Major Energy Users Inc.

Australian Energy Regulator

NSW Electricity Distribution Revenue Reset

Essential Energy Application for Transition Year 2014/15

A response

by

Major Energy Users Inc

February 2014

Assistance in preparing this submission by the Major Energy Users Inc (MEU) was provided by Headberry Partners Pty Ltd.

This project was part funded by the Consumer Advocacy Panel (www.advocacypanel.com.au) as part of its grants process for consumer advocacy and research projects for the benefit of consumers of electricity and natural gas.

The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission.

The content and conclusions reached are the work of the MEU and its consultants.

CONTENTS Page

Summary 3

1. Introduction 5

2. Essential WACC 11

3. Essential Opex and EBSS 14

4. Essential Capex 19

5. Revenue approach and smoothing 19

6. Service Standards 23

7. Pricing Methodology 24

Summary

The Major Energy Users Inc (MEU) welcomes the opportunity for presenting its views on the application from Essential for a reset of the electricity distribution costs in NSW for the transition year 2014/15.

Essential provides a view that the amalgamation of the three distribution networks has three objectives (page 5):

1. " To continuously improve safety.
2. To maintain network reliability.
3. To strive to contain average increases in our share of customers' electricity bills at or below the Consumer Price Index (CPI) "

The first two have determinative outcomes but the third - prices for consumers - is merely aspirational, and whilst Essential just fails to achieve the aspiration for the transition year, the cumulative impact of non-achievement takes prices well beyond the aspiration. Essential seems to imply that this is the fault of consumers because they are using less electricity (which drives prices up) but even so, Essential forecast is that its revenue will further rise over the 4 subsequent years.

The MEU is very concerned that the revenue for the transition year has been overstated. The MEU notes that this raises two very important issues:

- Community expectations are that there will be a considerable reduction in network revenues to reflect the rule changes that were introduced to achieve this outcome. If consumers do not see these reductions then there will be questions as to why the AER has not used its powers and discretions as they were intended - in the long term interests of consumers
- Even though there is expected to be a "true up" when the full review is carried out, as end user costs for capital are higher than those for regulated networks, an excessive allowance in the transition year will cause harm to end users even after a true up because of this disparity than the benefit that comes from a subsequent true up based on networks' cost of capital

Additionally, the revenue allowance for the transition year needs to reflect the reality that demand and consumption has fallen in recent years and that the revenue allowances in the current period included significant expectations of increasing demands and consumption. This means that the revenue allowance for the current period included amounts that were never needed and that there has been an over-recovery of revenue and investment in assets that was not needed.

To some extent, Essential's application for the transition year does refect these realities, in that overall capex claims are considerably lower than the capex

allowances granted for the current period, and that the claims for the transition year do reflect very slightly lower costs. However, even with the relatively lower claimed revenue for the transition year there are a number of anomalies where claims have increased significantly above costs that were actually incurred.

Overall, the revenue sought for the transition year reflects a very modest reduction compared to the revenue sought for 2013/14. However, within the lower costs sought for the transition year there are a number of anomalies and the MEU has identified these in the following sections.

The MEU has assessed the WACC, opex and capex claims:

- Essential approach to WACC is not acceptable to the MEU. The approach is a mish-mash of old and new. The MEU considers that, for the transition year, the WACC approach established by the AER for SP Ausnet transmission decision or alternatively the SP Ausnet gas distribution decision maintains consistency and recognises that more time is needed to develop and implement the detail for the new approach to WACC development. This additional time will be provided when the detailed review is carried out under the new guidelines

- The opex claimed for the transition year appears to be unnecessarily high when considering the efficiencies expected during the next period.

- Whilst the capex claim for the transition year appears reasonable, deeper investigation indicates that it is overstated and should be reduced

The current pricing methodology used by Ausgrid has resulted in some considerable anomalies and a loss of equity. The MEU has a concern that the pricing approach by Essential might reflect similar anomalies. The MEU therefore considers that the Essential approach to pricing does not exhibit these anomalies and must be assessed in keeping with the basic premise that each user pays its "fair share" and that prices will generally move with the AER approved yearly change in revenue.

1. Introduction

The MEU has addressed this proposal from Essential Energy (Essential) as setting the revenue allowance purely for the transition year 2014/15. The MEU will therefore focus on the revenue sought for this year to ensure that the allowance reflects an equitable basis.

Whilst the MEU would normally address forecast costs based on the long term performance of Essential, it appreciates for the current purposes that such detail is probably not warranted.

1.1 The scope of this review

There is an overall view that network charges (especially those with government ownership) have risen too much over the past 6-7 years and that the network revenue rules were biased in favour of the networks. Arising from this recognition, the rules on assessing network revenues were changed dramatically to redress what has been determined as over incentivising investment in networks and providing excessive revenues to networks. It was the AER that sought the rule changes that have been implemented to address this imbalance and it is up to the AER to ensure that there is better consumer outcomes by using the discretions now embedded in the rules applying to network revenue setting.

As a result of heavy involvement in the development of the new rules and the guidelines developed by the AER to implement the new rules, consumers have an expectation that the new rules and guidelines will result in significant reductions in network revenues. If this does not occur then all of the effort devoted in the changing of the rules will have been wasted.

Ambit claims (such as provided by Essential) and front loading of costs for the transition year allowance fly in the face of community expectations. The community also expects (as occurs in competitive markets) that declining demand and consumption should result in falling prices as providers struggle to maintain market share yet what is seen in the network claims is that declining demand and consumption results in higher prices. To achieve community expectations of lower prices, requires the networks to reduce their revenues to offset the impact of lower demand and consumption. But this has not occurred!

The transition year revenues will be the first seen by consumers since the new rules were developed so the AER decisions on the transition year allowances will be seen as a test of the efficacy of the new rules and how well the AER will use its new powers.

The AER has traditionally allowed the networks to "smooth" the prices over the regulatory period and considers that "truing up" any over payment in the transition year can be achieved with lower prices in the subsequent years. In

the current environment where large electricity using firms are reducing and even ceasing operations, such a true up is of little benefit.

Over the coming year, Essential is to provide the AER with a detailed application detailing its claim for a revenue stream to apply for the entire five year period 2014/15 to 2018/19. This revenue stream will be assessed under the new electricity rules and the recently published AER guidelines.

The MEU recognises that the AER decision regarding this transition year application from Essential will only provide a "place setter" amount of revenue for the transition year. When the AER releases its decision on the detailed application by Essential for the entire 5 year regulatory period, the AER will adjust the revenues for the last 4 years to reflect any over/under allowance made for the transition year.

In theory this might be considered to mean that there is little need to get the allowance for the transition year to be as close as possible to being correct. The MEU considers that just as much care needs to be devoted to getting the allowance for the transition "right" as would apply under any other regulatory decision. This approach is based on equity. It is inequitable for users of the services in later years to be liable for errors in revenue setting for the transition year.

Whilst the setting of the transition revenue is a "place setter" subject to a later "truing up" care must be taken to ensure that the transition year revenue is still in keeping with community expectations of overall lessening of network revenues. If the revenue for the transition year is higher than it need be, then end users will incur additional costs which they will have to fund at their cost of capital. Whilst a "true up" will be carried out using the networks WACC, consumers have to fund over payments for the transition year based on the higher WACC that competitive markets achieve. This means that the penalty on consumers if the transition year revenue is set too high will be greater than the benefit from any "truing up" by the AER which is based on networks' WACCs[1].

There is no doubt that users and the services they utilise will be different in the transition year to those in the subsequent years. It would be inequitable to require a temporal cross subsidy between users where the cause is attributable to such a significant change in approach.

In its discussion, Essential approach to pricing seems to imply that consumers want stability in pricing. The MEU agrees that some stability in pricing is preferable yet consumers also do not want to be paying more than needed. In its approach to revenue smoothing, Essential appears to be pre-empting what the revenue stream will be under the new rules. With such uncertainty as to

[1] The AER has, in the past, used the networks' WACC to smooth the revenue stream but firms in the competitive market have (or should have) higher WACCs than the networks as they face greater risks. For the AER to smooth the transition year revenue will therefore not recompense end users for the additional costs they incur as a result of a higher than needed revenue allowance for the transition years

what the application of the new rules will result in, the MEU disagrees with Essential about price stability being a driver of the forecasts, and considers that the pricing for the transition year should be based on getting the "right" revenue rather than one arbitrarily influenced by unknowns.

The MEU view on price stability recognises that under a revenue cap approach, under/over recovery of revenue in one year needs to be offset in the following year - a process that results in significant price instability.

1.2 Essential past performance

The MEU notes that the regulatory decisions for the past two regulatory periods have massively increased Essential annual revenues: from 2008/09 when Essential expected ~$732m (nominal) annual revenue to an expectation of ~$1475m (nominal) in 2013/14. Over the same period inflation has increased by ~14% implying that the increase in Essential's distribution revenue has increased by more than 85% in real terms.

At the same time, the volume of electricity transferred in NSW has fallen in every year since and is currently about 11% less and the peak demand has decreased year except once and is now ~2.5% lower. Overall the quality service provided has not significantly changed. NSW consumers have great difficulty in understanding why the distribution costs have risen by so much in comparison to the service required by consumers.

Essential is proposing that the revenue for the transition year will be marginally lower than last year (2013/14) of the current period. At the same time, the allowance for 2013/14 reflects a massive increase in its revenue over the last five years.

It is not apparent in the detailed claim for increased allowances (such as for the WACC development, opex and some elements of capex) that the benefits of cost efficiency have been transferred to consumers, and that the outcome for consumers is further increases in revenue against a declining consumption base. The MEU is of the view that there is scope for Essential to reduce its costs and claims for increased WACC levels so that consumers can see lower prices.

The MEU notes that the EBSS carryover has resulted in cost reductions (penalties) being deducted from the assessed revenues implying that the opex allowance for the current periods were being exceeded by the actual opex performance.

1.3 Customer and consumer engagement

Essential noted that it proposes to increase its customer and consumer engagement and points to research on customer feedback. Essential received clear and definite advice that their customers do not understand why their prices are rising so much. Essential notes that their customers believe that the

price rises are outside Essential's control but expect that price rises are genuine. This observation is at odds with customer feedback received by other distribution businesses.

Whilst Essential appears to dissemble a little regarding vulnerable customers, what is clear is that excessively high network prices have also impacted on how to address the needs of vulnerable customers. Accepting that network pricing comprises at least 50% of a small customer's bill, lower pricing by Essential would have a significant impact on the number of customers requiring financial support, and the extent of that support, due to high electricity costs.

The MEU is pleased that this engagement has occurred but is still concerned that such interaction still consists more of "this is what we have planned" and "the reliability and availability is this and this is that it costs" rather than "how can we provide the service you need which meets your ability to pay".

The MEU is also concerned that consumers are unaware that Essential:

- Has made massive savings due to much less capex being used than was allowed for but has not passed much of these benefits to consumers.
- Is only offering modest revenue savings for the transition year and revenues thereafter will equal or be greater than revenues now
- Lower consumption is forecast and this will mean higher prices into the future, even thought the service will be the same.

It would be expected that consultation would provide an indication of the future price movements to see if consumers were prepared to accept prices increasing further, or if Essential could take action to prevent this occurring.

Although the MEU is concerned about the detail and approach by Essential, the MEU recognises that the consumer engagement process will, hopefully, improve over time, to the benefit of both consumers and Essential.

1.4 Forecasts of demand and consumption

The amount of energy used within NSW rose from 1999 levels to peak in 2009 but since then consumption has fallen to 2003 levels and the expectation is that consumption will continue to be static or even fall further.

Although the most recent full year peak demand showed an increase on the previous year's much lower demand, this was for a single day and the peak demand for the year 2013/14 so far shows a reduction from the rise seen for 2012/13, to the low peak demand seen in 2011/12 year. The forecast peak demand (10% PoE) is not expected to exceed the highest recorded peak demand in NSW (2009/10) in the next regulatory period, reflecting a general trend in the NEM.

Based on this data, there is little expectation for a need to significantly augment the Essential network in the next 5 years but particularly there will no need to augment the network during the transition year.

At the same time, Essential highlights that the lower consumption seen in recent years has impacts on the revenue recovered under a price cap regime. If consumption continues to decline (as Essential forecasts in figure 3-2) then there would be concern as to what the price cap approach on Essential's revenue would be. The MEU notes that the AER has determined that the regulatory approach for Essential (and the other two NSW distribution networks will be based on a revenue cap approach. The MEU agrees that this is a sensible and pragmatic approach to a considerable change from historic trends.

1.5 The helicopter view of the Essential proposal

Essential highlights that its allowed maximum revenue will fall only marginally from 2013/14 for the transition year; it will then increase through the next regulatory period. The MEU finds that this is anomalous when considering that Essential did not use its allowed capex and allowed opex basically matched that allowed during the current period. Essential proposes to continue reducing its overall capex but increase its opex considerably despite under-running its capex allowance in the current period.

The MEU notes that Essential will incur an EBSS penalty in the next period due to its opex performance in the current year.

Essential forecasts that revenues in the subsequent years of the next period will see a rise in revenue and when this is combined with the forecast continued falls in consumption, real prices will show an increase for the transition year and thereafter, real prices will rise for the rest of the next period.

The import of the Essential proposal is that consumers should be pleased with what Essential is proposing as the price rises are small compared to the large price increases seen in previous years. The Essential proposal is a continuation of the current trend, albeit with a degree of "flattening" the historic price rises, despite there being a massive reduction in demand and consumption and little change in the service standards.

1.6 Escalation of costs

As the AER is only to assess the revenue allowance for 2014/15 year under the transition year process, Essential provides little detail as to its expected escalation of opex and capex costs, although on page 37 Essential comments:

> "To demonstrate our commitment to minimising charges for our customers, Essential Energy will undertake initiatives to improve the productivity of the workforce such that the net increases in labour costs are confined to 2.50 per

> cent, the expected level of CPI. This means that our forecast operating expenditure contains zero real labour cost escalation for internal labour."

The MEU agrees with Essential that for the purposes, the transition year assessment should only include for expected inflation and not include for any other escalation. However, Essential also states (page 37) that:

> "Forecast operating expenditure needs to account for changes to the price of cost inputs in order to reasonably reflect a realistic expectation of the cost inputs required to achieve the operating expenditure objectives in the next regulatory control period. These price increases may not necessarily be at the same rate as the CPI, due to a number of factors".

The import of this statement is that Essential has built into its forecasts escalation for external costs (contract labour and materials).

The MEU considers that for the purposes, the transition year assessment should only include for expected inflation and not include for any other escalation, especially as Essential has not provided any indication as to what this "real escalation" on external opex and capex costs might be.

2. Essential WACC and "pass through" of risk

2.1 WACC

In its transition year proposal, Essential seems to propose that the WACC applicable to its transition year should be based on the AER new guideline, albeit somewhat modified. Essential does offer its views on what the new guidelines will achieve (or not) and that the new approach will put a downward bias from the AER's return on equity model - something that Essential does not agree with along with the AER decision to implement transitional arrangements for introducing the new guideline for return on debt[2].

However, it is clear that the AER has not yet developed in full, the implementation details of the new approach, and neither has Essential. This then raises the issue as to whether the AER should attempt to implement the approach *for the transition year* to WACC development under the new guideline or under the old guideline. The MEU is firmly of the view that *for the transition year only*, the WACC should be based on the methodology and parameters used most recently, such as in the SP Ausnet (SPA) transmission review and released on 31 January 2014 or the SPA gas distribution review released in March 2013.

It is recognised that the new guideline includes for considerable discretion by the AER and for the AER to exercise this discretion in a foreshortened review process could lead to unnecessary concerns and unintended outcomes. As the transition year allowed revenue will be adjusted for any overs/unders later in the regulatory period after the new guideline methodology has been tested within a full review process, it would be equitable to apply the historical approach to setting the WACC for the transition year.

Adopting the recent past approach to setting the WACC for this transition year should be non-controversial and, if anything, favour the regulated firm as the recent rule changes were introduced in order to bring greater balance to regulatory decision making and, in particular, to introduce a realistic methodology for assessing the cost of debt considering that the Competition Tribunal and consumers have been so critical of the AER's previous methodology.

The MEU is most concerned that Essential has elected to approach the setting of the WACC for the transition year based on a variety of inputs reflecting both the old and the new approaches and has done so in a way that results in a higher WACC than might be expected when viewing the current relatively low risk free rate. Essential has also utilised those elements of the old approach which increases the WACC (such as equity beta) and then overlaid elements of

[2] The MEU agrees with Essential that there is no need for transition arrangements for moving from the "on the day" approach to a trailing average approach and made this point in its submission to the AER on the approach to return on debt.

the new approach which also increase the WACC (such as a higher market risk premium).

Essential has offered a range of inputs on which to develop its WACC and these with the most recent decisions on WACC (SP Ausnet electricity transmission decision which is influenced by the 2009 WACC decision) and the most recent decision for distribution (SP Ausnet gas distribution) are shown in the following table:

	Essential approach			AER on SPA elec trans	AER on SPA gas distrib
Parameter	**Lower bound**	**Upper Bound**	**Proposed**		
Risk free rate (nominal)	4.78%	5.17%	4.78%	4.31%	3.14%
Market risk premium	6.5%	6.5%	6.5%	6.5%	6.0%
Equity beta	0.8	0.9	0.8	0.8	0.8
Cost of equity	9.98%	11.02%	9.98%	9.51%	7.94%
Cost of debt - 10 year BBB+ (nominal)	7.55%	7.84%	7.55%	6.79%	6.50%
Expected inflation	2.50%	2.50%	2.50%	2.45%	2.50%
Gearing (D/V)	60%	60%	60%	60%	60%
Gamma	0.25	0.25	0.25	0.65	.25
Corporate tax rate	30%	30%	30%	30%	30%
Vanilla WACC (nominal)	**8.52%%**	**9.11%**	**8.52%**	**7.87%**	**7.07%**

The MEU considers that the only change the AER should make to their SPA assessments when applying it to Essential is to assess the risk free rate as has been previous practice (and recalculate the WACC based on the risk free rate applying at the time of the final decision) and to decide whether the parameters of MRP should be 6.0 coupled to gamma of 0.25 or MRP of 6.5 coupled to gamma of 0.65. The approach to the cost of debt used for the SPA electricity transmission is the most recent assessment of debt made and this applies equally to all regulated energy networks.

2.2 Pass through events

The use of “pass throughs” is a mechanism for the regulated entity to reduce its risk by passing these onto consumers. Regulators have been inclined to accept this approach as they (rightly) fear that an allowance in the costs to accommodate this risk might be too high reflecting the likelihood of exogenous low probability high impact events.

In the current Rules there are defined elements where the “pass through” of actual costs is permitted. However, it is important to recognise that in a competitive environment, the ability to pass through costs to consumers is not possible, and firms have to absorb the costs (either through insurance or directly) of any exogenous impact. Because there is the ability to pass through such costs to consumers by regulated NSPs, the AER must recognise that with

this transfer of risk there needs to be a compensating reduction in the equity beta to reflect the reduced risk faced by NSPs.

The request by Essential for a pass through provision for the loss of synergy through the sale of its retailing function reflects the AER view that the loss of the function might increase costs. On page 37 Essential comments:

> " On termination of the TSA, our costs of providing standard control services increased due to the loss of scale and scope of being an integrated network and retail business. These 'loss of synergy' costs have been factored into the forecast operating expenditure for the 2014-19 regulatory control period. The AER recognised this potential 'loss of synergy' in its draft 2009-14 NSW distribution determination. In accepting the 'Retail project event' (i.e. sale of the retail business) as a nominated pass through event, the AER stated:
>
> > *"If the NSW electricity retail businesses are privatised the DNSP's cost of providing direct control services*
> > *may increase due to loss of synergies."* "

Essential comments that it lost this retail function on 3 January 2014 and therefore the loss of scale benefits have been added to the next regulatory period opex allowance. Essential provides no information as to what these costs are. If the costs are significant then the amount should be at least stated if not fully substantiated in this application for the transition year. If they are not significant, then they should be excluded

The revenue allowance for the transition year is a "place holder" allowance which has been developed under a foreshortened regulatory review. This precludes a more detailed assessment of the conditions that would constitute a claim for a "pass through" event. As stakeholders will not have the opportunity to review the costs incurred by Essential from the loss of the retail function, no costs for this should be included as a step change in the transition year opex.

3. Essential Opex and EBSS

Essential provides figure 4-2 which tracks the AER allowance (including the pass through from the loss of retail synergies), the actual opex and the forecast opex for the next period, including the transition year.

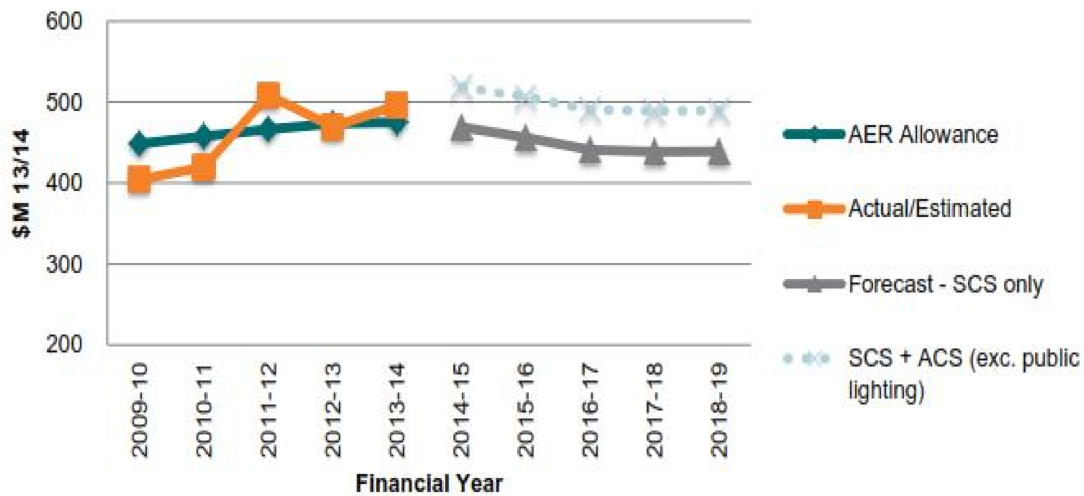


Figure 4-2: Operating expenditure 2009-10 to 2018-19 ($M, 2013-14)

It is quite apparent that Essential significantly under-ran the opex allowance in the early years of the current period and matched or exceeded the allowance in years 3 and 4; the forecast over run in the final year is estimated. On the basis of its performance, Essential has assessed that it is liable to pay a penalty for its opex performance in the current period

Essential also provides a longer term view of its opex in figure 4-3

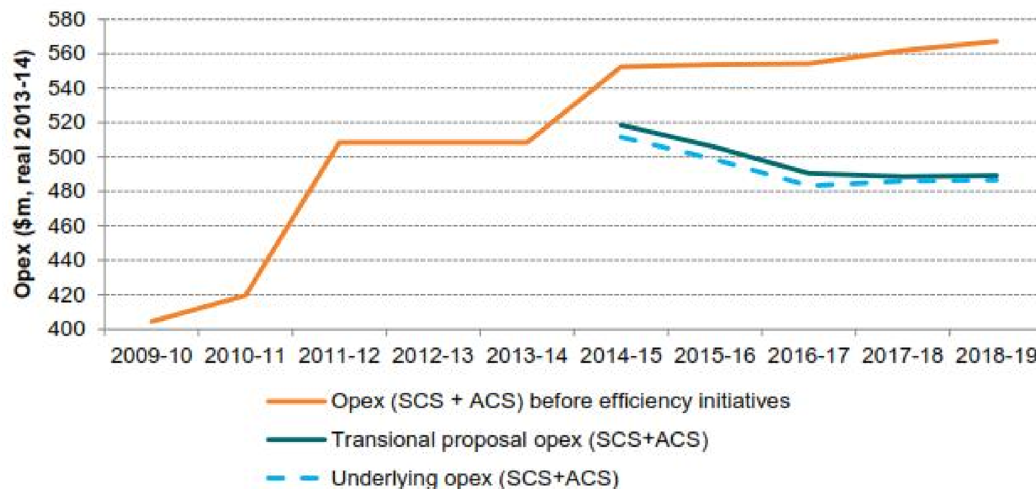


Figure 4-3: Operating expenditure productivity and efficiency savings 2014-15 to 2018-19 ($M, 2013-14)

This provides some significant points of concern:

- The current period shows that opex exhibited a rise of more than 25% between the first year for the current period (2009/10) to the three final years of the current period. This has to be seen in context with the 25% increase between the 2008/09 opex and the 2009/10 opex.
- Essential opines that without efficiencies its opex would increase for the next period by abut 10%
- The import of the opex movements over a six year period (2008/09 to 2014/15 is in excess of 50% in real terms or 10% real per annum. No firm in a competitive environment would survive under such circumstances when demand for the product was reducing!

The opex forecast for the next period shows real reductions of up to 20% by the end of the term actions. Essential comments (page 38)

> "A further round of productivity and efficiency gains has been factored in to operating expenditure forecasts to ensure that the upward cost pressures identified above can be controlled.
>
> Overall, the productivity and efficiency improvements necessary to deliver these gains will see a real cost reduction of $296 million or 11 per cent over the next regulatory control period. Figure 4-3 below demonstrates the results of this concerted effort to find efficiency savings for our customers. It shows that without this effort, the operating expenditure required over the 2014-19 regulatory control period would be $296 million higher due to upward cost pressures."

The MEU questions why this is now possible yet under the AER processes, opex has been allowed to burgeon to such a massive extent despite there being a strong incentive under the EBSS to reduce opex. For example, Essential has claimed considerable increases in the main cost elements of opex for the transition year compared to the costs estimated in 2008 for 2008/09 and claimed in 2008 for 2013/14 as the following table shows

$m ('13/14)	Estimated 2008/09	08/09 forecast for 2013/14	Forecast for 2014/15
Inspection	27	50	30
Maintenance and repair	49	87	79
Vegetation management	76	140	166
Emergency response	53	64	83
Other network maintenance costs	107	108	107

Source: Essential applications 2014 (table 4-2), 2008 (table 4.7)

This shows that there has been little pressure imposed on Essential to limit its opex in a number of categories which has resulted in little outcome. In particular, the ever increasing costs for vegetation management and emergency response show little constraint. The MEU acknowledges that Essential has addressed the increase in vegetation management in qualitative terms and references the outcomes of the Victorian bushfire Royal Commission and cites

increases in 20111/12 of $40m above the AER allowance and an increase in 2012/13 of $70m above the allowance. The MEU accepts that the 2009 Victorian bushfires did provide a "wake up call". However, the Essential claims for vegetation management need to be seen in context, and not be allowed to increase unchallenged.

Also of great concern is Essential's comment (page 37) that

> "Due to the substantial reduction proposed in forecast capital expenditure for the next regulatory control period, Essential Energy has marginally increased forecast operating expenditure in recognition that maintenance requirements and the allocation of common costs to SCS will increase.
>
> The lower forecast capital expenditure program will also mean not as many resources will be required as compared to the number needed to deliver the approved capital expenditure program in the current regulatory control period. These resources were previously tasked with the delivery of the capital program and therefore their costs were fully funded by the capital expenditure allowed by the AER for the current regulatory control period. These now stranded costs are a legitimate cost to be recovered as part of Essential Energy's operating expenditures."

The MEU finds this excuse to increase opex less than convincing.

1. Firstly as an issue of principle, the MEU does not see that the efficient opex for maintaining the network should be influenced by inefficient management of the capex program. The efficient costs of managing capex should reduce as the capex program reduces and not be transferred to another cost centre - if staff are not required to manage capex, then they are not required in the opex program.

2. Secondly, the capex program implemented by Essential was dramatically reduced in the last two years of the current period and the decision to cut back the capex program would have been made in 2011/12. The capex program proposed for the transition year and onwards is much the same as that to be achieved in 2013/14 so there is little need to increase opex to accommodate staff excess to the capex program requirements as they should have already been made redundant under the current opex allowance.

3. Thirdly, the allowed opex for the current period included opex for the forecast growth of the network. In fact, the growth of the network did not occur as forecast and Essential reduced its growth capex considerably as a result. Opex does increase with some growth (but no all, such as where that growth occurs without the increase in asset numbers). This means that the reduction in growth should have led to less opex being needed, but this has not been allowed by Essential in its opex forecasts.

The base-step-trend approach

Essential states that it has used the 2012/13 opex as its base year. It comments that this year opex is efficient because there was a commercial incentive to make it so. The MEU queries that if this is the case; why is it that Essential is forecasting considerable increases in efficiency over the next period. If such efficiencies that are forecast can be achieved, why did this not occur before under the EBSS[3].

The MEU considers that Essential base year was not efficient (by the admission of Essential and affirmed by figure 4-3) and should not be used as the base year. Another method for setting the efficient base year costs could be to use the amount forecast for 2018/19 and to discount this for scale, growth and price escalation to set an efficient cost for the transition year. To use the 2012/13 as the base year and escalate this to 2014/15 is merely a cost plus exercise which is contrary to the NEL and the NER.

Essential claims that the base year has been adjusted by step changes as follows:

- The synergy loss of the retail business (see comments in section 2.2)
- An increasing asset base. This assertion needs to be qualified by the comments made above regarding growth
- Cost escalators. See comments made in section 1.6
- Reductions in capex. See comments 2 and 3 above

When analysed, the claims for step increases would appear to be insubstantial.

The MEU considers that, based on the information provided, the step changes claimed by Essential should result in the base year actual opex adjusted for CPI should be the value for the opex needed for the transition year as there is no supporting information that Essential provides to quantify any of these positive step changes it claims.

EBSS

The MEU notes that Essential is to pay a penalty under the EBSS as Essential could not contain its opex below the allowance provided by the AER. In most years this results in a penalty each year including the transition year, but the penalty in the transition year is less than it might be.

The MEU considers that the EBSS penalty should be amortised equitably over the entire regulatory period both directly and through the smoothing approach

[3] This seems to imply that the EBSS was not sufficient to improve efficiency and some other driver has been needed to get the forecast efficiencies

and not to be so light in the first year of the period. If this was done, the EBSS penalty attributable to the transition year would be greater than the amount proposed by Essential.

4. Essential Capex

Essential capex is presented in figure 4-1 showing the actual capex in comparison to that allowed for the same period. This shows that that in every one of the five years of the current regulatory period, Essential used significantly less capex than was allowed by the AER at the last revenue reset.

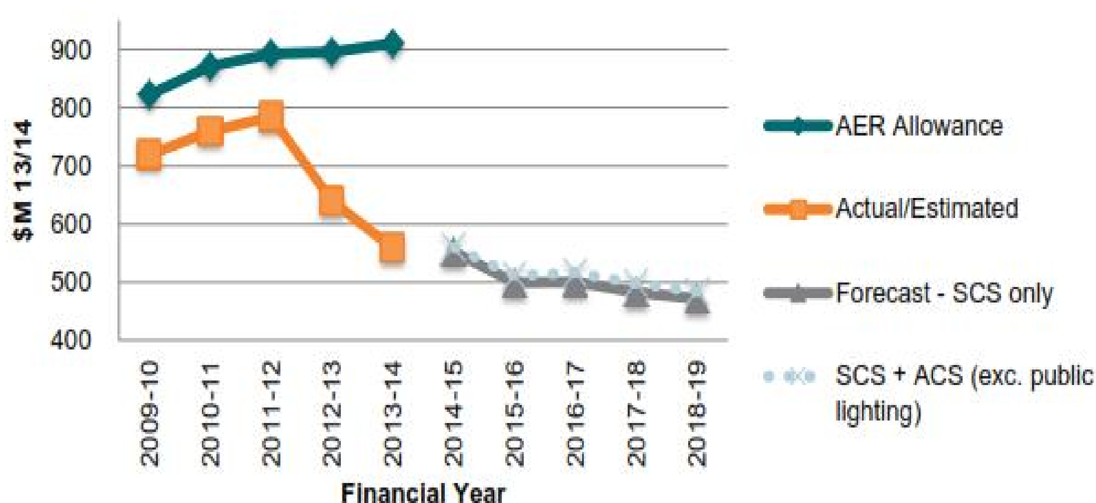


Figure 4-1: Capital expenditure 2009-10 to 2018-19 ($M, 2013-14)

In aggregate terms Essential used about 80% of its allowed capex (with the bulk of the under-run in the last two years) and as a result achieved a significant benefit of over $190m from this under-run in capex which, if passed to consumers, could have resulted in significantly lower prices.

The capex proposal by Essential for the transition year would appear to reflect the recent downward trend in capex seen over the current period. The MEU considers that what Essential has achieved in its capex reductions is commendable but notes that it reflects a significant reduction in consumption and demand as distinct from its expectation of large increases at the time of the last reset.

Whilst Essential provides detail of its different capex elements for the next period, it provides no breakdown as to where the capex was incurred in the current period. Therefore the MEU is unable to assess which elements of capex reflect reasonable allowances. In particular, as noted above, many networks have reduced there current period capex for growth assets and transferred considerable amounts to replacement assets, thereby using the capex released from being used for growth to reducing the average age of the assets overall. This transfer of capex use has considerable impact of other aspects (especially opex) but Essential's lack of information precludes such useful comparisons.

However in Table 4-1, Essential provides a breakdown of the forecast capex. This shows that growth capex is to continue its decline and becomes dominated by replacement capex. In the revised application for the current period,

replacement capex was 20% of all capex with growth capex being some 36%. In the forecast for the next period, replacement capex is nearly 50% of all capex with growth capex about 30% of all capex.

Comparing the revised application for the current period with the forecast period, in total terms replacement capex is forecast to increase by some 30% above that sought for the current period although growth capex is now half of that sought for the current period. In the absence of better data, this high level assessment seems to provide some comfort that the growth capex forecast reflects the reality of declining consumption although the MEU is concerned that Essential has still sought so much growth capex in a falling market. What is more concerning is that refurbishment capex has taken a step increase compared to the current period - the MEU finds it difficult to identify why forecasts for refurbishment capex have changed so much period on period.

What is also concerning is that the transition year appears to be heavily loaded with the bulk of the capex with the transition year being loaded with 50% more capex and 100% more non system capex than the other years of the forecast period.

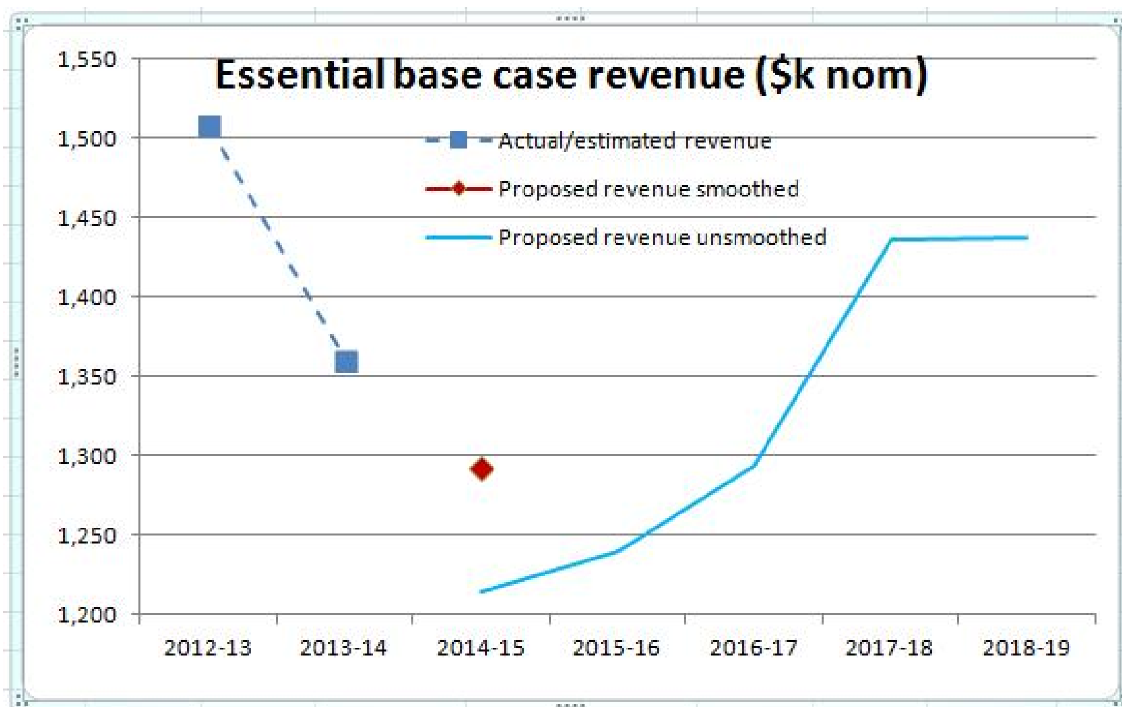
Overall, the capex claim for the transition year appears to be overstated in two ways:

1. The claim for refurbishment capex for the entire period is overstated when compared to the claim for refurbishment capex for the current period. Based on this comparison the MEU considers that refurbishment capex for the next period should be no more than $180m pa which is much less than the $235m pa average claimed. Making this adjustment would reduce the transition year capex by some $30m
2. The overstatement of capex for growth and non system capex for the transition year would reduce the transition year capex by $85m

The MEU considers the AER should reduce the transition year capex by at least $110m.

5. Revenue approach and smoothing

Essential has identified that its revenues for the next five years will start at ~11% lower than in 2013/14 and then after rise in nominal terms. This is shown in the following chart. Essential then seeks for the transition year revenue to be "smoothed" which results in the transition year revenue rising to reflect a fall of about 5% from the 2013/14 revenue (as shown in tables 3-2 1n3 3-1).



Source: Essential application,

Analysis shows that the revenue is expected to increase in real terms as well. When this real increase is coupled to a decline in expected consumption (as shown in figure 3-2) then Essential's application will result in an increase in prices on a real basis for the balance of the next regulatory period. What is also concerning is that despite the modest reduction in revenue claimed for the transition year, prices in the transition year will remain virtually static in real terms due to the lower consumption of electricity forecast.

There is no certainty that the AER will allow Essential either the transition year allowance assessed or the forecast revenues for the following four years under the new rules and guidelines. In fact, there is an expectation that the new rules and guidelines will reduce the revenues allowed under the old rules and guidelines - otherwise why were the rule changes needed!

The MEU considers that the transition year assessed revenue needs to be set as a stand alone estimate, not adjusted for smoothing as Essential has done. On completion of the full review under the new rules there has already been made provision for smoothing the unders/overs between the allowed transition year revenue and the revenue for the year assessed under the new rules.

There is no need for smoothing the transition year allowance as has been done by Essential.

6. Service Standards

Essential provides no projection for the service standards it proposes to achieve in the transition year. What it does provide is a view that the amalgamation of the three distribution networks has three objectives (page 5):

1. "To continuously improve safety performance.
2. To maintain network reliability.
3. To strive to contain average increases in our share of customers' electricity bills at or below the Consumer Price Index (CPI)."

The second of the aspirations seeks to maintain reliability and sustainability at current levels. There is no aspiration to improve these aspects. To a degree this is understandable as the determinative approach used to provide reliability has ensured that service standards (at least for the majority of consumers) is already relatively high - such that customer consultation has stated unequivocally that (page 12)

> "Customers expect a constant supply of electricity, but generally view current levels of reliability as acceptable. For most, a reduction in price would not compensate for reduced reliability. Power interruptions are an inconvenience for most household customers, but for small businesses and some rural customers interruptions can have financial impacts."

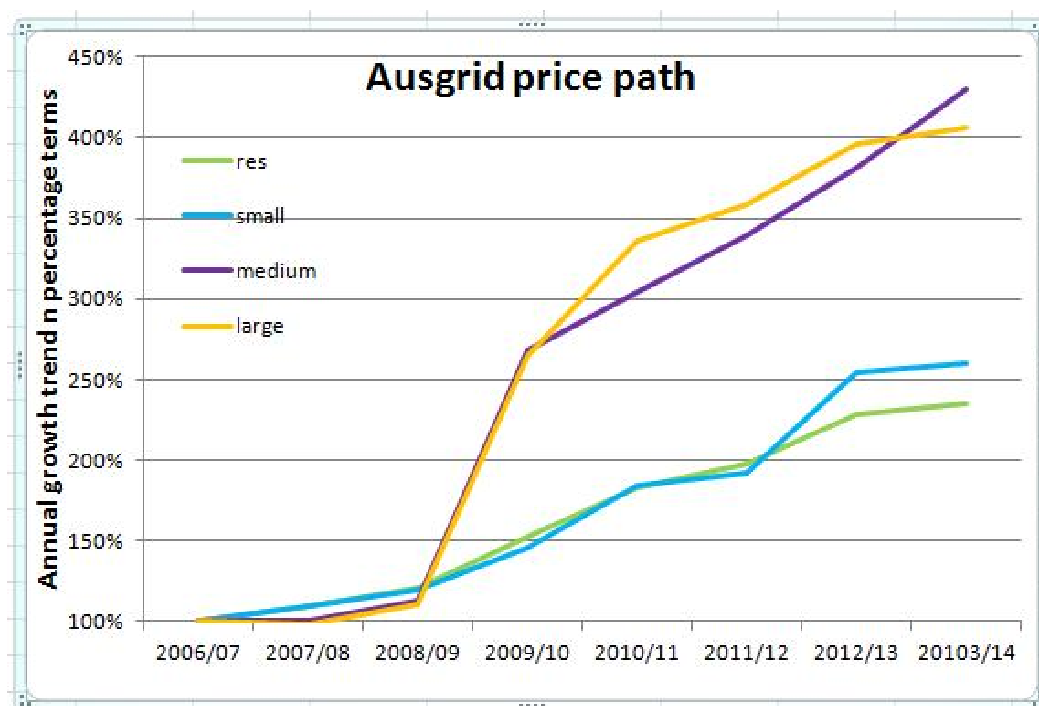
Despite this apparent support for no reduction in reliability, the MEU is concerned that reliability is probably higher (for the majority) than might be needed and that the costs consumers incur is greater than need be.

The MEU considers that there needs to be a requirement that certain standards of performance should be set for the transition year so that the cost of this reliability can be clearly balanced against the costs involved with its maintenance and achievement.

7. Pricing methodology

The MEU is extremely concerned about the outcomes of the Essential pricing methodology. In a submission made recently to the AEMC the MEU provided the following longitudinal assessment of Ausgrid pricing. The MEU recognises that Essential pricing approach could be different to that of Ausgrid, but the MEU considers that it is worth highlighting what effects pricing methodologies have on outcomes for consumers.

> "The MEU has tracked the Ausgrid network prices over the past eight years. The distribution costs for the four different load profiles were tracked and the following chart shows the costs each consumer would pay in each of the past five years.



Source: Ausgrid tariff lists, MEU calculation

> The massive increase in prices from 2008/09 to 2009/10 for large and medium businesses was reported by MEU members as was the rise again from 2009/10 t0 2010/11.
>
> An explanation given by Ausgrid to MEU members for the large increase in medium and large user tariffs was a large price increase in TransGrid charges, and the analysis in section 2.1.1 does not support the assertion as rises in TransGrid prices between 2008/09 and 2009/10 were relatively modest[4]; the price changes by TransGrid do not explain the magnitude of the Essential price

[4] The spike in TransGrid prices seems to occur the following year

increase seen just by medium/large users. In practice, any increase in TransGrid charges should have impacted residential and small users to a similar extent seen by other users.

The fact that, overall, Ausgrid prices for residential and small users show little change from the general trend seen in the three years prior to the large step increase in revenue Ausgrid was awarded by the AER and the Competition Tribunal in 2009 indicates a clear bias by Ausgrid in where revenue increases were to be levied. It would appear that a decision was made by Ausgrid that medium and large users would carry the bulk of the large increase in revenue awarded in 2009.

One explanation for this might be that there had been under-recovery in revenue by these sectors in previous years. To a large degree this argument is spurious as Ausgrid could have made some adjustments to these tariffs prior to the revenue adjustment in 2009, or even at the 2004 revenue decision, but did not see a reason for doing so. In fact, prices for residential and small business users merely reflect the trend in price changes over the previous 3 years.

A major concern of medium and large consumers was the massive price hike about which they had no knowledge and therefore no ability to plan for the cost increases. The AER decision had indicated a step increase of some 15% would occur to the average tariff in 2009, yet an increase many times this actually occurred for the medium and large sector. That such an increase could occur demonstrates the clear ability a distribution network has to set prices to suit itself.

The fact that Ausgrid was able to so massively increase costs to larger electricity users yet allow residential and small business prices to remain at the same small annual price increase trend as previously applied **without formal explanation or independent verification** highlights consumer concerns that networks have little control placed on them as to how their revenue is to be recovered through pricing approaches."

The MEU is extremely concerned that Essential pricing might not reflect the costs for the service provided. The AER has an obligation to ensure there are no anomalies in network pricing through the pricing methodology approved but the outcomes do not support this requirement.

The MEU accepts that in the foreshortened review process for the transition year, it will be difficult to investigate the reasons for such variation as have been seen. Equally, consumers expect that prices will be equitable and will generally track the AER approved revenue allowances. It is not acceptable for such significant inconsistencies to be allowed to continue.