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## Submission

# Australian Energy Regulator

# Draft Decision - Essential Energy Distribution Determination (2015-16 to 2018-19)

150213

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## Introduction

The NSW Irrigators' Council (NSWIC) represents more than 12,000 water access licence holders across NSW. These licence holders access regulated, unregulated and groundwater systems. Its Members include valley water user associations, food and fibre producers, irrigation corporations and community groups from the rice, cotton, dairy and horticultural industries.

This submission represents the views of the Members of NSWIC with respect to the Australian Energy Regulator's *Draft Decision on Essential Energy's Distribution Determination 2015-16 to 2018-19*. However, each Member reserves its right to independent policy on issues that directly relate to their areas of operation, or expertise, or any other issues that they may deem relevant.

# Executive Summary

NSWIC has concerns that there is substantial burden placed on the Australian Energy Regulator to explain and justify its decision. The current 'propose and respond' regulatory arrangement creates a massive advantage for network businesses - including Essential Energy - relative to the AER. Effectively the regulator has to demonstrate that Essential Energy's proposal is wrong. While the AER is free to ask questions during the reviews and to seek information, it is not free to set the agenda - this has been established through the businesses proposals and the regulator is therefore constrained in responding to those proposals and conducting its review accordingly. The 'propose-respond' model provides an opportunity for Essential Energy to effectively inundate the regulator through the weight of material that it provides. This has certainly occurred in the recent draft determination. NSWIC believes that such an the inundation of information jeopardises the regulator's ability to provide a comprehensive response and also undermines consumers' or their advocates ability to participate and critique the proposal in detail.

Despite these obstacles, NSWIC welcomes the AER's draft decision on Essential Energy's distribution determination. The Council does however believe that more work needs to be done to ensure that electricity costs remain affordable for irrigators in the future.

Firstly of all, NSWIC seeks fundamental reforms to how network businesses receive their revenue and has little confidence that incremental changes to the current arrangements will address existing concerns. There is a range of systemic issues that need to be addressed before a final determination is made in April 2015:

- The first issue is the average costs per kWh for distribution network services - a comparison analysis with international network business showed that NSW customers pay 10 cents per kWh more on average than customers in the United States and 4 cents more than customers in the United Kingdom[1]. Such large discrepancies must be addressed and a sensible balance must be found to ensure electricity costs remain affordable.

- The second issue is Essential Energy's Regulated Asset Base (RAB). The NSW network was built for a consumption level and demand that has never materialised, and on the contrary, has declined. The result has been an over-investment in the network that will continue to costs billions of dollars to maintain and renew if no re-evaluation of the asset base value occurs.

- The third issue is the AER's proposed weighted average cost of capital (WACC). The artificial construct of the WACC does not resemble current or prospective borrowing costs of businesses. There needs to be a further downward adjustment to more realistic borrowing rates.

- Finally, the draft decision and Essential Energy's revised response to the AER has not convinced NSWIC that Essential Energy has reached an efficient operating level. Further clarification and reevaluation must take place to ensure that customers only pay for those assets and services that are efficient and directly benefit customers. It is unreasonable that customers are expected to continue to pay unsustainable network charge increases to support inefficiencies within the networks.

[1] These findings were presented at an AER forum in Sydney.

In order to address these issues and ensure that electricity costs remain affordable for irrigators in NSW, we have provided a range of recommendations in this submission.

## Key Recommendations

NSWIC presents the following recommendations to the AER on the draft decision on Essential Energy's distribution determination:

*NSWIC rejects any allowance made to Essential Energy to transition to a lower revenue allowance.*

*NSWIC submits that the AER require Essential Energy to find alternative approaches to asset replacement capital.*

*NSWIC submits that further savings are achievable to increase Essential Energy's efficiency.*

*NSWIC submits that Essential Energy's WACC is comparatively high to other network businesses. A downward revision of the return on debt must be made to accurately reflect Essential Energy's borrowing costs.*

*NSWIC submits that there must be regulatory oversight of Essential Energy's tariff setting.*

## General Comments

NSWIC welcomes the opportunity to make a submission to the draft decision on Essential Energy's distribution determination (2015-16 to 2018-19). Together with Cotton Australia (CA) and the National Irrigators' Council (NIC), NSWIC has engaged with the AER and Essential Energy on multiple occasions to discuss the determination process, Essential Energy's revenue requirement, network tariffs and demand side management strategies.

While NSWIC holds concerns about the 'propose-respond' model for network determination adopted in the National Electricity Market, the Council is pleased that the AER was able to conduct a detailed assessment of Essential Energy's revenue proposal and address a number of stakeholders' concerns. It is however disheartening to observe that Essential Energy has in most cases rejected the AER's analysis and benchmarking methodology outright and submitted a revised regulatory proposal to the AER that is only marginally different to its original proposal in May 2014. As NSWIC outlined in its original submission to the AER, Essential Energy's original proposal would have detrimental consequences for the irrigation industry as it would result in network charges that are unsustainable for the industry.

As also mentioned in the previous submission to the AER and other state and regulatory bodies, electricity is a vital input factor in irrigated agriculture and is utilised on an increasing scale due to structural adjustments on-farm. These structural adjustments, which have been supported by the Commonwealth Government, have led to productivity gains and water efficiencies through installation of new irrigation infrastructure but have caused overall electricity use in irrigation to rise. Greater electricity use and higher electricity rates have been a significant financial burden for irrigators throughout NSW.

Network charges have been the most significant drivers of electricity cost increases and often constitute between 55 and 65 per cent of an irrigator's electricity bill. Under the current network prices, many irrigators have found it increasingly difficult to continue using their electricity intensive irrigation equipment and some have switched off their electric pumps or reverted back to less energy intensive irrigation practices like flood irrigation. The losses in terms of water use efficiency and productivity are immense.

NSWIC congratulates the AER on a well reasoned draft decision that would bring some relief to irrigators in regional NSW who continue to struggle with rising electricity costs. However, the Council urges the AER to resist any pressure from the networks or the NSW government to revise the draft decision to more closely reflect Essential Energy's initial and revised pricing proposal. The Council does not believe Essential Energy has presented a compelling case that would justify the proposed capital and operating expenditures or the required rate of return.

In addition, it appears that Essential Energy is justifying its proposal not through solid evidence, but rather through sweeping statements about reliability and safety of the network. While NSWIC does not disregard the importance of safety and reliability, it must be recognised that the current price pressure is driving a large number of irrigators off the grid. Those who remain on the grid are increasingly faced with network costs that are simply not affordable and will continue to become even more unsustainable as those consumers who have access to alternative energy sources are forced off the grid - leaving fewer to bear the cost of network operations and maintenance, through higher network charges. If there is no change to the current trend of network prices, the network 'death spiral' of stranded assets and unaffordable operational costs will lead to a collapse of the network. Such an outcome must be avoided and more effort should be expended in finding solutions that allow both the NSW regional network and the irrigation industry to remain viable, productive and competitive.

**1. Total Revenue Allowance**

NSWIC supports the AER's decision to reduce Essential Energy's overall revenue allowance although the reductions result from changes in current financial market conditions, risk management practices and lower consumer demand. While NSWIC does not dispute these key drivers, the Council believes there are other systemic issues with Essential Energy stated costs that need to be addressed.

One of these key issues is Essential Energy's current regulated asset base (RAB). As Essential Energy has admitted in its pricing proposal to the AER, the previous demand forecast was not met over the last determination period. The result has been that the significant capital investments have created a larger asset base than is needed under the current market conditions. The AER's own analysis has shown that the utilisation rate of Essential Energy's asset base is lower in 2012-13 than it had been in 2008-09. The increasing asset base and lower utilisation rate indicates that there are a number of assets within Essential Energy's network that are idle or significantly under-utilised and do not benefit consumers. In discussions with Essential Energy, we were informed that a third of Essential Energy's assets are currently underperforming.

The issue of under-utilisation and the treatment of these assets within Essential Energy's asset base needs to be addressed urgently. NSWIC urges the AER to bring this issue to the attention of the NSW Government and the Australian Energy Market Commission to initiate a rule change that would enable a thorough evaluation of the use and usefulness of Essential Energy's asset base. It is the Council's view that only those assets that benefit customers and have a high utilisation rate should form part of Essential Energy's regulated asset base at full value. The value of idle or underutilised assets should be written down or written off.

Another key issue for NSWIC is how the revenue reduction will be translated into lower tariff rates for irrigators. NSWIC notes that the AER does not currently have the jurisdiction to review and set individual tariff rates. As irrigators have a very inelastic demand for electricity, this lack of regulatory oversight leaves irrigators vulnerable to monopoly exploitation by Essential Energy. Despite the rhetoric of Essential Energy that network charges will decrease by 9.1% on average over the next regulatory period, it cannot be guaranteed that this estimated cost reduction will apply to the irrigation industry charges as Essential Energy is given sole discretion to set its own tariff rates. The Council believes that this regulatory gap should be addressed as a matter of urgency. For that purpose, the AER should bring the issue of tariffs to the attention of the Australian Energy Market Commission to suggest a rule change that would assist in this matter.

While the Council recognises that the above mentioned suggestions are outside the jurisdiction of the AER, NSWIC believe that the AER must play a crucial part in bringing about changes to the way network prices are being determined. The current regulatory arrangements provide incentives for the networks to invent needs and convince the regulator of those needs. This is evident in the volume of information and data that is provided by Essential Energy in their original and subsequent proposals. The Council remains unconvinced by Essential Energy's revenue proposal and does not share the network's opinion on the inappropriateness of the AER's draft determination.

Finally, NSWIC does not support any provisions that would allow Essential Energy to place even greater financial burden on customers while it transitions to the new revenue allowance. NSWIC is of the opinion that Essential Energy, together with its NSW peers, have achieved abnormally high profits over the last regulatory period (over $1 billion in 2013-14 alone) which should be sufficient to enable any transition to a lower revenue allowance - particularly as any financing gap should be able to be met by borrowings at historically low international and Australian interest rates. As such, no concession should be given by the AER as a monopoly operator which has enjoyed extraordinary profits over the past determination period. It is the Council's view that should any transitional funding need to be made available, this should be paid for by the NSW Government as the owner of the networks and the recipient of the dividends generated by the networks.

> **NSWIC rejects any allowance made to Essential Energy to transition to a lower revenue allowance.**

## 2. CAPEX

NSWIC welcomes the AER's draft decision to reduce Essential Energy's allowed capital expenditure over the next regulatory control period.

Given the inaccurate demand projections prior to the last determination, the capital expenditure allowance provided for the last regulatory period by the AER led to a network that is larger than necessary based on current consumption/demand conditions. The size and resulting inefficiency of the network will continue to generate unnecessary ongoing maintenance and replacement costs under the current regulatory arrangement. What is particularly worrisome is the fact that the inefficient capital investment over the last regulatory period combined with any further capital allowance provided by the AER in the next regulatory period, will lead to increasing cost pressures for irrigators due to a growing regulatory asset base (RAB). As the AER draft decision has highlighted, Essential Energy's capital efficiency has been declining over time and is one of the lowest among the distribution networks in the NEM. NSWIC urges caution in allowing any further non-critical capital investment to ensure that Essential Energy's efficiency rate does not decline further. As we have outlined at the beginning of this submission, the Council only supports electricity costs that are based on efficient assets that directly provide a service to customers. As such, should assets be identified as 'under-utilised or idle' they should be written off from the asset base and not be subject to further replacement costs.

Despite our support for the AER's decision to reduce Essential Energy's allowed revenue allowance, we are concerned that the reduction is mainly a result of inter-temporal adjustments of capital expenditure rather than an avoidance of replacement capital costs. As such, future capital replacement costs will be an ongoing issue for irrigators and other electricity consumers. NSWIC believes there is urgent need to find a suitable substitute to replacement capital expenditure that will allow the network to continue to supply electricity in a safe, reliable and efficient manner. The Council has engaged with Essential Energy on a number of occasions to explore opportunities for demand management strategies however it appears that not much progress has been achieved. The Council stresses that demand management alternatives are a cost effective and sustainable alternative to capital investment and should be explored further. It is certainly concerning for NSWIC that Essential Energy has claimed that the AER's proposed capital expenditure cannot adequately service customers or enable a safe and reliable network to be maintained without considering alternatives to capital investments. NSWIC reiterates that the current regulatory structure does not provide incentives for Essential Energy to reduce its capital expenditure or increase its capital efficiency.

> **NSWIC submits that the AER should require Essential Energy to find alternative approaches to asset replacement capital.**

### 3. OPEX

NSWIC supports the AER's decision to reduce the base and step-change OPEX for Essential Energy, however we are somewhat concerned that the AER's approach to set base OPEX would result in the efficiency of Essential Energy being 18 per cent lower than the most efficient distribution business in the NEM.

In addition, the Council is concerned about the proposed increases by Essential Energy for their vegetation management expenditure. As we outlined in our previous submission to Essential Energy's original proposal, the Council is not convinced that the significant OPEX expenditure for vegetation management is prudent or efficient. Furthermore, Essential Energy has provided insufficient evidence to justify even higher vegetation management expenditure. Despite the independent consultant reports commissioned by Essential Energy, NSWIC believes that Essential Energy follows a very high vegetation management standard that does not incorporate the trend changes in network utilisation. Without a flexible approach to vegetation management that recognises a reduction in consumption/demand which will lead to changes in vegetation management (and a possible reduction), the Council believes Essential Energy's vegetation management proposal is significantly overstated.

Furthermore, Network NSW CEO Vince Graham has publically confirmed, that Essential Energy experiences significant labour inefficiencies and uncompetitive enterprise agreements. While current legislative requirements imposed on Essential Energy in this regard are outside Essential Energy's control, NSWIC points out that the Network NSW statement clearly highlights the inefficiencies and excessive costs that Essential Energy is imposing on customers. NSWIC believes that more needs to be done to increase Essential Energy's efficiency and reduce costs for its network customers.

> **NSWIC submits that further savings are achievable to increase Essential Energy's efficiency.**

### 4. WACC

NSWIC has outlined in its submission to the Senate Inquiry into the performance and management of electricity network companies that the AER's draft weighted average cost of capital (WACC) is set at a higher rate than was previously allowed by the NSW Independent Pricing and Administrative Tribunal (IPART) and by similar international regulators.

Furthermore, the determination of the WACC is based on an abstract concept which is often removed from the actual cost of capital for the regulated business. While the AER's draft decision of 7.15 per cent is lower than Essential Energy's initial and revised proposal, it is still higher than the actual cost of borrowing for a government owned monopoly in NSW.

While the discrepancy in proposed borrowing cost is a result of the methodology applied to calculate the WACC - and by design outside the AER's control - NSWIC points out that the proposed rate of return is a key driver of continuously rising electricity costs. Despite the discrepancy arising from the methodology, NSWIC suggests that the AER considers the underlying risk to Essential Energy of finding a lower WACC than the currently nominated rate of 7.15 percent under the draft determination and make appropriate adjustments that would lead to a closer alignment of proposed and actual borrowing cost for Essential Energy.

> **NSWIC submits that Essential Energy's WACC is comparatively high compared to other network businesses. A downward revision of the return on debt must be made to accurately reflect Essential Energy's realistic borrowing costs.**

## 5. RAB

As outlined previously in this submission, NSWIC is deeply concern about the existence and growth of Essential Energy's current regulated asset base (RAB). While an evaluation of the efficiency and usefulness of Essential Energy's RAB is currently outside the AER's control, NSWIC believes that the future sustainability of network charges on customers are crucially dependent on the size and future growth rate of the RAB.

NSWIC points out that the AER draft decision shows that Essential Energy's RAB will bouble by 2019 (compared to 2009), which is a trend that is not sustainable. Given the customer density, the costs associated with maintaining such a large network will make it prohibitively expensive for irrigators to utilise electricity on farm. The effect will be that a large number of irrigators will leave the network and source alternative production inputs and methods (including diesel and renewable energy sources) - leaving remaining consumers facing exponential growth in charges.

In order to avoid such a scenario, NSWIC urges the AER to bring this issue to the attention of the NSW Government and the AEMC and request that a re-evaluation of Essential Energy's existing RAB be urgently conducted to ensure that all of Essential Energy's assets are used and useful. NSWIC contends that should any asset not be utilised it should be removed from Essential Energy's RAB and not be subject to future maintenance and replacement costs.

NSWIC recommends that a rule change is initiated through the AEMC that will include a clause similar to the National Gas Rules (85(1)) into the National Electricity Rules. At this point in time, clause 11.56.5 of the NER precludes the AER from conducting such an analysis.

To reiterate, NSWIC is concerned that the opening RAB at 1 July 2014 is simply a rolled forward value from the 2009-14 regulatory control period without any evaluation whether the existing asset base is used and useful. While NSWIC understands that this is a requirement of the NER, we consider it fallacious as it does not allow for an assessment on the appropriateness of the existing asset base. With continuous investment of capital expenditure allowed in the following regulatory period, the regulated asset base will continue to grow off an already inflated base value and generate increasing and completely unsustainable costs for irrigators. This will still occur despite the reduction of $782.5 million of proposed CAPEX in the AER draft decision. Without a revaluation of the asset base and a greater focus on demand management options, the cost pressures for irrigators will not subside. As Attachment 2 of the AER draft determination indicates, a 10 per cent increase in the opening RAB causes revenues to increase by about 5.9 percent. With an increase in RAB, network costs  for customers will continue to increase. This is particular the case as the future capital expenditure allowance is nearly twice as high as the depreciation rate over the next regulatory period.

NSWIC recognise that the capital expenditure sharing scheme will over time allow the AER to punish/reward Essential Energy for over/under spending on its allowed CAPEX, however it does not take into consideration the actual utilisation of the current asset base. In addition, Essential Energy appears to reject the incentive schemes outright which would suggest to the Council that the actual cost increases might be larger than initially estimated.

> **NSWIC calls for a re-evaluation of Essential Energy's asset base to ensure that the current assets are used and useful, and the asset base value is realistic.**

## 6. Tariff Structure

While NSWIC acknowledges that the AER has no regulatory oversight of Essential Energy's tariff setting,  NSWIC would like to voice its frustration that despite an extensive regulatory framework, there is no guarantee that irrigators will experience lower network charges as a result of the AER's draft decision.

NSWIC hopes that the AEMC rule changes currently underway will assist in shedding light on the current tariff structure setting and potentially will allow for the consideration of the extension of the AER's regulatory power to assess the efficiency of Essential Energy's tariff structure.

NSWIC wants to ensure that the reduction in Essential Energy's allowed revenue will also translate to tangible benefits for irrigators in the forms of lower network charges.

> **NSWIC calls for regulatory oversight of Essential Energy's tariff setting.**

## Conclusion

As we have outlined on multiple occasions to the AER, current network charges are unsustainable for irrigated agricultural producers. Significant changes in the regulatory structure need to take place to ensure that network businesses and irrigators continue to remain financially viable.

**ENDS.**