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Mr Warwick Anderson
General Manager
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Dear Mr Anderson

Submission to Australian Energy Regulatory – Determination of allowable revenue for NSW electricity distribution networks

EnergyAustralia welcomes the opportunity to contribute to the Australian Energy Regulator's consultation process for the determination of allowable network revenue for the three electricity distribution networks in NSW (the businesses).

EnergyAustralia is one of Australia's largest energy companies, providing gas and electricity to over 2.6million households and business customers in NSW, Victoria, Queensland, South Australia and the Australian Capital Territory. We supply 31.5% of NSW's retail electricity and own and operate a multi-billion dollar portfolio of energy generation and storage facilities across Australia, including coal, gas and wind assets with control of over 5,000MW of generation in the National Electricity Market.

Network prices are an important issue to households, businesses and industrial users of electricity across New South Wales. Spiraling network costs, through over-investment and inefficient operations, have driven substantial increases to electricity bills in an environment of declining demand and flat wholesale energy prices. Network driven price increases have contributed to increased cases of hardship amongst households.

We are pleased that the businesses have identified further opportunities to reduce their proposed opex and capex relative to their initial revenue proposals. This indicates a more realistic view of the future demand for network services and greater operational efficiencies, and also reflects community expectations. However, the revised proposals from each business still seek revenue that far exceeds that which the AER identified in its Draft Determinations as necessary to recover efficient costs. Furthermore, the AER concluded that the NSW businesses are inefficient relative to their counterparts in other jurisdictions.

EnergyAustralia supports initiatives to alleviate cost pressures on our customers, either through regulatory reform or in this case, through the close scrutiny of one of the most significant contributors to the final prices that our customers face. As such, we support the AER's approach to the assessment of network revenue and the consequential reduction in network tariffs in NSW.

The remainder of this submission focuses on those issues on which EnergyAustralia believes it is best placed to comment, namely:

- Why the determination of network revenues matters to our customers and therefore, why the AER's role is important.
- Relative efficiency of the NSW businesses and who should bear the cost of any transition to more efficient operations.
- Revised proposals with respect to metering charges and in particular, the three businesses' proposals for 'meter transfer fees'.

Importance of network costs to our customers

Our customers have faced substantial price rises in recent years, driven in large part by network expenditure to satisfy levels of demand that did not eventuate. The incentive to overinvest has been exacerbated by government ownership and is further driven by more stringent reliability standards in NSW than those applying in most other jurisdictions. It is not clear whether these standards reflect customers' willingness to pay for network reliability.

Tariff reform will play some part in encouraging more efficient utilisation of existing network infrastructure and future investment decisions but it is important that the AER carefully scrutinises expenditure proposals and only allows network businesses to recover efficient costs. Our customers bear the consequences of these determinations over numerous regulatory periods and decisions made now, particularly in terms of capex, influence the prices that they pay into the future.

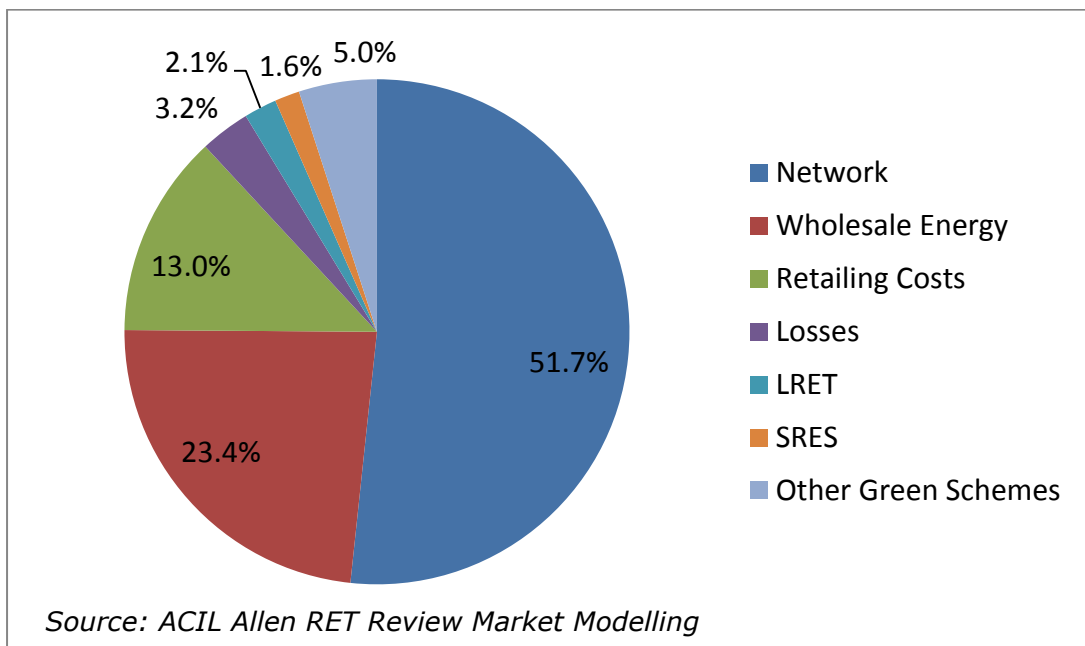
During the period from 1996/7 to 2012/3, NSW average annual electricity prices rose approximately 83%. During the same period the average annual network prices rose 122%. Network prices have been the major driver of the increase in electricity price in NSW.¹

As shown in Figure 1, total network costs account for up to 51.7% of total electricity bills. The majority of these costs are attributed to distribution networks. The actual percentage will vary but has traditionally been highest in New South Wales and Queensland. ACIL Allen forecast this percentage to increase to 56.3% by 2020². Given the high proportion of the bill attributed to network costs it is important that they are closely monitored by Governments and regulators.

¹ Ernst & Young – *Electricity Network Services: Long term trends in prices and costs*, 2014 , p.7

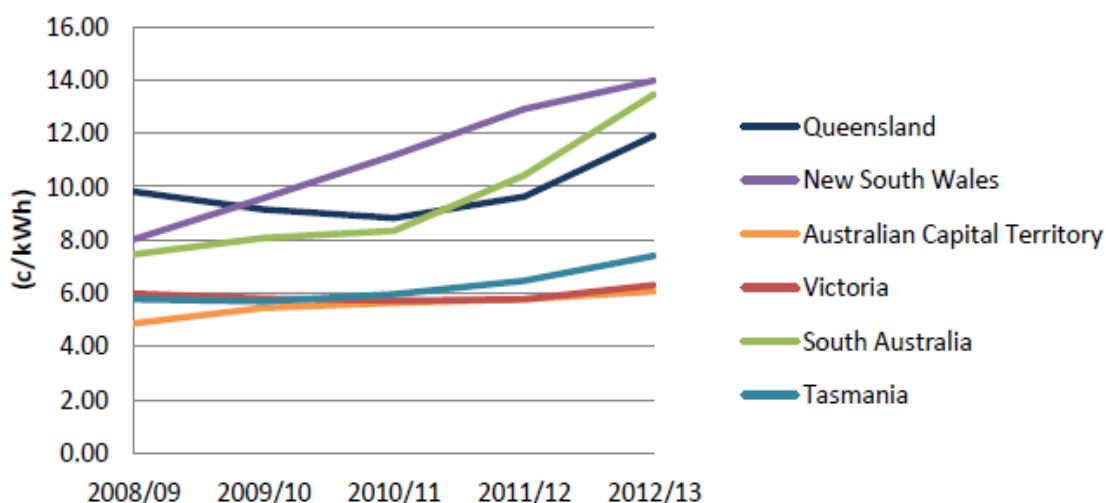
² ACIL Allen – *RET Review Modelling*, August 2014, p.24

Figure 1: Electricity Bill Breakdown 2014



Since 2008/09 average network costs have increased by 30%, which has placed increased pressure on household and business electricity bills. Retailers pass these costs on as part of the retail tariff but explaining the precise reasons for these price increases to customers is difficult due to the complexity of the energy system. Retailers also manage and bear the costs of concession programs, hardship activities and the credit risk associated with higher electricity prices.

Figure 2: Total network charges (real): 2008/09 – 2012/13

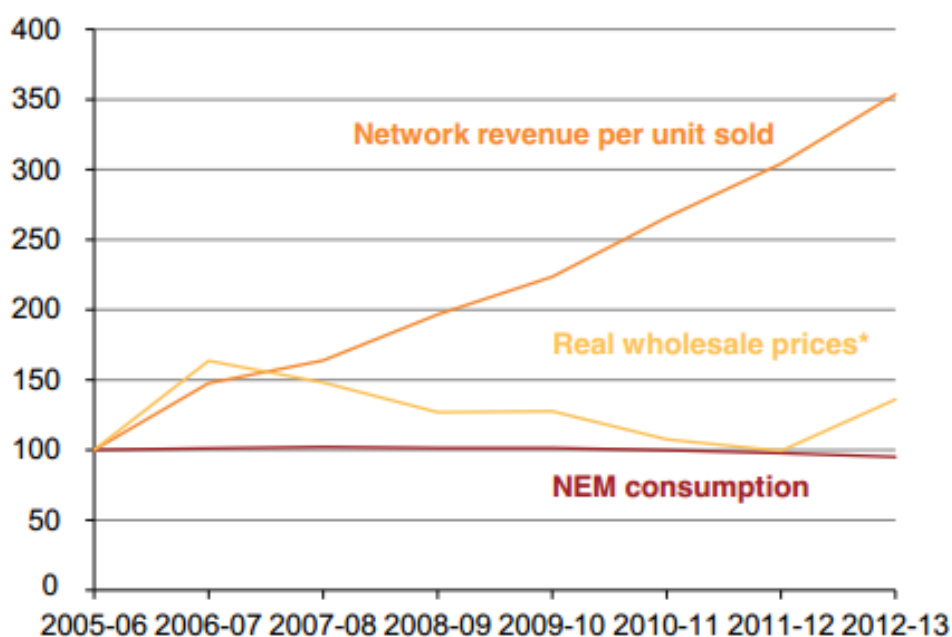


Network price increases have come at a time where there is an overall reduction in electricity demand, which is the result of reduced economic activity, increased penetration of distributed generation (such as solar PV) and consumer response to higher prices.

As shown in Figure 3, the competitive aspects of the electricity sector (i.e. generation and retail) have felt the impact of lower demand, whilst monopoly services (i.e. transmission and distribution) have continued to recover against their regulated asset base at a higher rate per unit sold.

As more and more people embrace solar PV in response to higher electricity bills fewer people are left to pay the same quantum of network costs. This experience, colloquially known as the 'death spiral', may be alleviated to some degree by network tariff reform but the demand for energy that is transported through centralised networks remains uncertain over the longer term. EnergyAustralia believes it is important to ensure networks are priced efficiently to ensure the cost-competitive supply of grid supplied electricity now and into the future.

Figure 3: NEM electricity consumption, network revenue per unit sold and wholesale electricity price: 2005/06 – 2012/13 (index 100 = 2005/06)



*Note: *Real wholesale prices are adjusted for the carbon price in 2012-13*

Source: Grattan Institute based on AEMO data (1998-2013) and regulatory determinations

This highlights the importance of the AER's role with respect to regulated network revenue. EnergyAustralia fully supports the current framework and in particular the 2012 rule changes, which enhanced AER's ability to scrutinise revenue proposals. This includes the use of benchmarking to assess the relative efficiency of the various distribution networks.

Relative efficiency of network businesses

The AER's approach to benchmarking has clearly raised important issues of how regulators should discharge their responsibilities and we note that the businesses have devoted considerable attention to this in their revised proposals.

We recognise the compression of the AER's consultation timeframe and the time available for stakeholders to analyse and respond to its benchmarking methodology. This is obviously the first time the AER has undertaken this process. While there may be some learning opportunities, its process for the determination of network revenue is transparent and external stakeholders now have an opportunity to analyse and comment on its approach and the businesses' response. Furthermore, the AER is obligated to explain how its Draft and Final Determinations are consistent with the NEL and NER, and will satisfy the NEO; it is also accountable for its decisions through the prospect of legal challenge. In short, we are confident that an appropriate regulatory framework is in place and that there are numerous disciplines on the AER's decision making that create a strong incentive to ensure it acts in accordance with its regulatory roles and responsibilities.

We also note that the AER's benchmarking contributes to the existing stock of evidence of the relative inefficiency of the NSW distribution businesses. This has been well documented by the Productivity Commission, for example, which concluded that 'state-owned network businesses have conflicting objectives, which reduce their efficiency and undermine the effectiveness of incentive regulation. Their privately-owned counterparts are better at efficiently meeting the long-term interests of their customers'.³ Similarly, recent analysis by Ernst and Young for NSW Treasury concluded that 'residential electricity customers in Victoria and South Australia have benefited in terms of both network prices and service levels'.⁴

There is also extensive material provided to the AER over the course of this review – from the Consumer Challenge Panel, for example – that seeks to illustrate the relative efficiency of the NSW networks and other distribution businesses. The AER now has access to a large volume of information from which it can draw reasonable conclusions about what constitutes efficient network operations. The key issue for the AER now is to determine the appropriate pace of transition to more efficient network operations. Our customers have borne the cost of these decisions and inefficiencies in the past and we don't accept they should continue to do so, even as the businesses become more efficient. Neither should they experience any decline in service standards, as the Victorian and South Australian experiences demonstrate.

Other observations about expenditure proposals

EnergyAustralia acknowledges the businesses' focus on their regulatory obligations, compliance with which is a major driver of opex and capex. Our initial submission encouraged the AER to carefully scrutinise how the businesses have proposed to comply with their full range of regulatory obligations and licensing requirements (occupational health and safety, network reliability and vegetation management, in particular). This included the businesses' processes for assessing and managing risks, the identification of feasible options, evaluation frameworks for the comparison of alternatives and the selection of the preferred approach. Therefore, we welcome the AER's focus on these methods and in particular, its engagement of specialist advisers, EMCa and WorleyParsons, who highlighted inefficiencies in some of the businesses' initial capex proposals.

³ Productivity Commission (2013), *Electricity Network Regulatory Frameworks, Report No. 62*, Canberra.

⁴ Ernst and Young (2014), op. cit., page 3

As with the initial proposals, AER should focus on the degree of prescription in regulatory obligations and the businesses' compliance strategies with respect to vegetation clearance and bushfire mitigation. These are significant drivers of Endeavour and Essential's opex proposals.

We also note the businesses' numerous statements about their workforce practices, previous agreements and how they influence proposed capex and opex. This includes their impact on labour productivity and levels of employment (permanent staff vs. contractors, for example). We also note the businesses' statements about how previous agreements will influence the pace of transition to more efficient operations (in comparison with network operators in other jurisdictions).

EnergyAustralia does not agree that it is appropriate for our customers to continue to bear the cost of previous decisions – such as entering into certain enterprise agreements that determine employment levels and greatly influence labour productivity – that have led to what are now recognised as inefficient practices and excessive expenditure. For example, Ausgrid engaged permanent staff during the 2009-14 regulatory period in advance of a capital work program that did not proceed. The magnitude of the resulting redundancy costs suggests Ausgrid may not have managed this process in the most efficient way, either in terms of the duration and type of employment contracts or the reasonable assessment of the likelihood that demand at that level would actually occur. These adjustment costs should be borne by the networks themselves; their existence, even where this is due to contractual arrangements, does not mean they should automatically be approved as efficient costs.

Another example is Ausgrid's opex forecast, which included cost increases associated with the end of Ausgrid's Transitional Services Agreement with EnergyAustralia to provide retail services, and the subsequent need to restructure its cost base and the 'loss of synergies'. Once again, any such adjustment costs do not reflect the efficient cost of network operation and we agree with the AER's view that they should be absorbed by Ausgrid, rather than contributing to higher energy prices.⁵

Furthermore the concept of a transition to a more efficient operating model is illogical and cannot be supported. Other businesses in a range of industries, including energy generators and retailers, are required to adjust to changing market dynamics and have experienced revenue declines in excess of 30%. It is imperative that inefficient network costs are removed immediately from the cost stack to benefit the households and businesses of NSW.

EnergyAustralia welcomes the businesses' initiatives to improve their efficiency into the future, either through improved labour practices or more efficient regulatory compliance. However, allowing the businesses to recover inefficient costs through regulated tariffs penalises customers and undermines their incentive to improve the efficiency of current operations in a timely manner or to enter into more efficient arrangements going forward. It is important that our customers enjoy the benefits of more efficient practices as soon as possible rather than have to wait for subsequent regulatory periods.

⁵ EnergyAustralia addressed this specific issue in its submission to the businesses' initial revenue proposals and through supporting analysis from OakleyGreenwood. The AER is encouraged to revisit this discussion if it requires further justification for its decision.

Demand forecasts

We note some reductions in proposed capex relative to the businesses' initial proposals, which are the result of reduced demand forecasts (peak and average). For example, Ausgrid has proposed revised capital expenditure that is 15% lower than its initial proposal; it notes that forecast augmentation expenditure is at historic lows and that it is not planning any major projects driven by load growth. Furthermore, its revised expectation of future summer system coincident peak demand is significantly lower than that contained in its initial proposal.

We are pleased to see the recognition of the evolution of the energy market and how it will moderate demand peaks relative to current usage profiles. The level of peak demand has driven network investment even as average consumption has declined. In the near future, residential customers will increasingly have control over the timing of their consumption and the source of generation (including distributed generation). This will be facilitated through the widespread installation of smart meters, through other technological developments (such as storage), and initiatives to promote greater demand side participation.

At the same time, the implementation of more cost reflective network tariffs will remove some of the cross subsidies inherent in current tariff structures, encouraging more efficient utilisation of existing network infrastructure. Historical trends and previous assumptions about the link between the demand for energy and the need to expand existing network infrastructure should no longer apply. This includes the satisfaction of the energy requirements of greenfield developments, with potential options including embedded network and off-grid solutions, cogeneration or trigeneration.

EnergyAustralia notes that the AER's Retail Branch is currently consulting on the regulation of 'innovative energy sellers' (i.e. combined solar and storage service offerings) and the COAG Energy Council's Energy Market Reform Working Group is consulting on 'new products and services in the electricity market'. These consultations are in response to emerging business models.

EnergyAustralia is also involved in discussions with various stakeholders – including government, regulators and networks – on the practical implementation of more cost reflective network tariff structures. The AEMC's recent rule changes for distribution network pricing included transitional arrangements, which will see these tariffs rolled out across all networks in some form over the next two years.

There may not be significant reductions in peak demand over the course of the forthcoming regulatory period other than those envisaged in the businesses' revised proposals. Combined solar and storage service offerings remain very small in scale and the network tariff reform process is still in development. However, the gradual recovery of capital expenditure over time means AER should have regard to factors such as the changing profile of demand, potential responses to different tariff structures and the increasing range of alternative mechanisms for addressing peak demand and for what Endeavour refers to as 'expected pockets of spatial demand growth' as it considers the businesses' capex proposals and underlying demand forecasts.

Proposed metering fees

The final part of our submission relates to the businesses' proposed metering fees, including the new 'meter transfer fee'; this was also a major component of our submission to the businesses' initial revenue proposal reflecting EnergyAustralia's strong views about the benefits of smart meters. These benefits include more efficient network operation.

We remain concerned about the implications for a market led rollout of smart meters of the AER's determinations. The AER has determined that the businesses can recover the incremental administrative costs associated with the transfer of customers to another meter provider and while this appears valid in principle, the amount that the businesses propose will still create some obstacle to greater competition in the provision of metering services.

As such, EnergyAustralia encourages the AER to carefully scrutinise the efficiency of the businesses' costs and processes, and the assumptions underpinning the incremental administrative cost. Their description of the process identifies a number of steps in the transfer process, many of which involve entities other than the businesses themselves. Similarly, we expect this process should be relatively straightforward and potentially automated so the AER should test assumptions about the time that should reasonably be allocated to each task. We expect that the estimated cost reflects the relative inefficiencies that are driving the businesses' opex and capex proposals and on which AER has focussed considerable attention.

We also note that Essential Energy now proposes a meter transfer fee based solely on estimated administrative costs of \$64.91, after initially proposing an exit fee of \$65.74 for 2015-16 (comprised of 'Opening RAB Recovery' of \$13.98 and 'Administration Cost' of \$51.76).

As with the absolute level of allowable revenue, we do not believe that our customers should bear the costs associated with inefficient processes and flawed decisions. Neither should they be denied the benefits of a market led, smart meter rollout.

If you require any further information with regard to this submission, please contact me on 86281479 or via email at geoff.hargreaves@energyaustralia.com.au.

Yours sincerely,



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