

30 January 2015

Mr Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

By Email: SAElectricity2015@acc.gov.au; AERInquiry@aer.gov.au

Dear Mr Roberts

Issues Paper on SA Power Networks' 2015-20 Regulatory Proposal

SA Power Networks welcomes the opportunity to provide comment on the Australian Energy Regulator's (AER's) Issues Paper relating to our Regulatory Proposal for 2015-2020 which the AER released on 5 December 2014.

We note that the Issues Paper summarises aspects of our Regulatory Proposal and raises matters for consideration by customers and stakeholders. We encourage customers to take the opportunity (if they have not already done so) to read our customer overview document and detailed Proposal. These documents provide significantly more information on the rationale and integrity of our proposed expenditures over the next five years than that which is covered in the AER's Issues Paper.

For the benefit of customers, stakeholders and the AER our submission provides comments which:

- Clarify and correct a number of errors in the information included in the AER's Issues Paper;
- Outline our views on certain AER positions and statements as articulated in the Issues Paper;
- Clarify and correct information presented by Consumer Challenge Sub Panel 2 (CCP2) at the AER's Public Forum on 10 December 2014;
- Outline our views on certain CCP2 positions and statements as articulated at the Public Forum; and
- Advise our response to other matters raised by attendees at the AER's Public Forum.

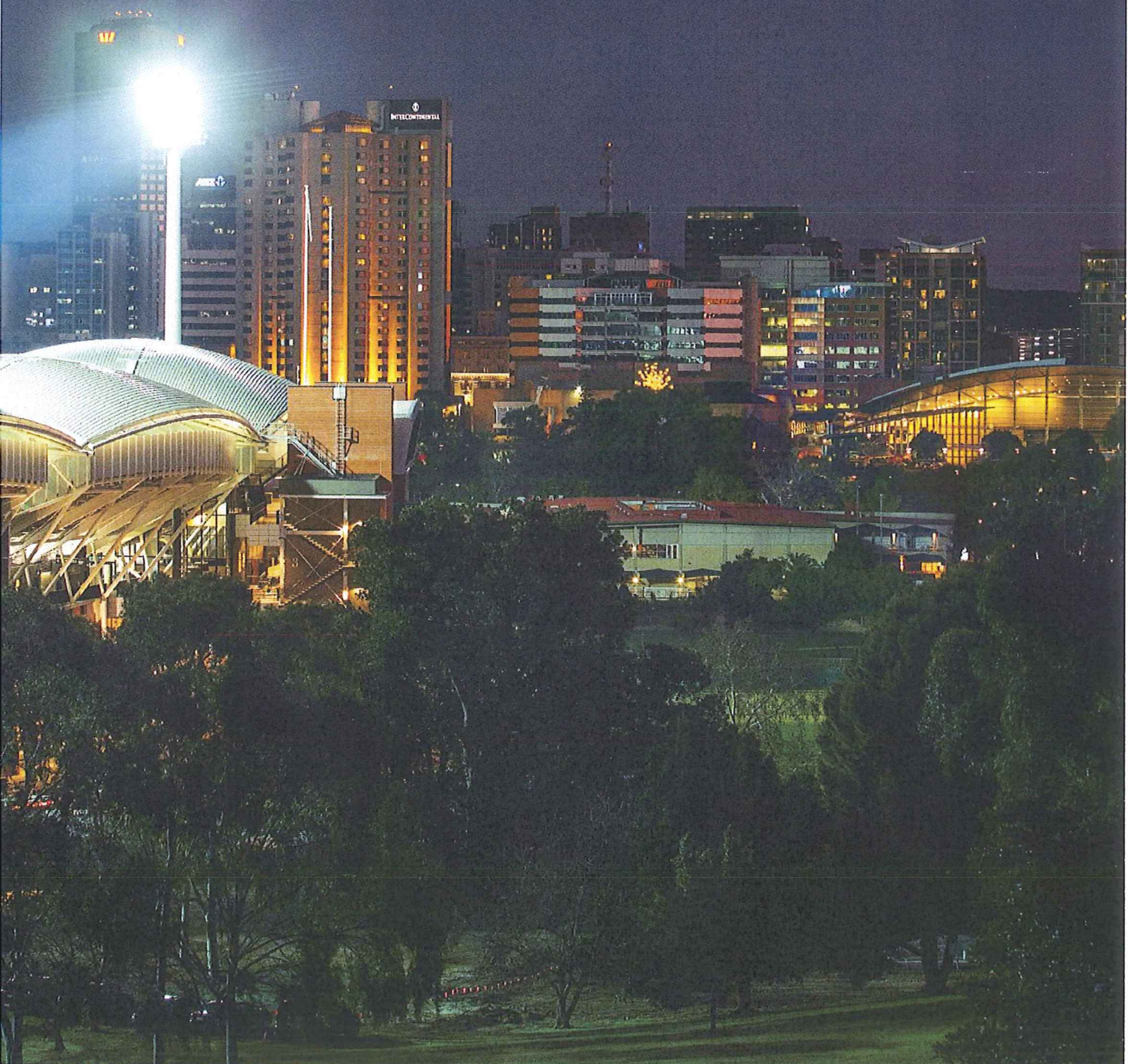
SA Power Networks trusts this submission will enhance customers', stakeholders' and the AER's understanding of our Regulatory Proposal as we work towards the AER making its Preliminary Determination for the 2015-20 regulatory control period. Please contact me on (08) 8404 5842 or Wayne Lissner, Head of Regulation, on (08) 8404 5391, if we can be of further assistance.

Yours sincerely



Sean Kelly
General Manager Corporate Strategy

**SA Power Networks response to the AER's Issues Paper:
SA Power Networks electricity distribution regulatory
proposal 2015-16 to 2019-20**



Summary

This submission is divided into three parts covering the Australian Energy Regulator (**AER**) Issues Paper, the Customer Challenge Panel (**CCP2**) presentations made at the Public Forum held on 10 December 2014 and matters raised by attendees at that Forum.

While we understand the important role the AER's Issues Paper plays in the consultation on our Regulatory Proposal, we do encourage customers to take the opportunity (if they have not already done so) to read our customer overview document and detailed Proposal. These documents provide significantly more information on the rationale and integrity of our proposed expenditures over the next five years.

This submission does not seek to replicate our Proposal but rather addresses matters by exception. For convenience our comments are provided in the same order as the sections of the Issues Paper. Key aspects of this submission are:

- SA Power Networks' capital expenditure proposals are driven by a range of factors. Localised demand forecasts contribute to a relatively small component of our capital program and the overall sales and demand forecast levels have limited bearing on the level of investment proposed for 2015-20;
- The deployment of broad-based Demand Side Participation strategies (such as the introduction of cost-reflective tariffs and maximising controllable load) over the next five years are key to minimising future network upgrade and augmentation expenditure;
- The historical growth in SA Power Networks' regulatory asset base is the lowest of any Distribution Network Service Provider (**DNSP**) in the National Electricity Market (**NEM**);
- From the AER's benchmarking analysis and an appropriate consideration of its environmental factors, SA Power Networks is at or close to the efficient frontier of DNSPs, and from this position it is more difficult to achieve ongoing efficiency improvements;
- SA Power Networks has a number of concerns with the AER's approach to estimating an appropriate rate of return and the tax allowance as indicated in the recent NSW decisions and we request that the AER reconsider their stated position on these matters;
- CCP2 presentations made at the Public Forum would be more informative for customers if they:
 - focussed on the details of the Regulatory Proposal rather than seeking to reopen matters relating to the National Electricity Rules (**NER**) which is the responsibility of the Australian Energy Market Commission (**AEMC**) and not the Australian Energy Regulator (**AER**); and
 - provided further relevant background information and explanation when making comparisons between businesses and across regulatory periods. For example, SA Power Networks' proposed tax allowance in 2015-20 is some 7.6% lower than the current period when compared in 2014/15 dollar terms. This differs significantly from the CCP2 assertion that SA Power Networks is seeking a 300% increase in tax allowance;
- The additional information available to the CCP2 on our Customer Engagement Program (**CEP**) should address their concerns with our CEP as presented at the Forum; and
- We have provided responses which address the matters raised by attendees at the Public Forum.



PART A: Issues Paper

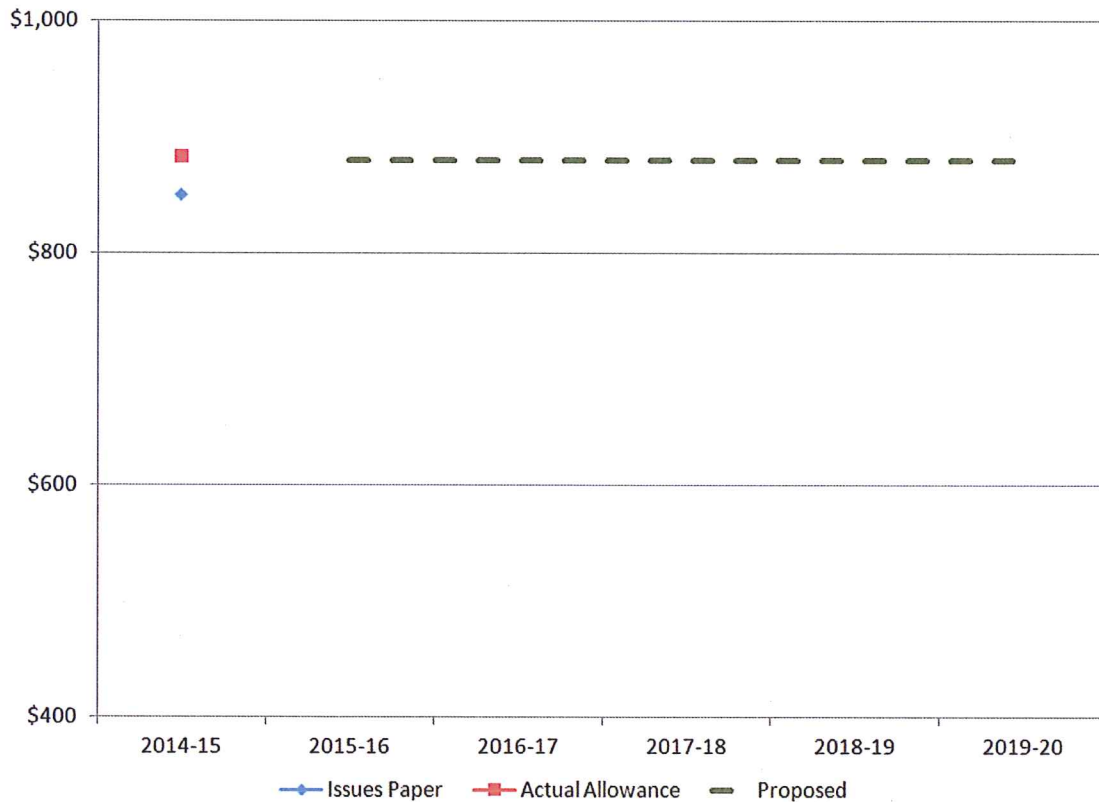
AER's initial observations (Section 2)

SA Power Networks' Proposal includes increases in capital and operating expenditures to meet our obligations under the National Electricity Objective (NEO) to deliver electricity distribution services in the long term interests of consumers, in meeting our regulated services standards for reliability, customer service and to prudently manage our poles and wires as well as meeting changing expectations that customers have asked of us. We have proposed to do all this whilst delivering increases in network charges of less than CPI on average.

The AER's Figure 1 (page 10) compares actual and allowed revenues since 2005/06 and our proposed revenues for the 2015-20 period. We note that there are two aspects of this information which require correction:

- Firstly, the revenue allowance shown for 2014/15 is incorrect. The correct allowance is \$883 million (in real, 2014/15 dollar terms) and includes the approved pass-through for the step change in vegetation management activities following the breaking of the 'millennium drought' in South Australia. Consequently, as shown in the graph below there is a reduction in the allowed revenue between 2014/15 and our Proposal from 2015/16, contrary to that shown in the Issues Paper.
- Secondly, whilst the difference is marginal, the actual revenues in the 2005-10 period were slightly below allowances, not above allowances as shown in the Issues Paper.

SA Power Networks' proposed total revenue (\$million, 2014-15)



Capital expenditure (Section 3)

Total capital expenditure

The AER correctly notes that SA Power Networks has underspent its capex allowance in the 2010-15 period and then suggests the “previous allowance may have been higher than necessary.”

Capital allowances are set prior to the commencement of each five year regulatory period based on the best available information at that time. It is widely accepted that circumstances within a regulatory period will often change from when allowances were set.

In our Regulatory Proposal (Table 20.2, p 175) we forecast that by June 2015 we will be underspent by \$184 million or 11% relative to the \$1.7 billion capital expenditure allowed for the five year period. Further, we explain in our Proposal that the under expenditure is primarily due to fewer capacity upgrade works and fewer customer connections than forecast, partially offset by an increase in expenditure on asset replacement works. Clearly the economic recovery in South Australia (after the Global Financial Crisis) has taken longer than was forecast back in early 2010 and we have also seen a higher than expected uptake in solar panels.

The national regulatory framework is an incentive-based regime which encourages distributors to meet service standards and deliver capital works efficiently. Where circumstances change, distributors should prudently and efficiently defer capital expenditure if it can be done without compromising service levels. Such deferral of capital expenditure results in a lower regulatory asset base and lower prices to customers in the next regulatory period. In this context we are confident that SA Power Networks has prudently managed the deferral of capital expenditure.

With respect to 2015-20, the AER notes we are proposing to increase capital expenditure by around 50% and comments whether this expenditure is justified “given SA Power Networks’ forecasts ongoing flat demand”. Overall demand is not the primary driver of our total 2015-20 capital expenditure program of \$2.5 billion. Our demand related capital expenditure is driven by changes in demand requirements at the local community level (such as new areas of growth like Mount Barker) and not the overall accumulated State demand. The forecast investment to meet local demand increases are only requiring \$345 million of augmentation expenditure (Refer Table 20.16, p 213) which is less than 14% of our total capital expenditure proposals.

It is inaccurate to link the capital expenditure program solely to flat demand forecasts. The program is driven by a range of factors as outlined in our Regulatory Proposal (refer Chapter 20, p 173).

Key Drivers of Capital Expenditure (Section 3.2)

Asset replacement

The AER clearly identifies the significant increase in asset replacement expenditure reflects the better knowledge we have of the condition of our assets and the work necessary to ensure we meet our obligations under our safety, reliability, maintenance and technical management plan (SRMTMP) and our reliability service standards as approved by the Essential Services Commission of South Australia (ESCOSA).



Augmentation expenditure – safety

The AER correctly notes that we are proposing significant safety-related expenditure. The increase is prudent and is largely driven by:

- A new bushfire mitigation program which takes into account strong concerns expressed by customers and the outcomes of the Victorian Bushfire Royal Commission and the Victorian Power Line Bushfire Safety Taskforce (\$220 million); and
- A new program to address road safety hazards from power lines located in high risk locations (\$78 million) specifically raised by customers during our customer engagement program.

SA Power Networks has a duty to take reasonable steps to ensure its distribution system is safe and safely operated (Section 60(1) of the Electricity Act) and to maintain and operate our distribution system in accordance with good electricity industry practice (NER Clause 5.2.1(a)). SA Power Networks considers that the Victorian Powerline Bushfire Safety Taskforce's recommendations now constitute good electricity industry practice in Australia.

Results from our customer engagement program clearly show the South Australian community places a high priority on bushfire risk management and expects SA Power Networks to adopt appropriate practices. Customer feedback also strongly supported strategic investment by SA Power Networks that focuses on public safety.

The recent Sampson Flat (north-east of Adelaide) bushfire that occurred earlier this month serves as a timely reminder of the growing bushfire risk in South Australia. That fire injured 134 people, mainly fire fighters, and burned more than 12,500 hectares over a few days, destroying or badly damaging 27 homes. It also destroyed four businesses, more than 100 sheds and other buildings, farm infrastructure and resulted in the deaths of 932 livestock animals.

Connections expenditure

The AER notes "Connections spending is proposed to increase, despite SA Power Networks forecasting flat or declining demand." The net expenditure (that is, gross expenditure less customer contributions) is forecast to be \$189 million for the 2015-20 period compared with \$153 million for the 2010-15 period and includes alterations to existing connections as well as new connections to our network. The Connections forecasts have been based on independent data provided by BIS Shrapnel.

While new connections will bring new loads onto our network and may increase localised peak demand requirements, other factors such as continued uptake of solar photo-voltaic (PV) systems, improved energy efficiency of appliances and general economic conditions contribute to the flat or declining overall demand. It is therefore misleading to link connections expenditure with overall flat demand forecasts.

Augmentation expenditure – other

Our 'augmentation' expenditure proposal includes expenditure other than demand-driven expenditure including reliability expenditure, expenditure on strategic projects (such as the replacement of the undersea cable to Kangaroo Island), expenditure to address environmental compliance, safety-related expenditure and expenditure to underground existing overhead assets in accordance with South Australian legislation requirements (via the Power Line Environment Committee (PLEC) program).



Augmentation - Non-network options

The AER also discusses the potential for non-network solutions to defer the need for augmentation of the network. The AER correctly identifies our position that in the next five years non-network alternatives have limited potential to affect forecast capex levels.

The limited potential is a natural consequence of the low peak demand growth forecast for the 2015-2020 period and, in turn, the relatively low proportion of capital expenditure directed toward demand driven expenditure. To clarify this position, SA Power Networks' view has been formed based on undertaking preliminary regulatory investment test (**RIT-D**) assessments on eight projects over \$5 million in value. These assessments showed that two of these projects have potentially viable non-network solutions which are being investigated further.

Over the next five years, SA Power Networks considers that the most critical 'non-network option' is the deployment of broad-based Demand Side Participation strategies such as the introduction of cost reflective tariffs and maximising controllable load as outlined in our Regulatory Proposal (s 14.22, p 130) and detailed in Attachments 14.3 and 20.34 respectively. These are key foundational strategies that, over time, have the potential to significantly improve network utilisation thus minimising future expenditure related to network upgrades and augmentations.

Regulatory asset base (section 3.3)

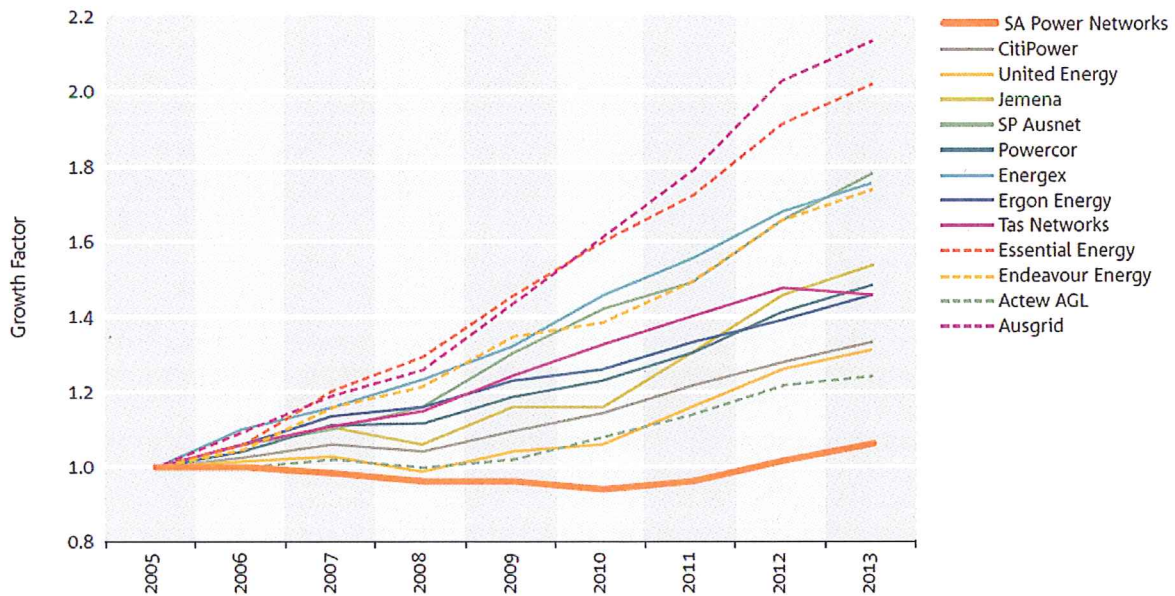
The AER has produced a chart displaying the SA Power Networks Regulatory Asset Base (**RAB**) value over 15 years. As the chart shows values in nominal terms, it includes the effects of inflation. 15 years is a relatively long time frame in which the compounding effects of inflation become significant. It is therefore misleading to infer all of this RAB 'growth' results from SA Power Networks' capital expenditures.

To avoid this potential inference, it would have been preferable for the AER to display the RAB growth in real, not nominal, terms. For example, the CCP2 presentation reproduced this graph at the Public Forum on 10 December 2014. During the presentation, the CCP2 member queried whether SA Power Networks' RAB increases are similar to the rates of RAB growth that have occurred in NSW and Queensland over the last decade. The CCP2 member further stated that they believed SA Power Networks was replicating what had happened in NSW and was potentially "building in a structural problem".

To allay CCP2 concerns and for the benefit of South Australian consumers we reproduce below the chart we provided in our Proposal which compares the real RAB growth of all distributors (ie excluding inflation). This chart clearly shows that SA Power Networks' RAB growth has been the lowest in the NEM, providing assurance that our investment in network infrastructure has been prudent, measured and that we only invest in infrastructure assets when have to.



Figure 2.2: Real RAB growth since 2005— NEM DNSPs



SOURCE: SA POWER NETWORKS ANALYSIS, BASED ON AUSTRALIAN ENERGY REGULATOR BENCHMARKING DATA 2014

Operating expenditure (Section 4)

Key drivers of operating expenditure & Step Changes (sections 4.1 & 4.2)

The AER has summarised key cost drivers in our operating expenditure proposal. Specifically, Table 6 outlines a number of step changes to our efficient 2013/14 base year operating costs. These costs reflect the necessary expenditure to:

- Meet new regulatory obligations;
- To ensure we effectively comply with existing obligations where there has been changes to good industry practice or where enhanced information has identified additional activity and work not currently undertaken nor provided for in the 2013/14 allowances;
- To ensure the South Australian community and our employees are kept safe; and
- To deliver on the concerns, expectations and new services that customers have told us they want addressed.

We take the opportunity to provide further clarification on two of the descriptions of the cost drivers in Table 6 as follows:

- Labour cost escalation is forecast to increase by \$57.1 million. Around 60% (\$34 million) of this increase is due to an increase in internal labour costs with the other 40% (\$23 million) being increases in external service contract labour costs.
- Telecommunications expenditure includes \$7.9 million to migrate to the existing South Australian Government mobile radio network, not to maintain a new mobile radio network as stated. Migration to the Government's network was identified as the most prudent and efficient option available to SA Power Networks.



Efficiency carry-over (section 4.4)

The AER has incorrectly indicated the efficiency benefits that SA Power Networks proposes to be carried forward into 2015-20. The correct amount is \$13.9 million (refer Table 23.1, p 280 of our Proposal) and not the \$25.9 million included in the Issues Paper.

Benchmarking results (section 4.5)

SA Power Networks' management and employees continually strive to deliver our services to the South Australian community at an efficient cost.

The AER's first benchmarking report, released 27 November 2014, indicates, on a state-wide basis, that South Australia (serviced solely by SA Power Networks) has the highest multilateral total factor productivity (MTFP) of any state in the NEM.

In the Issues Paper, the AER has presented MTFP and average operating expenditure benchmark comparisons. Out of the 13 distributors in the NEM, SA Power Networks is the second best performer in terms of MTFP (behind the Melbourne city distributor, CitiPower) and third best performer in terms of average operating expenditure (behind CitiPower and the Victorian rural distributor, Powercor).

In interpreting these results the AER suggests that "SA Power Networks appears to perform relatively well compared to many of its peers, though it may not be as efficient as the most efficient service providers" and "there may be scope for SA Power Networks to make efficiency improvements".

SA Power Networks urges caution if the AER is indicating SA Power Networks has significant scope to make further efficiency improvements, particularly given the leading state-wide performance and the supporting information published with the benchmarking report which shows that, on a state-wide basis, South Australia's operating expenditure multilateral partial factor productivity (MPFP) results are also the most efficient on average over the benchmark period.

Further, the AER states in the Issues Paper, relative efficiency outcomes "could be attributable to external factors". Such environmental factors may include customer densities, network configurations, vegetation management obligations, relative penetration of embedded photo-voltaic generation, service standard framework obligations and capitalisation and overhead allocation policies. For example, we note from the recent draft determination for ActewAGL that the AER provided a 30% increase to the benchmark operating expenditure, largely due to low capitalisation of overheads. SA Power Networks also capitalises a low percentage of overheads compared to other distributors.

SA Power Networks contends that, from the AER's benchmarking analysis and an appropriate consideration of our environmental factors, SA Power Networks is at or close to the efficient frontier of distribution service providers, and from this position it is relatively more difficult to achieve significant efficiency improvements.



Rate of Return (Section 5)

This section provides a brief response to the rate of return issues identified in the Issues Paper. This includes, where relevant, new issues raised by the AER in its recent draft decisions for the NSW/ACT electricity businesses and Jemena Gas Networks (NSW) Ltd (**NSW Draft Decisions**).

Based on the following comments we request that the AER revisit its approach to rate of return when considering its Preliminary Determination for SA Power Networks.

Return on equity (section 5.2)

As noted in the Issues Paper, in the NSW Draft Decisions the AER has maintained its Rate of Return Guideline approach to estimating the return on equity (the 'foundation model' approach).¹

SA Power Networks has a number of concerns with this approach, including:

- the AER's foundation model approach presupposes the existence of a superior model. However, the evidence before the AER demonstrates that there is no superior model;
- the Sharpe-Lintner Capital Asset Pricing Model (**SLCAPM**) has known deficiencies and cannot be said to be superior to other models;
- the AER's approach to alternative models is unreasonable. As a result, the AER's approach does not properly have regard to all relevant estimation methods, financial models and other evidence (as is required under the NER);
- there is no empirical evidence to support the AER's equity beta estimate. The AER has erred in its interpretation of key evidence in relation to beta; and
- the AER has also erred in its interpretation of key evidence in relation to the market risk premium (**MRP**).

Due to these errors, the AER's foundation model approach will not produce a return on equity estimate which contributes to achievement of the rate of return objective. The multi-model approach, as proposed by SA Power Networks, will deliver a return on equity estimate which reflects prevailing market conditions and which contributes to achievement of the rate of return objective. Accordingly, this approach should be used instead of the foundation model approach.

To the extent that the AER maintains its position on the return on equity in its Preliminary Determination for SA Power Networks, SA Power Networks will provide a detailed response – including identification of key errors in the AER approach as part of its submission for the Final Determination.

Return on debt (section 5.3)

We note that the AER's description of the transition approach for the cost of debt outlined in the Issues Paper is contrary to the AER Rate of Return Guideline. We seek clarification that this is solely an error in description of the Guideline's transition arrangements.

¹ AER, *Issues paper: SA Power Networks electricity distribution regulatory proposal 2015–16 to 2019–20*, December 2014, p 25.



New evidence presented in the NSW Draft Decisions in relation to return on debt transition

In its Regulatory Proposal, SA Power Networks proposed to adopt the return on debt transition approach set out in the Rate of Return Guideline – that is, estimating the return on debt for year 1 of the forthcoming regulatory period as an ‘on-the day’ rate, and then progressively transitioning to a trailing average return on debt over a 10 year period.

SA Power Networks adopted the Guideline approach to the return on debt transition because it understood the AER had formed a view in the Guideline process as to appropriate transitional arrangements, based on evidence as to efficient financing practices.

However in the NSW Draft Decisions, the AER has undertaken new analysis and referred to new evidence in relation to this issue. This includes:

- new AER analysis of what a benchmark efficient entity would have done under the previous regulatory approach to estimating the return on debt;² and
- expert analysis on this issue by Associate Professor Lally.³

Based on this new analysis and expert advice, the AER concludes that the efficient debt financing practice of the benchmark efficient entity under the previous regulatory approach would have been:

- to borrow long term (10 year) debt and stagger the borrowing so that only a small proportion (around 10 per cent) of the debt matured each year;
- to borrow using floating rate debt (or to borrow fixed rate debt and convert this to floating rate debt using fixed-to-floating interest rate swaps at the time of issuing the debt and which extended for the term of the debt, being 10 years); and
- to enter into floating-to-fixed interest rate swaps at, or around, the time of the service provider’s averaging period and which extended for the term of the access arrangement period, being typically five years).⁴

Under this financing strategy, the base interest rate component of the benchmark efficient entity’s actual return on debt is essentially matched with the regulatory allowance set using an “on-the-day” rate, while the debt risk premium component each year would reflect the historical (or trailing) average of the debt risk premiums over the previous 10 years.

SA Power Networks has previously explained that its debt financing practices under the previous regulatory approach were similar to what the AER now recognises would have been efficient practice.⁵ SA Power Networks has explained that it would not have been prudent, or even possible for SA Power Networks to refinance its entire debt portfolio and/or to fund new capex requirements during the averaging period used to estimate the risk free rate for the AER’s determinations. To manage risk to an acceptable level, SA Power Networks implemented treasury risk management strategies that aimed to lock in fixed interest rate swaps in the averaging period for the existing level of debt. However even under this approach, SA Power Networks retained the debt margin risk and sought to manage this risk by diversifying the timing of debt issuances and the debt maturity dates.

² For example: AER, *Draft decision: Ausgrid distribution determination 2015–16 to 2018–19 – Attachment 3: Rate of return*, November 2014, [3-113]-[3-128].

³ Lally, *Transitional arrangements for the cost of debt*, November 2014.

⁴ AER, *Draft decision: Ausgrid distribution determination 2015–16 to 2018–19 – Attachment 3: Rate of return*, November 2014, [3-115].

⁵ ETSA Utilities, CitiPower and Powercor Australia, *Joint Response to AER and EURCC Rule Change Proposals (ERC0134 / ERC0135)*, 8 December 2011, p 138.



SA Power Networks considers that the new analysis undertaken in the NSW Draft Decisions (which is consistent with SA Power Networks' previous submissions) does not support the AER's position on transitional arrangements in the Rate of Return Guideline. The AER's finding that efficient financing practice for the benchmark entity under the "on-the-day" approach would have involved some staggering of borrowing implies that a 10-year transition for the full return on debt – including both the interest rate and margin components – would not be appropriate. Given this finding, the AER's proposed transitional arrangement is unlikely to minimise the difference between the allowed return on debt for the forthcoming regulatory period and the required return on debt for the benchmark efficient entity.⁶

Therefore in making its Preliminary and Final Determinations for SA Power Networks, the AER should not adopt the Guideline position on transitional arrangements for the return on debt. Rather, the AER should adopt a position that is consistent with the new analysis it has undertaken and the expert advice it has received on this issue.

In light of the AER's findings in the NSW Draft Decisions, a 'hybrid' transitional arrangement would be more appropriate. That is:

- there should be a ten-year transition to trailing average estimation of the risk-free rate component of the return on debt; and
- there should be no transition for the debt margin (or debt risk premium) component. That is, the AER should immediately move to trailing average estimation of the debt risk premium component. This means that for the first year of the forthcoming regulatory period, the debt risk premium would be estimated as a ten-year trailing average, and this trailing average estimate would be updated in each subsequent year.

This approach would provide for an estimate of the return on debt which better reflects the required return on debt for the benchmark efficient entity. As noted above, under the efficient financing strategy identified by the AER in the NSW Draft Decisions, the base interest rate component of the benchmark efficient entity's return on debt would have been matched with the regulatory allowance set using an "on-the-day" rate, but the debt risk premium component each year would have reflected the historical (or trailing) average of the debt risk premiums over the previous ten years.

Accordingly, SA Power Networks submits that the AER should **not** adopt the Guideline position on transitional arrangements for the return on debt in its Preliminary and Final Determinations for SA Power Networks. Rather, the AER should adopt the hybrid transitional arrangement described above.

Other return on debt issues

SA Power Networks notes that in the NSW Draft Decisions the AER has adopted contrary positions to those proposed by SA Power Networks on a number of other issues relevant to estimation of the return on debt. These include:

- benchmark credit rating; and
- incorporation of a new issue premium.

SA Power Networks requests that the AER reconsider its position on these issues in its Preliminary Determination for SA Power Networks.

⁶ NER, cl 6.5.2(k)(1).



Gamma (section 5.4)

As noted in the Issues Paper, in the NSW Draft Decisions the AER has departed from its Guideline position in relation to gamma.⁷

SA Power Networks considers that the AER's revised position on gamma involves a number of errors, including:

- the AER's revised definition of theta – which seeks to exclude the effect of certain factors on the value of imputation credits – is conceptually incorrect and inconsistent with the requirements of the NER;
- the AER incorrectly uses equity ownership rates and redemption rates from tax statistics as direct evidence of the value of distributed credits (theta);
- the AER has erred in its interpretation of the equity ownership rate data;
- the AER's approach to evidence from market value studies is erroneous and unreasonable; and
- the AER's ultimate conclusion as to the value for gamma is inconsistent with the evidence presented in the NSW Draft Decisions, including the AER's own analysis of the equity ownership rate and redemption rate.

Due to these errors, the AER's estimate of gamma will not reflect the value of imputation credits to investors. The AER's approach leads to an overestimation of gamma and consequently an underestimation of the overall return required by investors. Accordingly, the AER's approach will not contribute to the achievement of the National Electricity Objective.

SA Power Networks requests that the AER reconsiders its position on gamma in its Preliminary Determination for SA Power Networks.

With regard to the rate of return and gamma issues outlined above, SA Power Networks requests the opportunity to discuss these matters further with AER officers prior to the Preliminary Determination being made in April 2015.

Consumer Engagement (Section 6)

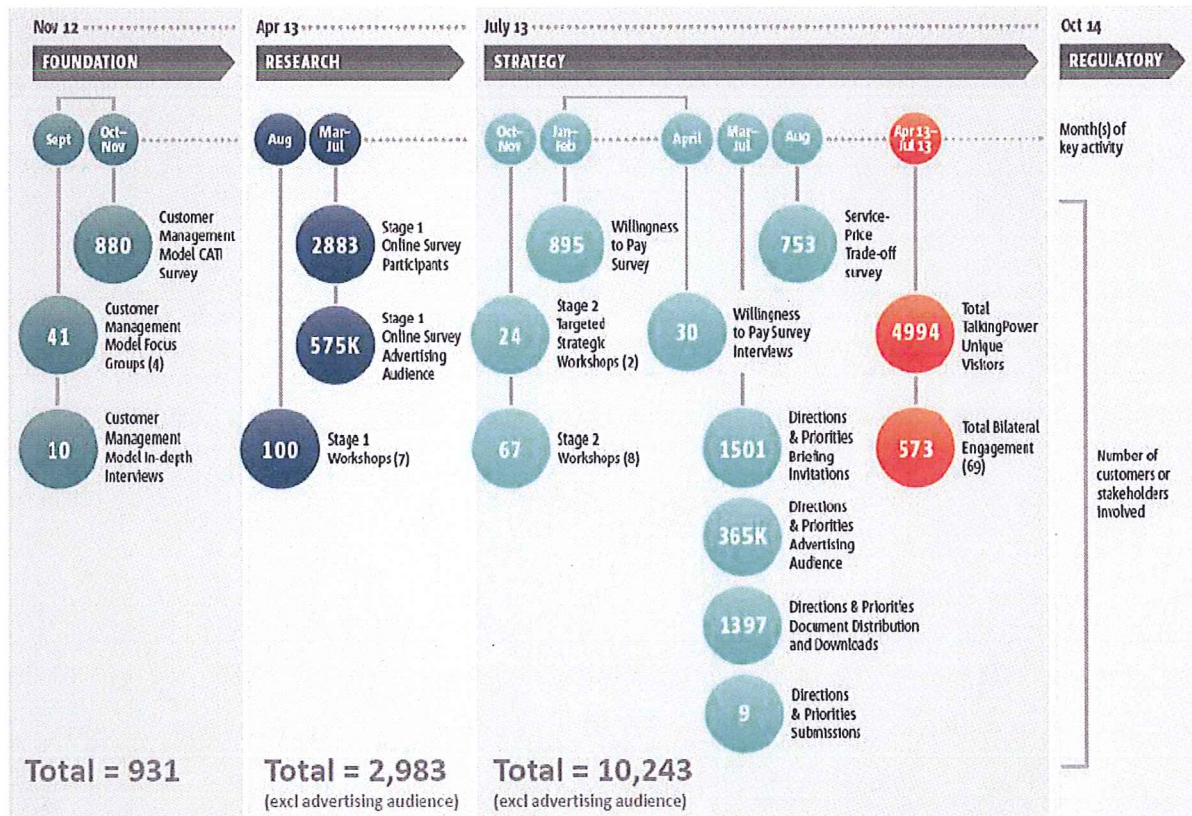
SA Power Networks has undertaken a comprehensive customer engagement program which has provided many useful insights into South Australian customer needs and expectations that have been incorporated into our Regulatory Proposal. Further details of the program are provided in both our customer overview document and throughout our detailed Regulatory Proposal.

The AER commented that SA Power Networks "...involved 8590 customers or stakeholders in its TalkingPower program...". We are unsure from where this figure has been extracted. The infographic below (provided in our Customer Engagement Program Attachment 16.6 to the Regulatory Proposal) summarises the interactions as at 31 October 2014. As at this date, the total number of interactions with customers and stakeholders from our Foundation, Research and Strategy stages, excluding advertising reach, exceeded 14,000 customers.

⁷ AER, *Issues paper: SA Power Networks electricity distribution regulatory proposal 2015–16 to 2019–20*, December 2014, p 28.



SA Power Networks TalkingPower – number of customers involved in key activities



CCP advice to AER

We also note that the wider Consumer Challenge Panel (CCP) issued the following general advice to the AER in relation to consumer engagement by network service providers:

- CCP letter dated 16 July 2014⁸, which included CCP observations on network service providers’ consumer engagement programs and made recommendations to the AER; and
- CCP letter dated 30 October 2014⁹, which identified a number of high-level themes and further concerns and recommendations.

SA Power Networks understands that all network service providers are at different stages of designing and implementing their consumer engagement programs. We designed and commenced implementation of our program in 2012, prior to the development and finalisation of the AER’s Consumer Engagement Guideline in late 2013. We understand that our program assisted the AER in drafting its Guideline and we have subsequently enhanced our program to ensure it covers all material requirements of the final, published Guideline.

We will continue to refine and enhance our CEP but believe it is more comprehensive, and more advanced in implementation, than many other network service providers’ programs. We believe, therefore, some of the CCP’s stated concerns with network service provider programs may not be as relevant to SA Power Networks. We will soon prepare and separately submit to the AER a more comprehensive response to each of the CCP’s concerns stated in the above letters.

⁸ Consumer Challenge Panel, *Preliminary Advice on the Effectiveness of Consumer Engagement by Network Businesses*, 16 July 2014.

⁹ Consumer Challenge Panel, *Further Advice on the Effectiveness of Consumer Engagement by Network Businesses*, 30 October 2014.



Independent review of SA Power Networks' Customer Engagement Program (CEP)

SA Power Networks also wishes to advise that as part of our desire to continually improve and further embed comprehensive customer engagement into our everyday business we have recently commissioned an independent review of our CEP. This review was conducted by Banarra, certified sustainability assurance practitioners. Banarra assessed the extent to which the CEP aligns, in terms of process and content, with the core principles and requirements for stakeholder engagement articulated in the AER's Consumer Engagement Guideline. Further, we asked Banarra to advise on the extent to which our program meets AccountAbility's AA1000 series of standards, including the Stakeholder Engagement Standard (AA1000SES). Banarra concluded that:

- SA Power Networks' TalkingPower CEP largely met the principles and other requirements of the AER Consumer Engagement Guideline and AA1000SES;
- our CEP included:
 - a strong corporate commitment towards good practice stakeholder engagement;
 - the use of consultation outputs to influence decision making and inform the 2015-20 Regulatory Proposal; and
 - comprehensive program planning and delivery of engagement activities; and
- as the program was progressively staged, it allowed sufficient time and provided information for stakeholders to participate effectively and in an informed manner.

Metering (Section 7.1)

The AER has expressed a view that the meter exit and transfer fees proposed by SA Power Networks are likely to inhibit development of effective competition in the provision of metering services.

Consistent with South Australian Government policy, our metering plans for 2015-20 include increased capital expenditure (as outlined in our Regulatory Proposal, p247), associated mainly with the incremental increase in costs for installing 'smart-ready' meters instead of basic accumulation meters from 1 July 2015:

- for all new customer connections;
- when replacing existing meters found to be defective; and
- at premises where customers upgrade their metering to take advantage of capacity tariffs.

Some IT infrastructure upgrade expenditure is also required to transition to monthly meter reading.

Our metering operating expenditure (refer Regulatory Proposal, pp 271-272) includes additional expenditure to move to monthly meter reading during the 2017/18 year and a step increase in the operating cost to manage meter data from that time.

Our meter exit fees were calculated to ensure SA Power Networks remains financially "whole" in the event of customers choosing an alternative metering provider, when meter contestability commences during the 2015-20 period. In particular, they seek to recover our administrative costs associated with transferring a customer to the new metering provider and meter asset stranding costs (the average written down capital value of the specific meter assets involved).

In our discussions with the AER on the AER's Framework and Approach Paper we discussed alternative options to imposing meter exit fees. Further in our Regulatory Proposal (p 357) we advised that SA Power Networks remains open to other options to ensure we are kept financially whole and which facilitate an effective contestable metering market. We note that the AER has



opined on no exit fees in the NSW draft determinations and we welcome the opportunity to further discuss this matter with the AER prior to our Preliminary Determination being made in April 2015.

Additional incentive to improve supply reliability during major storms and heatwaves (Section 7.3)

The AER states that SA Power Networks is proposing changes to the financial incentives it is paid for supply reliability improvement. However, the Paper omits that these changes have been proposed because:

- the AER in its Framework and Approach paper¹⁰ seeks to apply a consistent methodology to SA Power Networks in 2015-20 for classifying and excluding major weather event days (MEDs) from the calculation of underlying reliability performance;
- the adoption of a new methodology for SA Power Networks will create transitional issues; and
- SA Power Networks is seeking to ensure it is neither financially advantaged nor disadvantaged during transition to the new methodology.

The AER's proposed methodology for excluding MEDs from the calculation of underlying reliability performance is set out in its Service Target Performance Incentive Scheme (STPIS)¹¹. SA Power Networks supports this change as it stabilises the method for determining whether a day should be classified as a MED. As future STPIS reliability targets will be based on the preceding five years' actual underlying reliability performance, the proposed methodology will alter the calculation of future reliability targets.

If the proposed methodology had applied since 1 July 2010 it would have excluded about half the number of MEDs that have been excluded by the current methodology. That is, the underlying reliability improvement would have been greater, resulting in SA Power Networks' allowed revenue being 1.25% higher, on average. This is a material amount. However, the impact on a customer's retail bill would be around 0.4%, not 1% as stated in the Issues Paper.

Because reliability targets will be based on the preceding five years' actual average performance, four years from the current period and one year from the prior period, altering the methodology will impact not only the calculations for the 2015-20 targets but also the 2020-25 targets.

The AER's STPIS contemplates that arrangements may be necessary to accommodate transitional issues between regulatory periods when there are changes to the scheme's parameters or other attributes¹².

Consistent with these contemplated arrangements, our proposal is that the actual reliability performance for each year in the 2010-15 period should be recalculated using the new methodology and then adjusted by an amount which achieves the equivalent revenue at risk that arose via the current STPIS regime. We believe this is reasonable and fair to SA Power Networks and our customers and aligns with the AER's STPIS arrangements.

¹⁰ AER, *Final framework and approach for SA Power Networks Regulatory control period commencing 1 July 2015*, April 2014, s3.1.1 (p 55)

¹¹ AER, *Electricity distribution network service providers Service target performance incentive scheme*, November 2009, Appendix D

¹² *Ibid*, s2.6 "Transitional arrangements", p 8



PART B: Public Forum CCP2 Presentations

Two presentations were made at the 10 December 2014 Public Forum by the members of the Customer Challenge Sub-Panel (CCP2) who are reviewing aspects of SA Power Networks' 2015-2020 Proposal. These presentations contain a number of errors and presented information in a way that has the potential to be misleading to consumers without further context. We provide the following comments on specific matters raised by the CCP2.

Weighted average cost of capital

The CCP2 showed the UK energy regulator's (Ofgem's), nominal weighted average cost of capital (WACC), cost of equity and cost of debt for UK distributors.

We understand that the data provided on the return on equity in the CCP2 presentation has been based on the real rates of return in Ofgem's November 2014 distributor determinations of 6.0% , plus an inflation assumption of approximately 1.1%. The table then provides the nominal WACC for the AER's NSW Draft Decisions and an amended nominal WACC for SA Power Networks which is higher than that proposed by SA Power Networks.

This table has the potential to allow customers to conclude that the proposed return on equity is significantly higher than that allowed in the UK. The presentation did not inform customers of two important considerations that should be taken into account when making such international comparisons. Adjustments should be made for the differential between the real risk free rates applying in each country and Australian inflation should be used. Australian inflation is currently around 2.5%, and there is a real risk free rate differential between Australia and the UK of 1.5% as at December 2014.

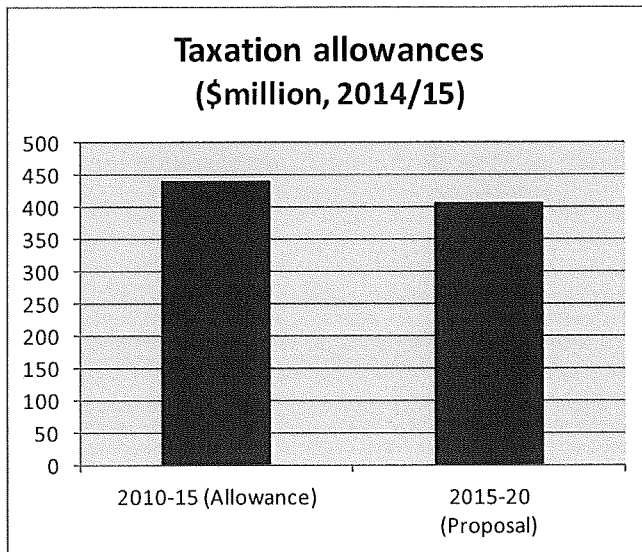
Adjusting the UK real cost of equity of 6.0% for these differences results in a nominal return on equity of around 10% for Australia, which is not dissimilar to SA Power Networks' proposal, and is in stark contrast to the CCP2 slide.

Tax allowance and Benchmark entity

CCP2 makes the statement that "the proposed income tax in the next period now almost 3X as much as AER allowed in the current period". This statement is factually incorrect and is misleading to customers. Firstly, the tax allowance for SA Power Networks for the current period for the 2010-15 period is \$441 million (in 2014/15 dollar terms) as per the AER Determination varied by the Australian Competition Tribunal on 19 May 2011. Secondly, to properly compare tax allowances across two regulatory periods it would be more appropriate to compare these allowances in the same dollars. In this regard we provide the following graph which compares the allowances in 2014/15 dollar terms and which shows that the tax allowance proposed for 2015-20 is 7.6% lower than what was approved by the AER for 2010-15.



SA Power Networks' taxation allowances (\$million, 2014-15)



It is important that customers are properly informed of the regulatory framework that applies in Australia. In particular, the use of a Benchmark Efficient Entity which is central to the National Electricity Rules (NER) and the way in which the AER is obliged to determine certain allowances.

Throughout the 2011-2012 review of the rules governing the economic regulation of distribution businesses, the Australian Energy Market Commission (AEMC), the rule maker, maintained the requirement for the use of a Benchmark Efficient Entity, including the calculation of the rate of return (NER 6.5.2) and the cost of corporate income tax (NER 6.5.3). The use of a Benchmark Efficient Entity is central to the incentive arrangements embodied in the regulatory framework. It provides incentives for distributors to efficiently structure their legal, financing and taxation affairs.

Accordingly, the AER is required under the NER to determine allowances for rate of return and tax based on this benchmark entity. The ownership structure, financing and taxation arrangements of individual distributors are not pertinent to the way the AER makes these decisions within regulatory determinations.

The CCP2 presentation suggests that the AER should amend the regulatory arrangements for taxation. Any changes to regulatory arrangements are a matter for the AEMC and not the AER. We note that a comprehensive review of and consultation on the NER was undertaken by the AEMC during 2012 which reaffirmed the requirement for the AER to consider the Benchmark Efficient Entity when making decisions on these matters.

Profitability comparisons

The CCP2 states that the profitability of SA Power Networks is of concern and requests the AER to investigate these matters. SA Power Networks remains concerned that the CCP2 continues to raise matters in a way which, in our view, is misleading to customers and is contrary to both the regulatory framework which the AER is obliged to use and also the independent role of the Customer Challenge Panel.



Firstly, the regulatory framework is about setting the allowed revenues (not profits) for distributors to efficiently meet their obligations under the National Electricity Objective which must take into account the long term interests of customers. A comparison of profits, even if properly calculated, is not consistent with the way the AER must make determinations. Any suggestion that the AER should move away from the building block revenue allowance calculation approach specified in the NER would require a change to the NER and this is a matter that would need to be addressed by the AEMC. The AER does not have the capacity to step outside the rules in making determinations.

By regulating revenue only, businesses have incentives to improve efficiency and thereby profitability. If profitability were to be regulated, businesses would not be incentivised to improve efficiency. Furthermore, under the NER, efficiency gains made by network businesses are shared with customers, who see lower charges as a result of improved efficiency. Relative profitability is an outcome of businesses responding to the incentive based regulatory framework as intended, not a sign of regulatory failure.

Secondly, we have previously advised the CCP2 that the basis of its profit analysis is flawed and misleading to consumers as the many variables that must be taken into account when considering such an analysis are not disclosed. Specifically, any attempt to compare a single distributor in Australia to another distributor in the UK raises, for a single year, many potential points of difference that include:

- differing rates of return between countries;
- differences in regulatory arrangements;
- differing accounting standards and policies;
- differing non-regulated activities included in the results which are not relevant to any comparison of regulated businesses;
- differing tax regimes in each country;
- differing corporate structures and financing arrangements;
- one-off factors in the results of either distributor in the single year chosen for comparison; and
- fundamental differences in the nature and operation of the networks involved, such as those arising from climate or customer density.

For example, customer contributions towards capital works and gifted assets are included in SA Power Networks' profit in compliance with Australian Accounting Standards. Customer contributions are not included in UK Power Networks' profit, in compliance with the UK's Generally Accepted Accounting Principles (**GAAP**). This increases SA Power Networks' reported profit by around \$100 million even though we receive no benefit from these two matters, that is, we receive no depreciation allowance or rate of return on customer contributions and gifted assets.

A fundamental aspect of the regulatory framework in both Australia and the UK is that the rate of return is applied to the assets employed in delivering the service to customers. The CCP2 correctly points out that SA Power Networks' asset base per connection is four times that of the UK. Accordingly, under the regulatory frameworks in both countries it would be expected that, if all other things were the same, then the returns to SA Power Networks would be four times that of the UK distributor.

We have previously advised the CCP2 that there are also a number of factors that contribute to the higher level of assets used to provide services to South Australian customers including:

- a much lower customer density in South Australia compared with London and the south-east of England (SA Power Networks' customer density is approximately 10 customers per



kilometre of line, whereas for UK Power Networks it is more than 40 customers per kilometre) which means that more assets are required to supply an equivalent number of customers in South Australia; and

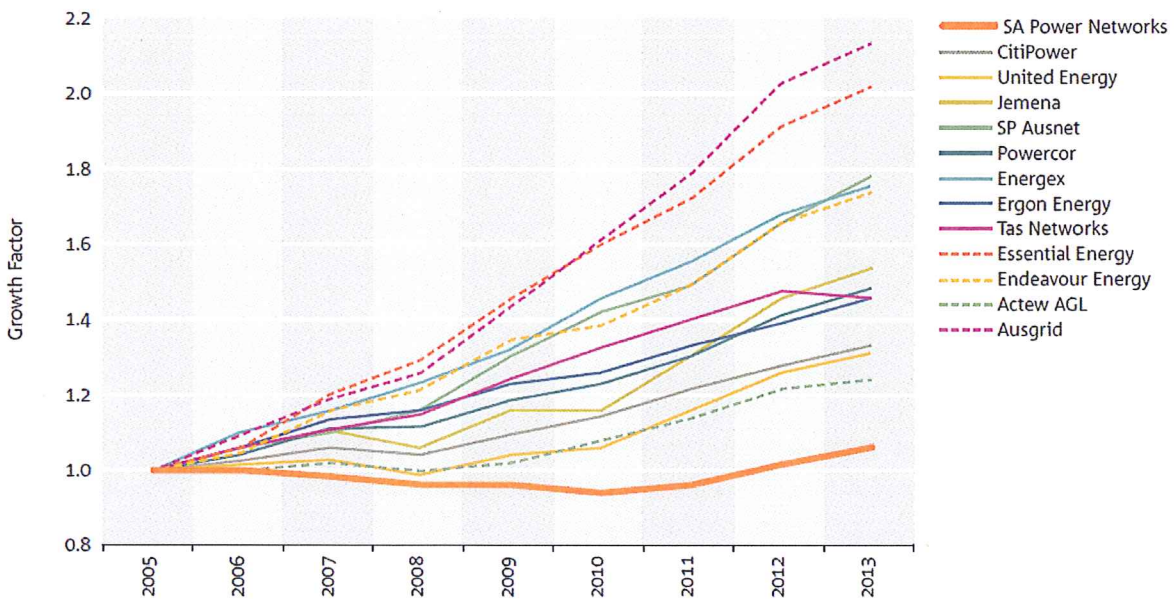
- a greater than 90% penetration of air-conditioning in South Australia which drives a much peakier demand profile, increasing the asset cost per customer to meet demands on hot days.

Thirdly, the presentation of profit before interest and tax on a per connection basis ignores the significant interest expense that is incurred in investing in the assets needed to deliver network services to customers. Furthermore, it can be misleading to some consumers in that they may interpret that the profit on their individual connection is at the level quoted by the CCP2 being \$710. Clearly, for the average residential customer such a number is absurd given the average residential customer's annual network charge is only \$672.

Regulatory asset base

We have noted earlier in this submission (Page 5) that the most appropriate way to look at the growth in the regulated asset base is in real terms and that SA Power Networks has had the lowest RAB growth across the NEM. Refer graph below.

Figure 2.2: Real RAB growth since 2005— NEM DNSPs



SOURCE: SA POWER NETWORKS ANALYSIS, BASED ON AUSTRALIAN ENERGY REGULATOR BENCHMARKING DATA 2014

Role of consumer engagement

The CCP2 presented their view of the 'pros and cons' of SA Power Networks' Customer Engagement Program (CEP) that supported development of SA Power Networks' Regulatory Proposal. Although the assessment was largely positive, the CCP2 indicated it had received consumer feedback which expressed concern at:

- the lack of clarity of cost/price implications of our expenditure proposals;



- the cost of our engagement program;
- the validity of the outcomes from our program, given the population sample involved;
- that service/price trade-off options had not been explored adequately; and
- whether Consumer Engagement was sufficiently mature to justify increased expenditures.

We provide the following initial comments on these aspects.

Clarity of cost/price implications of our proposals

Our CEP was designed to ensure that a comprehensive and appropriate range of service arenas and their attributes formed the basis of our engagement. A fundamental consideration of customer engagement is providing an understanding of the potential price impacts of changes in service outcomes.

Our consumer engagement discussions and customer surveys were held in the explicit context of distribution prices increasing by no more than CPI, or in the case of the online survey, the scenario of price increases presented was no more than those experienced in the current 2010-15 period. As such, the overall price impacts of our proposals were clear to CEP participants and, where targeted innovative services were contemplated, rigorous discrete choice modelling techniques were utilised. We consider our CEP allowed customers and stakeholders to come to a valid personal judgement of value and balance with regard to our proposals.

Cost of our engagement program

SA Power Networks' competitive purchasing practices ensured that the costs associated with the CEP were reflective of the market rates for the scope, types of engagement, methodologies put into practice and, where applicable, the experience of practitioners. SA Power Networks considers that the costs of the program struck the right balance between being efficient in delivery of the program whilst ensuring the program was suitably engaging and was comprehensive enough to be able to capture customers' concerns and expectations across our diverse customer base.

Validity of the outcomes from our program, given the population sample

We designed and implemented a practical and comprehensive program of customer engagement to identify services and service delivery options in the long-term interests of customers. Our CEP used a range of engagement methods including formal surveys, workshops, design-thinking approaches and 'Willingness to Pay' research in order to survey the views of a broad customer base. Statistically valid samples were achieved in the quantitative components of the program.

Stakeholder mapping and sampling methods ensured a representative view of the population, including specific age segments, solar and hardship customer segments, and provided multiple opportunities for customer and stakeholder groups to provide input. The rigour applied to sampling and recruiting by SA Power Networks and its service providers, in addition to independent analysis and reporting, supports the quality of the outputs and insights gathered from our CEP¹³.

¹³ Recruiting principles for focus groups, workshops and surveys as detailed by the professional standards of the Australian Market and Social Research Society (AMSRS)



Service/price trade-off options

Our reliability standards are set by the Essential Services Commission of South Australia (**ESCoSA**) and customers had clearly indicated in our CEP that they were satisfied with SA Power Networks' reliability performance. Under ESCoSA's recent decision on reliability standards to apply in SA for 2015-20, SA Power Networks must maintain historical reliability levels.

Notwithstanding this, we conducted further customer research titled 'Service-Price trade-off' to obtain further insights on supply reliability and price related issues and to explore price / supply reliability trade offs. The customer research was independently carried out by The NTF Group. The methodology and approach utilised focus groups and an online survey. It was found that:

- 80% of respondents would most likely pay about the same amount for the same standard of service;
- 11% of respondents would most likely pay more for a more reliable standard of service; and
- 9% of respondents would most likely pay less for a less reliable standard of service.

Maturity of our engagement program

We believe that the TalkingPower CEP design and delivery are sufficiently mature that the outcomes fairly represent the views of South Australian electricity customers. We conducted extensive research to quantify ongoing priorities for customers, and important shifts in their expectations of us, implemented multiple engagement methods and strong-capacity building mechanisms to enable effective and informed participation of stakeholders.

PART C: Matters raised by attendees at the Public Forum

SA Power Networks provides the following comments on matters raised by attendees during the Question and Answer segment of the Public Forum.

South Australian Council of Social Services

Representatives of the South Australian Council of Social Services (**SACOSS**) queried whether the translations of our Willingness to Pay research were valid and thus whether our Regulatory Proposal correctly reflected the outcomes of the Willingness to Pay (discrete choice modelling) research.

To assist in understanding of this research we have since published the Survey Tool on our TalkingPower consultation website (www.talkingpower.com.au) and we have also responded more comprehensively directly to SACOSS. In our response to SACOSS we outlined:

- proposed expenditures to meet customer-driven initiatives based on changing community expectations;
- a summary of key initiatives with corresponding proposed spend; and
- that the initiatives in our Proposal are significantly less extensive than many of the options that customers supported in the Willingness to Pay research.

We discussed this response with SACOSS' consultant and we understand they are satisfied with the clarifications provided.



Central Irrigation Trust

A representative from the Central Irrigation Trust (**CIT**) expressed the following concerns:

1. CIT power bills had increased 100% in the past five years, with the distribution component being a significant contributor to this increase;
2. Consultation on our Regulatory Proposal and expenditure plans was inadequate;
3. Marginal loss factors had cost CIT \$90,000 in the past year; and
4. SA Power Networks' sales forecasts may be overstated due to business closures such as the General Motors plant at Elizabeth and Bradken foundry, particularly with the volume risk moving to customers under a revenue cap arrangement.

Bill increases

We have reviewed our 2009/10 and 2014/15 prices (HV and LV Demand tariffs) and our initial analysis confirms that CIT's bills would have almost doubled during this period. During this period CIT has been impacted by tariff reform, specifically the removal of averaging of charges and consequent cross-subsidisation from other customers who use less electricity at peak times than CIT.

CIT's electricity bill reflects high irrigation pumping loads during the hottest and highest priced times of the year. We understand that CIT's customers value highly the availability of irrigation water during the hottest times of the year and prices will continue to be high at these times. This situation is not expected to improve as Australian temperatures are projected to increase, with more extreme hot days and fewer cool days¹⁴.

More cost-reflective price signalling should lead to investigation of alternative options to reduce CIT's overall costs and promote more economically and sustainable efficient outcomes for all customers.

Consultation

We disagree with the assessment that our consultation process has been inadequate. As noted earlier:

- our consultation to date has been thorough and extensive;
- the AER has acknowledged SA Power Networks' CEP as a positive exemplar¹⁵ for the industry; and
- an independent review by Banarra confirmed our CEP was comprehensive and allowed stakeholders to participate effectively.

Notwithstanding these positive assessments, we are committed to continually improving our CEP and will always look for ways to better engage with all stakeholders in groups or on an individual basis.

Marginal loss factors

Marginal loss factors (**MLFs**) reflect losses incurred on the transmission network and are applied to the energy (not network) component of customers' bills. SA Power Networks does not calculate or apply MLFs. It is the Australian Energy Market Operator (**AEMO**) that calculates MLFs using data sourced from ElectraNet SA's meters.

¹⁴ Bureau of Meteorology and CSIRO, *State of the Climate Report 2014*, 2014, p15

¹⁵ AER, *Better Regulation Explanatory statement Consumer Engagement Guideline for Network Service Providers*, November 2013, P17



SA Power Networks does have a role in assigning customers to a MLF in accordance with our obligations. We also have special approval for small customers to use a state-wide MLF but do not have approval to use such arrangements for large customers such as CIT. To do so would be contrary to the Australian Energy Market Commission and Government policy promoting cost-reflectivity.

If the MLF calculation is correct, then CIT is paying a cost-reflective price for their energy. If the MLF calculation is flawed, CIT should address this with AEMO.

Sales forecasts

SA Power Networks' sales forecasts have been based on the independently prepared forecasts from AEMO. They allow for major customer closures and load reductions such as the forecast closure of the General Motors plant at Elizabeth and mothballing of SA Water's desalination plant at Port Stanvac. They have also factored in general economic conditions, further up-take of solar photovoltaic systems and adoption of more efficient appliances.

Our forecasts are not overstated. They are the most accurate forecasts we can prepare based on currently available information.

Actual sales above forecast could eventuate if lower retail prices encourage more electricity use (price elasticity), economic conditions improve, or for other reasons. If sales are higher than under the revenue control applicable to SA Power Networks (as already determined by the AER) network prices will reduce.

