

## NSW ELECTRICITY DISTRIBUTION DETERMINATIONS: AUSGRID, ENDEAVOUR ENERGY, ESSENTIAL ENERGY 2019 - 2024

### 1. INTRODUCTION AND SUMMARY

The Energy Users Association of Australia (EUAA) is the peak body representing Australian energy users. Our membership covers a broad cross section of the Australian economy including significant retail, manufacturing and materials processing industries. Combined they employ over 1 million Australians, pay billions in energy bills every year and are desperate to see all parts of the energy supply chain making their contribution to the National Electricity Objective. Our members are highly exposed to movements in both gas and electricity prices and have been under increasing stress due to escalating energy costs.

These increased costs are either absorbed by the business, making it more difficult to maintain existing levels of employment or passed through to consumers in the form of increases in the prices paid for many everyday items. Many of our members have operations in NSW, including some with operations across all three DNSPs and have borne large rises in network charges over the last decade.

There have been some positive developments in network regulation that are welcomed by our members. Limited Merits Review has been abolished, while the AER is developing what we hope will be a binding rate of return guideline which will apply to the NSW distributors. Network wide reviews, like the recently initiated review of the taxation building block, provide all stakeholders with the opportunity to reassess the relevance of the current regulatory framework to the NEO.

This submission comments on the proposals submitted by Ausgrid, Endeavour and Essential Energy for the period 2019-2024 on 30<sup>th</sup> April 2018. We understand that further discussions have taken place between the AER and at least one of the networks regarding possible changes to their proposals from what was submitted. However, given we are unaware of the details of these discussions, this submission comments on the proposals as submitted.

Our primary criterion for assessment is affordability. This is no different for the vulnerable residential consumer, the vulnerable small business, or the vulnerable large business subject to international competition. With the exception of perhaps some isolated areas, in general we see no justification for spending to achieve improved reliability above the existing level. Rather we look to improved efficiencies to enable the DNSPs to provide the same level of service at a lower real cost. On affordability, our members:

- Look forward to seeing the “dividend” (lower capex/opex) from the high level of capex in the past decade
- Look forward to robust analysis by the AER of the opex and capex proposals from Ausgrid and Endeavour that appear to be much higher than what would be regarded as prudent and efficient
- Find it difficult to understand why the AER assumption of zero productivity improvement in opex should be acceptable; our members have continuous and relentless pressure to improve productivity in their organisations
- Strongly support the concept “causer pays”, particularly in relation to customer connections
- Look to substantial progress being made in cost reflective pricing for all consumers over the 2019-24 reset period

Our comments are based on:

- EUAA’s membership of the Ausgrid’s Customer Consultative Committee and Reset Working Group and attendance at the Stakeholder Deep Dive sessions in Q1, 2018
- Brief review of the Endeavour and Essential submissions
- Participation in the AER Forum on 3<sup>rd</sup> July, and
- Discussions with the ECA, PIAC and CCP 10

In summary we conclude that:

- the submission by Essential is that closest to capable of being accepted
- those from Endeavour and Ausgrid are a considerable distance for being capable of acceptance and hence this submission focusses on these two networks, and Ausgrid in particular.

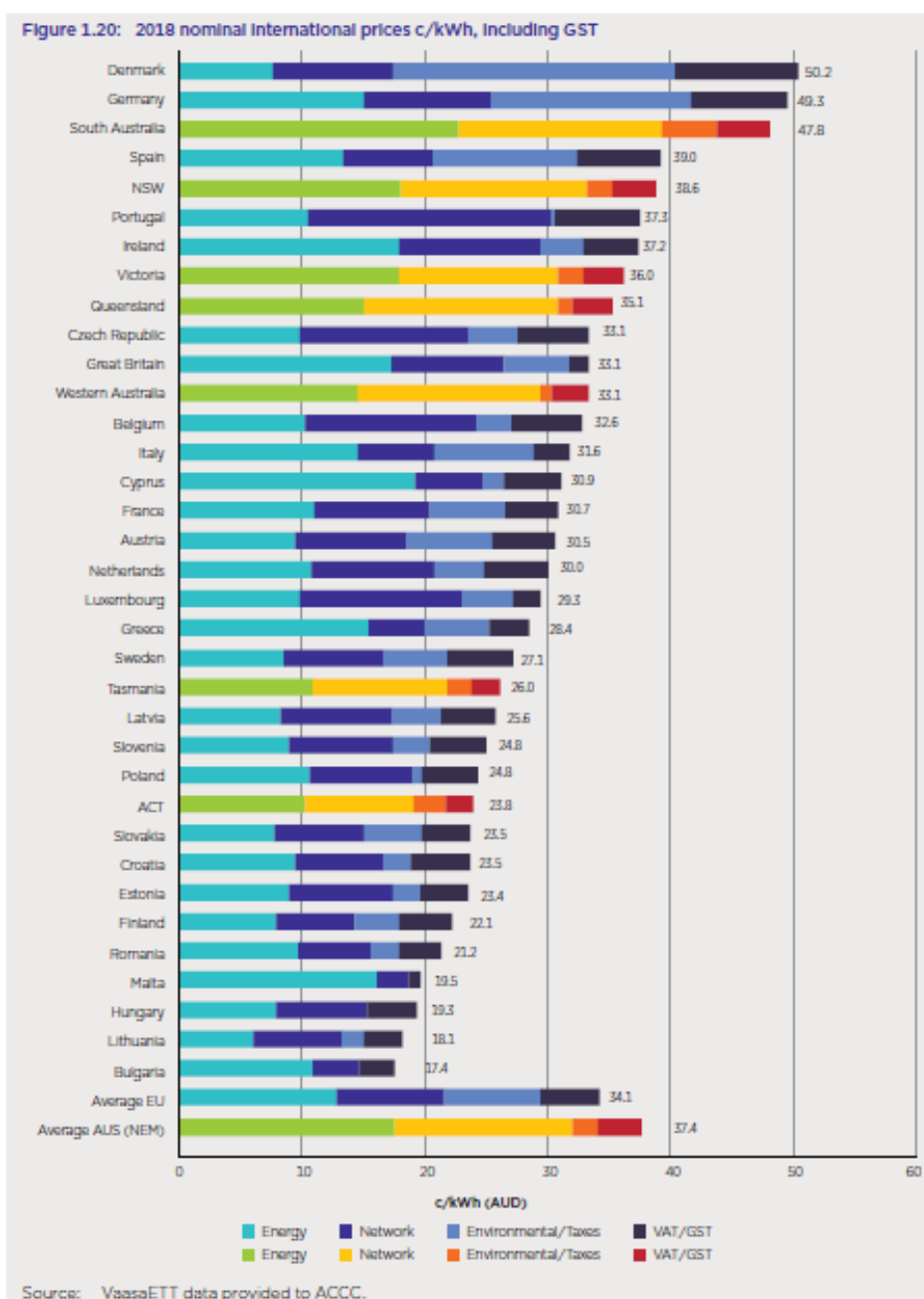
In addition to this submission, we support the separate submissions being made by Energy Consumers Australia, PIAC and the Consumer Challenge Panel.

**2. WE NEED TO CONSIDER THE CONSUMER CONTEXT**

It is important to put the three network proposals in context.

(i) *The number one consumer priority is affordability*

Ausgrid highlights customer feedback on themes of affordability, reliability and sustainability<sup>1</sup>. In EUAA’s view, affordability is the primary objective. Traditionally energy policy focusses on “vulnerable” customers on the assumption that they are only residential customers. There are vulnerable customers across all business sizes as well. Australia now has some of the higher electricity costs in the world as shown by the recent ACCC report<sup>2</sup>:



<sup>1</sup> Ausgrid pp. 27-35

<sup>2</sup> ACCC op cit p. 24

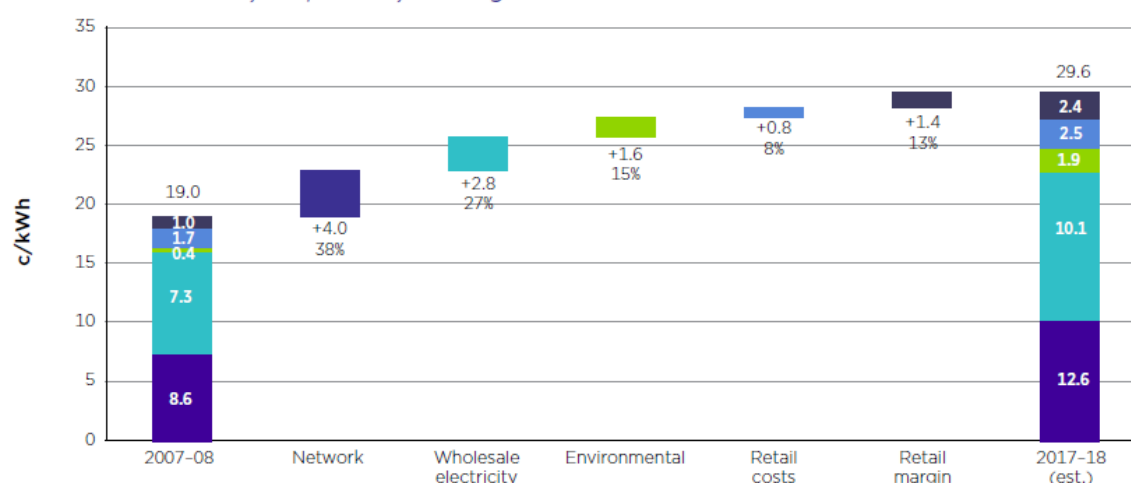
Australian industry has lost the competitive advantage it did have in energy costs and this will not be regained for many years, if at all.

Our members are happy with the current level of reliability and seek to have improved efficiency and productivity within Ausgrid being able to deliver that level of reliability at a lower real cost. Our members are paying for a huge level of capex and opex over the 2005-2017 period. They are now looking to see a “dividend” for that as shown by the ability of the DNSPs to provide the same level of reliability at a substantially lower cost.

(ii) *Network charges have been the major contributing factor to the loss of affordability over the past decade*

The recent ACCC report<sup>3</sup> concluded that network charges were by far the largest contributor (38%) to real price growth over the last decade. The fact that network prices have stabilised in recent years is welcome, but has little given little respite to consumers given the scale of previous rises.

**Figure B: Change in average residential customer effective prices (c/kWh) from 2007-08 to 2017-18, NEM-wide, real \$2016-17, excluding GST**



Note: The percentages show each components' contribution to the total increase between 2007-08 and 2017-18.

(iii) *There has been considerable past over-investment in NSW DNSPs that consumers will be paying for over the coming decades*

The recent estimates of the Grattan Institute are shown in the table<sup>4</sup>:

Network	Estimated Excess capex	Excess capex as % of RAB growth
Ausgrid	5,442	63%
Essential	3,304	72%
Endeavour	849	27%

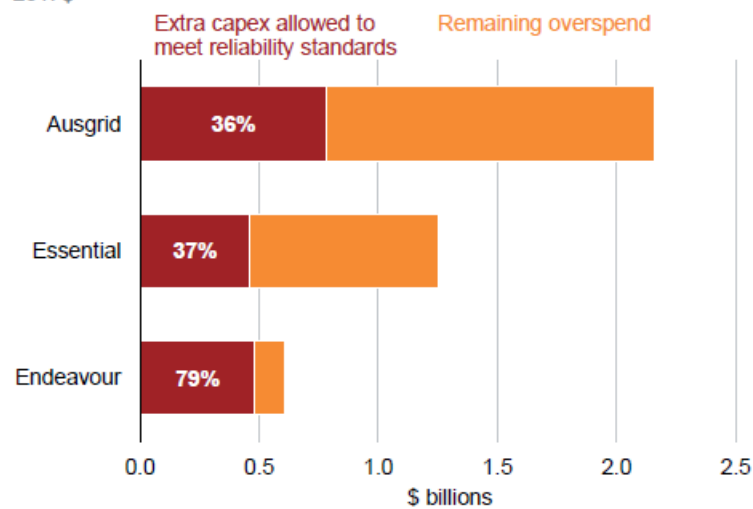
One major cause of this expansion were the higher reliability standards imposed by the State Government. Other factors include Government ownership, poor forecasting record and the regulatory framework were important contributors to an over inflated RAB with the Grattan analysis giving an indication of relative contribution<sup>5</sup>.

<sup>3</sup> ACCC “Restoring electricity affordability and Australia’s competitiveness – Retail Electricity Pricing Final Report” July 2018 p. v

<sup>4</sup> Grattan “Down to the wire” Technical supplement March 2018 p.35

<sup>5</sup> Grattan “Down to the wire – a sustainable electricity network for Australia” March 2018 p. 23

**Figure 4.3: Reliability standards caused some of the overspend of regulatory allowances in the late-2000s**  
Capex overspend by NSW distribution networks from 2005-06 to 2008-09, 2017\$



Source: Grattan analysis of network determinations (AER (2018a)) and IPART (2006).

We acknowledged that while there is debate over the level of this over-investment, it is difficult to argue that over-investment has not occurred. Grattan acknowledged that the numbers<sup>6</sup>:

“...provide a top-down ‘sense check’ on past RAB growth.”

However the ACCC commented that, after reviewing the arguments, it<sup>7</sup>:

“...considers that the numbers derived using the Grattan methodology represent a reasonable way to go about estimating the potential over-investment in electricity networks.”

(iv) *Networks’ poor productivity performance*

The latest AER productivity data for 2015-16<sup>8</sup>, shows that the NSW DNSPs performed poorly when compared with the 13 DNSPs in the NEM. The best was Endeavour at 8<sup>th</sup>, down from 7<sup>th</sup> in 2015; then Essential at 11<sup>th</sup>, up from 12<sup>th</sup> in 2015. Ausgrid was the worst performer at 13<sup>th</sup>, the same as 2015. Ausgrid has a MTFP score of nearly half that of the best performing DNSP – Citipower, which operates a very similar network to Ausgrid.

Taken over the decade 2006-2016, the NSW DNSPs have consistently been at or near the bottom of the performance tables by State<sup>9</sup>.

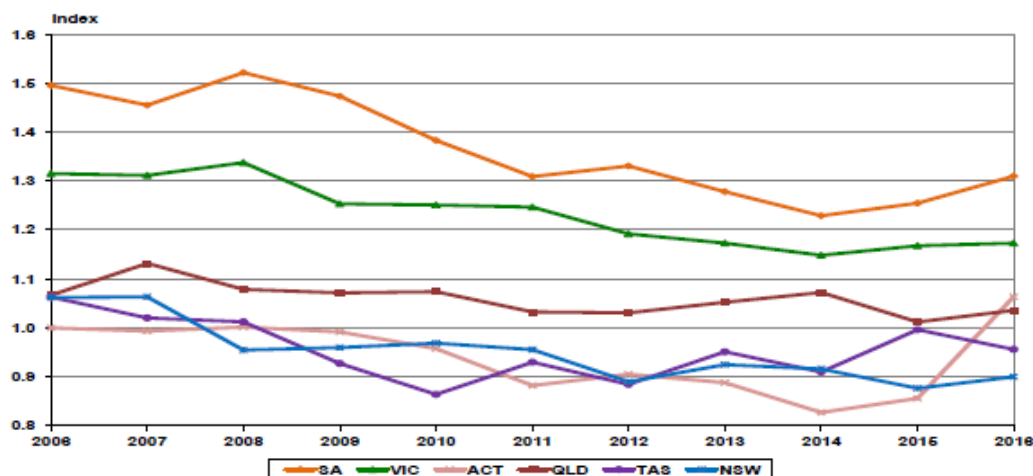
<sup>6</sup> Grattan op cit p. 29

<sup>7</sup> ACCC p. 165

<sup>8</sup> AER “Annual Benchmark Reporting - Electricity distribution network service providers” December 2017 p. 9

<sup>9</sup> AER op cit p. 8

**Figure 4 Multilateral total factor productivity, by jurisdiction, 2006–16**



We acknowledge the significant improved absolute productivity, particularly in opex over the last few years driven by significant workforce restructuring programmes. Revealed network opex so far in the 2014-19 period show that the original AER decision was reasonable, despite the network protests and appeals. We look forward to the trend in 2019-24 maintaining that rate of improvement. It remains to be seen whether these improvements move their relative position on the AER DNSP productivity league chart given the improvements underway in other DNSPs.

What the overinvestment and poor productivity do mean is that all NSW consumers are paying network prices that are much higher than the efficient level and this will continue for many years given the size of the RAB.

*(v) Sale of a majority shareholding in Endeavour and Ausgrid*

The privatisation process and the coming on board of new owners was a major influence on the preparation of the 2019-24 proposal. This was particularly the case with Ausgrid. It issued a draft proposal in August 2017 only to withdraw it a few months later. Then many of the Ausgrid staff involved up to that time departed the organisation and were replaced by new people. This contributed to the networks request for a three-month extension to allow deeper consumer engagement on their proposals. We comment further on this below.

*(vi) Remit process*

The extended appeals process undertaken by the networks following the AER’s decision on the 2014-19 period has led to a complex remittals process. Previously the EUAA has provided letters of support for both Essential and Endeavour as they sought to reach agreement with the AER on their re-made 2014-19 revenue cap.

It was pleasing to see the relatively quick approval of the Essential remit and we look forward to final approval of the Endeavour proposal in October 2018. However, it is very disappointing to see the length of time it is taking for Ausgrid to reach agreement. We look forward to Ausgrid submitting its proposal in the near future and the matter being resolved quickly.

*(vii) Impact of distributed energy resources*

Looking forward, the most significant issue facing networks in the next 10-20 years is the expanding level of distributed energy resources. This growth, particularly in solar PV and to a lesser extent batteries, encouraged by non-cost reflective network pricing, is presenting new challenges to all stakeholders. Grid demand is falling while at the same time of peak grid demand is getting later in the day.

Networks seem to want to see this situation as a way of saying “we are best placed to manage this and all we need to more capex/opex to do it.” Consumers are saying “Hold on, we want to be assured that there is indeed a “problem” and if there is then let’s have the market rules provide a level playing field for non-network alternatives and the ability of the market to respond” before signing a large cheque to the networks.

Consumers do not want the networks and the AER to make the same mistake twice. Around ten years ago networks launched on a massive capex spend to meet a peak demand that never came. Consumers are now paying the price and will continue to do so for another couple of decades. We do not want to be making the same comment in 10-20 years' time about the expenditure on smart grids and adapting to DER.

### 3. ESSENTIAL ENERGY'S PROPOSAL IS CLOSE TO BEING CAPABLE OF ACCEPTANCE BY THE AER

Our review of the Essential proposal leads to an initial view that it is the only network submission that is close to being capable of acceptance by the AER.

The table summarises the high-level comparison of what the networks are seeking in 2019-24 compared with the AER allowance for the current period. Essential are proposing a 19% reduction in capex and a 6% reduction in opex. This is significantly better than the Ausgrid and Endeavour proposals.

Opex (\$19)	Essential	Endeavour	Ausgrid
AER allowance 2014-19	\$1,798m	\$1,324.6m	\$2,207m
Network proposal for 2019- 24	\$1,698m	\$1,522.6m	\$2,402m
% Change vs AER allowance	Down 6%	Up 15%	Up 9%

Capex (\$19)	Essential	Endeavour	Ausgrid
AER allowance 2014-19	\$2,593m	\$1,726.4m	\$3,520m (Est)
Network proposal for 2019- 24	\$2,100m	\$2,165.6 m	\$3,083.7m
% Change vs AER allowance	Down 19%	Up 25%	Down 12%

Essential should be congratulated for their approach to setting aggressive targets for opex and capex – underpinned by assumed opex productivity improvements based on increased spend on IT – while seeking to maintain reliability, safety and network performance levels. There are risks associated with this approach but the EUAA welcomes their willingness to take the well calculated risk. It will be a big task to manage the change required, given what Essential has already achieved.

Our one remaining concern is that despite the welcome moves on opex and capex, prices are still rising in real terms, driven by the rise in RAB. We understand that Essential has engaged a consultant to review options around the RAB and we look forward to the outcome of that review.

### 4. CONSUMER ENGAGEMENT AT AUSGRID WAS REASONABLE BUT NOT GOOD

At a general level we welcome the genuine moves by many networks to improve their consumer engagement and recasting their whole approach to put the consumer at the centre. We welcome the current initiative to develop an Energy Charter. We look forward to this being a reflection of networks genuinely wanting to get better outcomes for consumers rather than better outcomes from consumers.

Our comments will focus on Ausgrid given the EUAA's membership of the Customer Consultative Committee and Reset Working Group. Our overall view is that it was reasonable but not good.

#### (i) *A time of lost opportunities in 2017*

Over the course of 2017, there is no doubt about the commitment of those responsible for consumer engagement to improve its scope and effectiveness given the adverse consumer comments from the previous reset. However, this commitment did not seem to be always shared by the wider organisation then undergoing significant organisational change following the privatisation process. This was demonstrated when the draft proposal distributed in August 2017 was withdrawn a few months later.

While the consumer engagement staff were saying all the right words to consumer advocates about the importance of consumer engagement - listening to consumers and responding to their concerns – this did not seem to be the intent of senior management.

Then over the course of late 2017/early 2018, most, if not all of the key Ausgrid staff involved in consumer engagement departed the organisation. While they were replaced by people that showed a similar commitment to engagement, the support of senior management was still unclear. So, while Ausgrid may say<sup>10</sup>:

“We have spent the last 18 months talking to our customers and stakeholders – from major industrial users to households – about their priorities.”

it is unclear what the engagement over 2017 actually achieved.

*(ii) The extension tsunami of information*

The organisational change over 2017 that acted to prevent Ausgrid genuinely engaging with consumers led to their request for a three-month extension. The EUAA was supportive of this extension as a “least worst” outcome compared to Ausgrid submitting in its original timetable. But we felt that this was never going to be a substitute for the lack of effective consultation over 2017. This turned out to be the case. While Ausgrid put in an immense amount of work into the concentrated engagement process in February/March 2018, the volume of information was simply too much for the EUAA to absorb and properly respond to. Early in the process the business case narrative was too reliant on a “lights will go out” approach. The asymmetry between Ausgrid’s and the EUAA’s (and other consumer advocates) resources is huge. If only that level of detail was provided over a longer period in 2017 and was part of a draft proposal process.

This lack of ability to properly analyse and critique the material would have been the case if Ausgrid was the only network undertaking this concentrated engagement. The concurrent engagement by Essential and Endeavour only added to the strain on clearly over-committed consumer advocates. So, while Ausgrid may say<sup>11</sup>:

“Having received the AER’s approval to extend the submission date for our Proposal to the end of April 2018, we were able to extend our consultation program to allow an even greater level of community and stakeholder engagement on key aspects of our Proposal.”

the level of scrutiny was considerably less than would have occurred had Ausgrid effectively followed the normal timetable. This asymmetry of resources is a key reason that consumer engagement is meant to occur over a long period. And informed by, for example, publication of a draft proposal for deep engagement. This time period gives advocates the opportunity to absorb and reflect on what is being proposed and provide thoughtful and helpful responses that are then responded to by the network in a timely and informed way. This is what “putting consumers at the centre” should be all about.

*(iii) But the remittal process was sending mixed messages*

At the same time as this consultation was underway during the extension – a consultation process designed to show that Ausgrid was genuinely seeking to engage with its customers, Ausgrid was in exhaustive negotiations with the AER and CCP10 on the details of the re-make of the 2014-19 decision. A negotiation that Essential had quickly concluded much earlier and that Endeavour seemed to be much further advanced on. We found it difficult to believe Ausgrid’s intended behaviour in the 2019-24 engagement given what was perceived as their actual behaviour in the remittal process.

*(iv) And then there was the 239-page submission on WACC*

We were as surprised as all other consumer groups when Ausgrid’s proposal included Attachment 7 – a 239-page report from Frontier Economics on certain aspects around the calculation of the rate of return. This was never discussed in the consumer engagement sessions. It seemed strange that it was submitted as part of the reset proposal when the AER was concurrently undertaking a WACC review. We concluded that it was symptomatic of the bifurcated approach Ausgrid seemed to be taking to consumer engagement – an example of the road that should not be travelled.

*(v) Final comments –and a hopefully brighter future*

It seems Ausgrid’s new owners took some time to fully understand what it meant to be the owners of a regulated monopoly providing an essential service. In particular, how consumers may perceive the social licence they are giving to the owners to operate the network assets. There seemed to be too much listening to lawyers on what were the supposed legal rights of the owners and too little listening to the customers on what their social obligation was to their customers. If these new owners

<sup>10</sup> [“Ausgrid and our customers” April 2018 p. 6](#)

<sup>11</sup> [ibid](#)

underestimated regulatory risk in their due diligence on purchasing Ausgrid, then that is a matter for the new shareholders to bear the cost of, not consumers.

It is good to see that Ausgrid acknowledges its engagement shortcomings, is looking to quickly complete the remittal process and looking to more substantive consumer engagement in the future. The EUAA welcomes this and looks forward to actively participating in a much more consumer focussed future.

## 5. OPERATING COSTS AT AUSGRID AND ENDEAVOUR ARE TOO HIGH

### (i) Introduction

The progress that all three networks have made over the current period in reducing their opex is very welcome. However, they were coming from a very high base. The EUAA believes there is still scope for further improvement.

We think that the Essential proposal well addresses the key themes of affordability, reliability and safety. In particular the forecast increases in opex due to output growth, customer numbers and real price changes from its base year are offset by productivity gains. This is not the case with Ausgrid and Endeavour and this discussion focusses on these two networks.

Our members operate in competitive markets. The AER regulatory framework is designed to replicate what occurs in a workably competitive market. To our members this means:

- The opex allowance should be set at an efficient level and given productivity changes, this efficient level falls over time
- Networks should continually seek productivity improvements – if our members do not do this then they have a high risk of going out of business
- If a business spends capex then it expects to get an opex dividend over the life of the capital asset, and
- Any increase in costs should be rigorously scrutinised – in the case of step changes these need to meet the criteria of a sustained change in business costs from an externally imposed requirement; it needs to be clearly separated from cost increases that are a normal part of business and which the business has to offset through savings in other areas and productivity improvements.

The AER applies this rigor through its base/step/trend approach. There are three issues:

- Are the revealed costs in the proposed base year of 2017/18 efficient?
- What is an appropriate consideration of productivity trends in the opex cost pathway over years 2-5?
- What are appropriate step change costs?

Both Ausgrid and Endeavour argued extensively through LMR and Federal Court proceedings that their original opex proposals for 2014-19 were required to meet their licence obligations. Yet the evidence is clear that this was not the case. As these networks highlight in their 2019-24 proposals, they have made significant and very welcome progress in reducing their opex costs and reliability has not suffered. The revealed costs for 2017/18 are close to the original AER efficient level allocation in 2015.

And yet we are now expected to believe that there is no scope for further productivity improvements – in fact we are asked to believe that real costs should be allowed to increase.

For Ausgrid the real level of opex is increasing – in total (by 7%) and per customer<sup>12</sup>:

**Table 20.**

### Forecast opex 2019/20 to 2023/24 (\$ million, real FY19)

OPEX	2019/20	2020/21	2021/22	2022/23	2023/24	TOTAL
Total	463	471	481	490	497	2,402

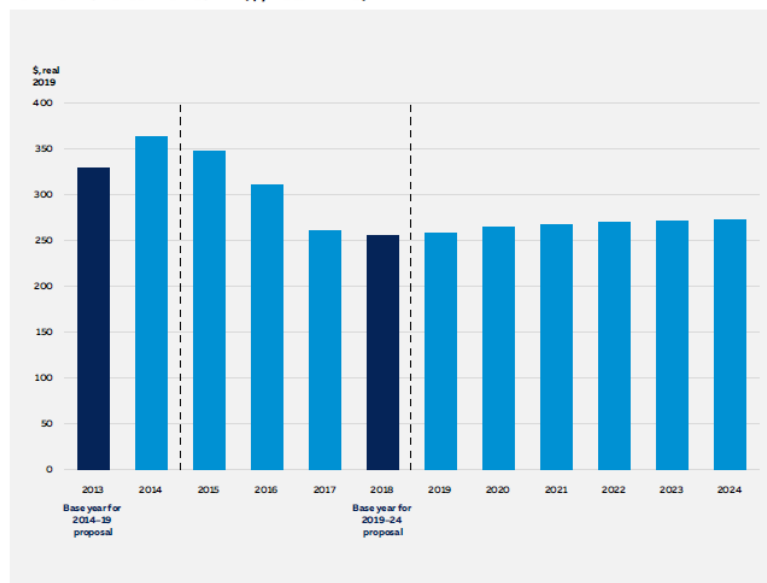
Note: Opex excluding debt raising costs.

<sup>12</sup> Ausgrid Proposal p. 116



Figure 46.

Actual and forecast opex per customer (excluding transformation costs) for 2012/13 to 2023/24 (\$, real FY19)



Note: Opex per customer excluding transformation costs and debt raising costs.

For Endeavour the real of opex is also increasing at double the rate of Ausgrid – 14% - over the reset period.

Table 11.1 Forecast standard control opex over the FY20-FY24 regulatory control period (excluding debt raising costs)

\$m; Real FY19	2019-20	2020-21	2021-22	2022-23	2023-24	Total
Opex	278.8	286.7	296.7	306.8	316.5	1,485.5

(ii) Are revealed costs in the proposed base year of 2017/18 efficient?

Both networks argue the revealed costs for 2017/18 are an efficient base year because:

(a) It is equivalent to the AER’s original allowance for 2017/18

We do not accept this argument which effectively says “the AER view in 2014 of the efficient level of opex in 2017/18 is the best measure of the level of efficient opex in 2019/20 made in 2018.” Efficiency is a dynamic, not a static concept.

(b) They are “efficient” compared to their peers

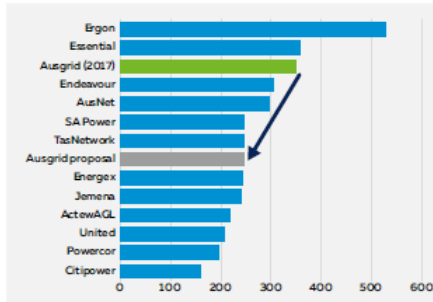
Ausgrid provides comparative data on a number of measures shown in the figure below<sup>13</sup>. While this data does indicate an improvement for Ausgrid from 2016/17 to 2017/18, it does not:

- Show what the movement over that time was for the other networks so these other networks may object to having their 2016/17 performance compared to Ausgrid’s 2017/18 performance
- Does not indicate what is Ausgrid’s forecast of its 2023/24 performance.

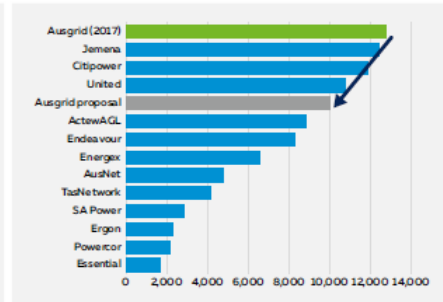
Other data on partial efficiency measures such as opex/customer against customer density, show that Ausgrid is now just above the middle of the pack based on Ausgrid 2017/18 performance. Yet it is unclear what are the data points for the other networks. We are not aware that the RIN data is available for the other networks for 2017/18 and Ausgrid gives no indication of the year for other networks.

<sup>13</sup> Ausgrid Proposal p. 119

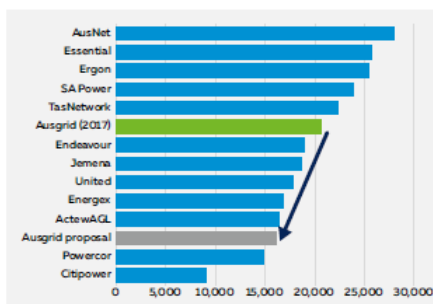
**Figure 49.**  
**Opex per customer (\$, nominal)**



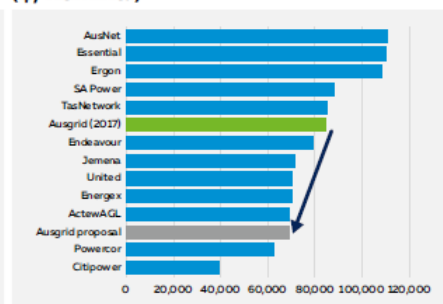
**Figure 51.**  
**Opex per km of circuit length (\$, nominal)**



**Figure 50.**  
**Opex per GWh delivered (\$, nominal)**



**Figure 52.**  
**Opex per MVA of maximum demand (\$, nominal)**

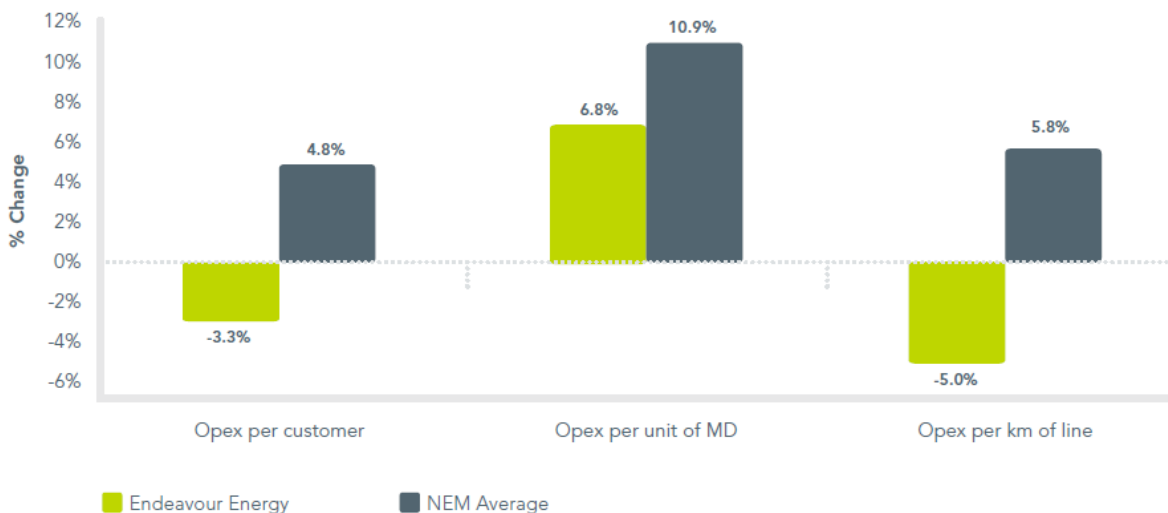


Source: Regulatory Information Notices available at [www.aer.gov.au](http://www.aer.gov.au) and Ausgrid analysis.

Our conclusion is that while Ausgrid’s absolute productivity appears to have improved, we remain to be convinced regarding how much that has changed its relative position. We will need to wait for the comprehensive AER data. We would expect over time that the efficiency frontier would move out reflecting dynamic efficiency benefits.

Endeavour cites its increased efficiency on a number of AER indicators<sup>14</sup>.

**Figure 11.4 Endeavour Energy percentage change in opex PPIs compared to NEM average (FY13-FY16)**



concluding<sup>15</sup>:

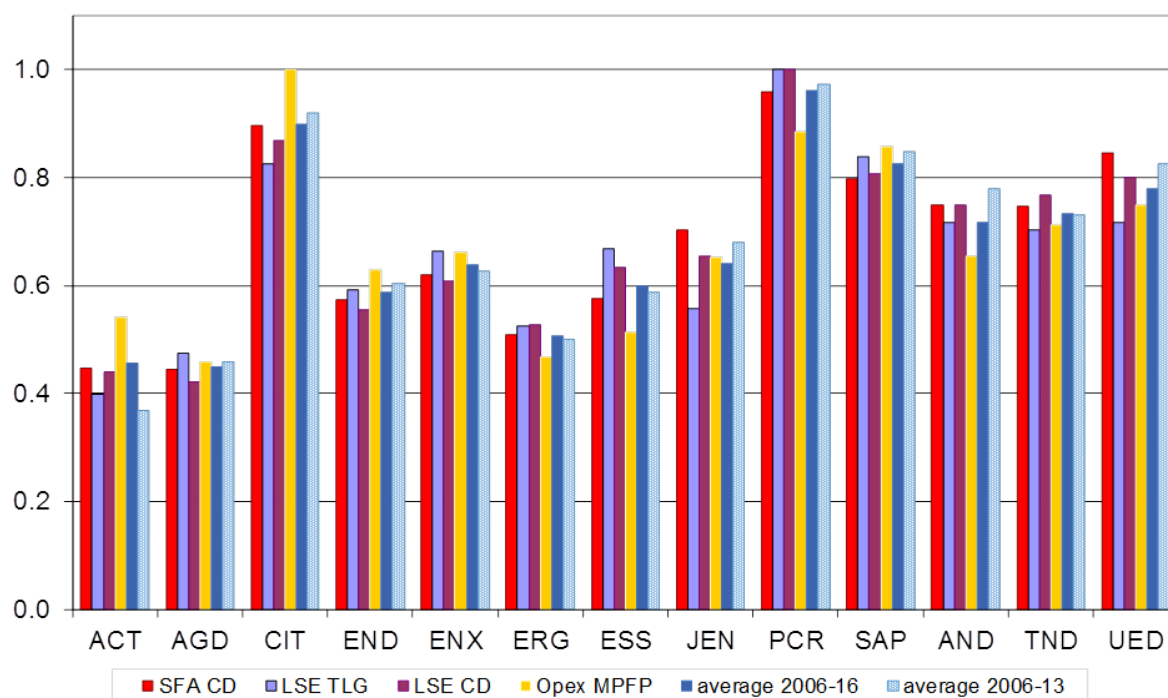
“We consider these measures indicate our opex efficiency has improved and our 2017-18 base year represents an efficient.”

<sup>14</sup> Endeavour Proposal p. 168

<sup>15</sup> ibid

The decision on whether the revealed costs in the base year are efficient is provided by the answer to the question: “are the proposed costs not materially inefficient?” The AER draws on benchmarking data to help answer that question. The current AER interpretation of that question is that a networks costs are “not materially inefficient” if its costs are at the bottom of the upper third of DNSPs benchmark level. Currently that means that a network that is 20-25% less efficient than the network on the frontier over the 10-year period (in the most recent data Powercorp) is “not materially inefficient”.

The following table combines all the AER’s measures of opex productivity – opex multilateral partial factor productivity (MPFP), opex econometric modelling – Cobb Douglas stochastic frontier analysis (SFA), translog least squares analysis (LSE) and Cobb-Douglas LSE as well as the average of these model’s scores<sup>16</sup>. Based on this long-term data<sup>17</sup>, both Ausgrid and Endeavour are well below the level that would qualify as “not materially inefficient”. So, we look forward to the AER analysis to see how the improvements in the last couple of years have improved their long-term relative position given other networks have also improved.



The EUAA believes that improvements in the quality of the benchmarking data, plus developments in other measures of opex efficiency, provide justification for reducing the wide 20-25% range used to determine whether a network in “not materially inefficient”.

(iii) *What is an appropriate consideration of productivity trends in the opex cost pathway over years 2-5?*

We think that a fundamental part of incentive-based regulation is that, once an efficient base year has been determined, the regulatory framework should ensure that networks continually seek to improve their productivity to reduce costs. Our members have to continually improve their productivity to stay in business. Again, regulation meant to reflect a workably competitive market should reflect what actually happens in workably competitive markets.

The AER benchmarking data develops an efficiency frontier. However, the AER assumes that this frontier does not move out over time i.e. a zero-productivity assumption. Both Ausgrid and Endeavor, in contrast to Essential, adopt these zero assumptions.

The EUAA does not think the AER assumption is in the long-term interests of consumers and we do not find the Ausgrid and Endeavour arguments for adopting this assumption, convincing:

- (a) Not seeking pass though of higher costs in certain categories

<sup>16</sup> Adapted from Figure 18 p. 39 in AER “Annual Benchmarking Report - Electricity distribution network service providers” November 2017

<sup>17</sup> And Ausgrid support the use of long term productivity trends – see Proposal p. 136

For Ausgrid, this included categories such as improved vegetation work practices and increased focus on education to improve engagement with CALD customers. For Endeavour, it is higher vegetation management costs and the costs of the *Endeavour 2020* initiative.

We do not accept an argument that actions that are really part of the normal course of business should be seen as “special”. It is a novel argument from Endeavour to think that consumers would welcome them not charging consumers an additional amount for the cost of their programme to reduce the excessive costs consumers were paying the past.

(b) Increased wages

Both networks highlight increased real wages costs. Ausgrid<sup>18</sup>:

**Table 26.**  
**Forecast change in real labour costs (% per annum)**

OPEX	2019/20	2020/21	2021/22	2022/23	2023/24
Labour	0.88%	1.37%	1.74%	1.73%	1.33%

Endeavour, which seeks labour from a similar geographic area, forecasts much higher real wage growth<sup>19</sup>:

**Table 11.5 Real labour escalators for FY20-FY24**

Real cost escalators (%)	2019-20	2020-21	2021-22	2022-23	2023-24
Labour – WPI EGWWS-NSW	1.55	2.04	2.41	2.40	2.00
Proportion of labour	64.8	64.8	64.8	64.8	64.8
Labour price growth	1.00	1.32	1.56	1.55	1.30

Standard practice in EUAA members’ businesses is that any wage rise is offset by productivity improvements. That does not seem to be the case for both networks. They should not be rewarded for their failure to do so. Achieving those productivity offsets would be part of what an AER productivity assumption would drive.

(c) Endeavour and Ausgrid are absorbing ‘step changes’ in costs so implicit productivity improvement

Both networks are using the term ‘step change’ for costs they claim they are absorbing but not seeking to claim as a “real” step change.

Ausgrid refers to ~\$48m in costs – land tax increases (\$30m), ‘customer operations’ e.g. summer readiness campaigns (\$10m) and cyber security (\$8m) as examples of costs they are absorbing through efficiency savings<sup>20</sup>.

Endeavour argues that its decision not to include ~\$10m of self-identified step changes in their cost base is a reason not to include a productivity improvement<sup>21</sup>. \$10m is 0.7% of the \$1,484.5m total proposed opex over 2019-24.

In both cases we think the categorisation is false.

(d) Ausgrid’s general justification

Ausgrid seeks to make a number of points around productivity<sup>22</sup>. The first seems to be that productivity changes effectively stop when “step change” transformative events have come to an end. Because they have saved \$100m in annual opex over the current period, there is no more improvement possible. Ausgrid do not provide evidence to support this claim. Our members in the competitive world are constantly seeking productivity gains.

<sup>18</sup> Ausgrid Proposal p. 133

<sup>19</sup> Endeavour Proposal p. 171

<sup>20</sup> Ausgrid Proposal p. 114

<sup>21</sup> Endeavour Proposal p. 177

<sup>22</sup> Ausgrid Proposal p. 134

Step changes assist them to survive in their respective industry. They will only sustain their business if they can sustain the cost reductions that come from continuous productivity improvement.

The second is that “because past productivity improvement has been poor that justifies a continuation of that poor productivity performance” or “because past productivity performance has been negative, justifying an increase in opex, Ausgrid should be congratulated because it is proposing zero productivity improvement”. A key consumer complaint is that the regulatory framework has failed to encourage productivity improvements in the past. Why should this failure be rewarded?

### Summary

Given the developments in the benchmark data analysis and in other aspects of opex assessment, we would encourage the AER to consider:

- Narrowing the 20-25% range from the frontier that is considered “not materially inefficient”, if the NSW DNSPs are “materially inefficient” then we would not support the application of EBAA in the rest period, and
- Imposing a productivity improvement benchmark over the reset period; we support the approach to this proposed by CCP10.

Other networks have led the way on showing that they do recognise the affordability pressures on consumers. Both Essential and Tasnetworks current proposals for 2019-24 include opex productivity improvements. Energy Queensland is proposing opex productivity improvements for their 2020-25 reset in their early engagement.

#### *(iv) What are appropriate step change costs?*

The AER sets out the requirements for costs to qualify as a step change<sup>23</sup> e.g.

“Where there is a binding (that is, uncontrollable) change in regulatory obligations that affects their efficient forecast expenditure.”

Ausgrid is claiming two step changes – demand management programmes (\$26m as a capex/opex trade-off) and pricing reform acceptance research (\$3m). We invite the AER to closely scrutinise the former as we doubt it fits the step change criteria. We certainly see no reason for the latter to qualify. This is expenditure that other businesses have made as part of their normal course of business and did so some time ago. Consumer advocates have given very clear feedback to Ausgrid on the need for pricing reform and more research is not going to bring any new information. Ausgrid say that it is a “once-off” cost<sup>24</sup>. Endeavour’s proposal has this vague general statement<sup>25</sup>:

“Endeavour Energy will next consider the need to incorporate any step changes into the forecast. These are considered additional costs arising from exogenous events which will impact our operating expenditure in the 2019-24 regulatory control period that were not reflected in the 2017-18 efficient base year or included elsewhere in the proposal.

Endeavour Energy considers step changes may be required following new regulatory obligations and efficient capital and operating expenditure trade-offs. The impact of recent regulatory and compliance changes and the continuous review of efficient service delivery alternatives may result in Endeavour Energy electing to nominate these additional costs as step changes. All proposed step changes will be evaluated against the AER’s specific criteria.”

The EUAA’s view is that if Endeavour is unable to specify the step changes in its proposal and then have them subject to scrutiny, then it should not be able to raise them later in the reset process.

We note, with strong support, Essential’s inclusion of leases as a negative step change.

## **6. CAPITAL COST PROPOSALS FOR AUSGRID AND ENDEAVOUR ARE NOT JUSTIFIED**

We support the comments made by PIAC, ECA and CCP10 on the Ausgrid and Endeavour capital programmes and add the following comments on Endeavour.

<sup>23</sup> [AER Expenditure Forecast Assessment Guideline for Electricity Distribution November 2013 p. 15](#)

<sup>24</sup> Ausgrid Proposal p. 137

<sup>25</sup> Endeavour Proposal 0.07 Expenditure Forecasting Methodology Statement Attachment 7 p. 24

There are two issues for the EUAA.

(i) *The increased level of capex compared to the current period*

Proposed capex of \$2.17b<sup>26</sup>

Table 10.1 Forecast standard control services capital expenditure (inc. equity raising costs)

\$m; Real FY19	2019-20	2020-21	2021-22	2022-23	2023-24	Total
Capital Expenditure	462.3	435.8	428.8	416.5	422.2	2,165.6

is nearly 40% above forecast capex in the current period<sup>27</sup>

Table 10.3 Actual and forecast capital expenditure compared to the FY15-FY19 regulatory allowance

\$m; Real FY19	2014-15	2015-16	2016-17	2017-18	2018-19	Total
Allowance	455.0	368.5	311.4	302.4	288.9	1,726.4
Actual/Forecast	390.4	225.0	195.5	347.5	401.5	1,559.9

Consumers seem to have received little benefit for the huge capital investments over the last decade. The \$417m augmentation capex is not justified given the moderate growth in customer connection numbers. The P50 peak demand is forecast to be only marginally higher than the current peak of 4,107MW on 30<sup>th</sup> January 2017.

Table 7.2 Forecasts of maximum demand for the FY20-24 regulatory period

	2019-20	2020-21	2021-22	2022-23	2023-24
Maximum demand (MW) 10% PoE	4,184	4,274	4,363	4,439	4,512
% change	3.6%	2.2%	2.1%	1.7%	1.6%
Maximum demand (MW) 50% PoE	3,949	4,039	4,129	4,205	4,278
% change	3.8%	2.3%	2.2%	1.8%	1.7%

On repex, we look forward to the results from the application of the AER’s repex model.

Given the nature of Endeavours customer profile – weather related peak demand and end of grid residential growth, we would have expected greater consideration of non-network alternatives and innovative tariffs.

(ii) *The decrease in developers’ capital contribution*

The proposal involves an estimated \$180m decrease in developers’ contributions for supplying networks services to new subdivisions. We do not support this. There was strong feedback from all consumer groups against this move which is seen as inequitable and contrary to the causer pays principle. We welcome Endeavour’s comments<sup>28</sup>:

“We have considered this feedback and at this stage are retaining our current practice given that the majority of our existing customers were connected on this basis (or an even more favourable basis). However, we understand our approach remains of concern to the AER’s CCP and others and we are planning additional and broader industry engagement to resolve this issue.”

<sup>26</sup> Endeavour Proposal p. 102

<sup>27</sup> Endeavour Proposal p. 113

<sup>28</sup> Endeavour Proposal p. 106

Given its justification for the change around benchmarking what other networks do<sup>29</sup> the fact that Ausgrid has now changed its proposed approach (which was similar to Endeavour’s) to reflect consumer sentiment, we hope this will influence Endeavours further consideration of the issue.

## 7. VALUE OF CUSTOMER RELIABILITY (VCR)

VCR is a key input into the development of the reliability standards that the NSW DNSPs are required to meet in their revenue proposals. It is also a key input into the RiT-D cost benefit analyses the DNSPs undertake to justify individual capital projects. Development of robust VCR values, that consumers can have confidence in, has been a difficult process. Over time there has been no shortage of organisations, particularly networks, who wish to claim they know how much users value reliability. These proponents then use these values to justify additional investment that may or may not be in the long-term interests of consumers. One thing is clear, that it has certainly been in the long-term interests of the networks expanding their regulated asset base.

Prior to the AEMO estimates developed in 2014, there were a variety of measures used, all of which lacked broad based consumer support being generally derived from desktop studies or very limited consumer surveys. The EUAA welcomed the AEMO analysis in 2014 and a number of our members actively participated in it. It was the first comprehensive study that actually engaged with a range of consumers to get their views. We recognise that the numbers had limitations e.g. in terms of the coverage across all categories of users in all locations, when the interruption occurs and its duration. But they were based on actually talking with consumers.

In the course of the 2015/16 IPART review developing the standards to apply to NSW DNSPS for the 2019-24 period, Transgrid submitted a study by Houston Kemp<sup>30</sup> to justify much higher VCR values for metropolitan Sydney and the CBD than the AEMO values<sup>31</sup>. The HoustonKemp study was a desk top study drawing on existing VCR estimates from Ausgrid and Oakley Greenwood, which are in turn desktop studies.

**Table 3.2 Value of customer reliability (\$/kWh)**

Customer	HoustonKemp (\$2016)	AEMO NSW aggregate, inc direct connect (\$2014)
Inner metropolitan	\$90	\$34.15
CBD	\$150-\$192 (\$170)	\$34.15

Source: HoustonKemp, *CBD and inner metro VCR estimates – A final report for TransGrid on research, methodology and results*, 28 July 2016. AEMO, *Value of customer reliability review – Final report*, September 2014.

HoustonKemp said in its report that it<sup>32</sup>:

“...has been engaged by TransGrid to determine defensible values of the Value of Customer Reliability (VCR) that can be applied to unserved energy estimates in both Sydney’s CBD and Sydney’s Inner Metropolitan (Inner Metro) areas, drawing on existing, publicly available VCR estimates. The resultant VCR estimates are to be suitable for use in the ‘Powering Sydney’s Future’ (PSF) study of electricity supply to the CBD and Inner Metro sub-regions of Sydney, being jointly undertaken by TransGrid and Ausgrid.”

IPART did not accept the HoustonKemp analysis of \$170/kWh but did conclude that the appropriate value for the CBD was \$90/kWh, still significantly above the AEMO value.

Despite the IPART’s conclusion, Transgrid sought to use the \$170,000/MWh VCR value in its RiT-T on Powering Sydney’s Future developed in parallel with the TransGrid 2018-23 Regulatory proposal. This value was eventually rejected by the AER and Transgrid used \$90,000/MWh as its central estimate for both inner metropolitan and CBD customers.

<sup>29</sup> Endeavour Proposal p. 102

<sup>30</sup> [HoustonKemp CBD and Inner Metro VCR estimates – A final report for TransGrid on research, methodology and results 28 July 2016](#)

<sup>31</sup> [IPART “Electricity transmission reliability standards” Supplementary Report September 2016 p. 19](#)

<sup>32</sup> HoustonKemp op cit p.1

Then in June 2018, Ausgrid sought to use \$170,000/MWh in its Final Draft Assessment Project for the RiT-D project “Ensuring reliability requirements in the Sydney CBD area”. In July 2018 the EUAA submitted a dispute notice under Clause 5.17.5 of the NER and in accordance with the RiT-D Guidelines objecting to the use of this VCR value<sup>33</sup>.

In the short term we look forward to the AER rejecting the Ausgrid VCR number. In the medium term we look forward to the results from the comprehensive VCR study that the AER is about to commence and then the rigorous application of these values in DNSP project evaluation.

## 8. RATE OF RETURN

The EUAA has contributed to the development of the binding Guideline through its membership of the AER Consumer Reference Group<sup>34</sup>. In particular we support the application of the 2018 binding guideline for 2019 decisions.

We welcome the approach of Essential Energy where, while it has applied the 2013 Guideline in its proposal, it states that this<sup>35</sup>:

“...will be updated as prescribed, following the finalisation of the AER’s 2018 binding Rate of Return Guideline in December 2018.”

By contrast Endeavour applied the 2013 Guideline in its proposal but strongly opposed the application of the 2018 binding guideline<sup>36</sup>:

“...we are aware that COAG may be considering applying an updated 2018 Rate of Return Guideline with immediate effect, due to be completed by the AER before 17 December 2018. We would not be supportive of this as it would undermine an outcome that has been discussed and agreed to by Endeavour Energy and our stakeholders.

...

An updated guideline will not be completed until one month before Endeavour Energy is required to lodge its revised regulatory proposal and therefore it will not provide us an opportunity to model the impacts on the 2019-24 period and consult with customers on this. On this basis we support the application of the 2013 AER Rate of Return Guideline for this determination process.”

The fact that the 2018 binding guideline is available only one month prior to Endeavour lodging its revised regulatory proposal should be immaterial to what is in the proposal – it will be applied mechanically. Is Endeavour suggesting that the level of WACC influences the capex it proposes? If so it would be contrary to many arguments networks have made in the past when they seek to refute consumer concerns about high WACC’s incentivising gold plating of networks.

Ausgrid applies the 2013 Guideline, commenting<sup>37</sup>:

“Although financial market observations suggest a higher return on equity than calculated using the 2013 Rate of Return Guideline, we are committed to minimising further debate on this issue and to delivering a positive outcome for our customers.”

Ausgrid’s interpretation of “minimising further debate” is, as noted above, the inclusion of a 239-page consultant’s report from Frontier Economics on why WACC should be higher than was not discussed in any of Ausgrid’s stakeholder engagement.



Andrew Richards  
Chief Executive Officer

10 August 2018

<sup>33</sup> See <https://www.aer.gov.au/communication/aer-receives-notification-of-rit%E2%80%93d-dispute-from-euaa>

<sup>34</sup> See <https://www.aer.gov.au/system/files/Consumer%20Reference%20Group%20submission.pdf>

<sup>35</sup> Essential Proposal p. 114

<sup>36</sup> Endeavour Proposal p. 180

<sup>37</sup> Ausgrid Proposal p. 143



