SA Power Networks' historical vs forecast capex snapshot ($ million, 2019–20)



CCP's response to the SAPN CAPEX

A 'missed opportunity' to demonstrate restraint, cost awareness and innovation

- Network performance did not support increased spend
- Replacement was generally supported, despite history of under-expenditure
- Augmentation – expected reductions
- Connections – reduced in line with less augmentation
- DER – show consolidated actions and costs
- ICT – looking for demonstrated benefits and restraint
- Other non-network – justification not clear, looking for innovative solutions

CCP's response to the SAPN CAPEX

A 'missed opportunity' to demonstrate restraint, cost awareness and innovation

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- ✓ Replacement was generally supported, despite history of under-expenditure
- ✓ Augmentation – expected reductions
- ✓ Connections – reduced in line with less augmentation
- ✓ DER – show consolidated actions and costs
- ✓ ICT – looking for <u>demonstrated</u> benefits and restraint
- ✓ Other non-network – justification not clear, looking for innovative solutions

Capex: Items for the revised proposal

- We acknowledge the 'door is still open' for SAPN to provide more supporting information re capex, but will this result in change ?
- Note that SAPN has commenced an engagement process on matters to be challenged, including: ICT, fleet, property, ADMS, repex
- We accept that ICT and DER spend is important, however the return on the investment in real terms must be more explicit
- ICT – is there a real commitment for restraint ?
- ICT – risk; a clear linkage to the Business Continuity Plans
- DER – the case for LV monitoring to include 3rd party solutions
- A top-down and bottom-up reconciliation will be helpful

Tariff Structure has been accepted

- SAPN to be commended on its tariff proposal and extensive modelling
- Key components:
  - Some increase in fixed ‘supply’ charges
  - Remove the IBT for customers with accumulation meters
  - ToU tariff for customers with interval meters – including ‘solar sponge’
  - New ‘prosumer’ demand tariff (5 – 9pm, November to March)
  - New ToU for small business
- An issue for consumers in the current period was the unexpected increase in prices in the last couple of years given the lower than expected energy consumption
  - Reflecting consumers accepting consumption risk in revenue cap regulation
  - This is expected to be less of an issue in 2020-25 given the greater component of fixed/demand/energy charge in consumers’ prices

- Emerging issues:
  - The extent retailers will pass on reductions in network charges
  - Who will show leadership in supporting tariff change, communication and information ?
  - Are the retailer needs paramount in the rollout of smart meters ?

Next steps

Next steps and consumer engagement

- We trust that SAPN will continue to engage with customers on any proposed changes or challenges to the draft determination – initial indications are encouraging.
- SAPN to submit final proposal in December
- Submissions due 15 January 2020
- CCP will be making a submission and we encourage consumer advocates to do likewise

Broader issues for the future

- We look forward to the day when the AER does not have to 'repeat' the significant level of detailed analysis of individual projects
- Invite the AER to consider a review of the contingent project definition
  - developed at a time when issue was how to meet increased demand
  - now an issue of uncertainty around capex in a falling/flat grid demand world and DER
  - Some alignment with the RiT-T thresholds?
- DER expenditure is moderate, accepted by AER, but an efficient response to *Intelligent Grid Enablement* will require a broader approach by utilities and the AER. We look forward to AER DER paper.
- Determination to provide greater clarity of P0 and network cost reductions
- An ageing pole population strategy will eventually need consideration outside 5 year 'slices'
- Re CESS calculation – AER bound by rules to accept a utility's proposal – but were projects just delayed? So a wider review of EBSS/CESS guidelines may be warranted ?
- Review of opex "not materially inefficient" methodology around the 0.75 trigger point

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