PIAC submission to the AER's draft determinations and the NSW DNSPs' 2019-24 revised proposals

7 February 2019

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About the Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in Sydney.

Established in 1982, PIAC tackles barriers to justice and fairness experienced by people who are vulnerable or facing disadvantage. We ensure basic rights are enjoyed across the community through legal assistance and strategic litigation, public policy development, communication and training.

Energy and Water Consumers' Advocacy Program

The Energy and Water Consumers' Advocacy Program (EWCAP) represents the interests of low-income and other residential consumers of electricity, gas and water in New South Wales. The program develops policy and advocates in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives input from a community-based reference group whose members include:

- NSW Council of Social Service;
- Combined Pensioners and Superannuants Association of NSW;
- Ethnic Communities Council NSW;
- Salvation Army;
- Physical Disability Council NSW;
- St Vincent de Paul NSW;
- Good Shepherd Microfinance;
- Affiliated Residential Park Residents Association NSW;
- Tenants Union;
- Solar Citizens; and
- The Sydney Alliance.

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Contents

1. Introduction

PIAC welcomes the opportunity to respond to the Australian Energy Regulator's (AER) draft revenue determination and the revised regulatory proposals submitted by the three NSW electricity distribution network service providers (DNSPs).

We also thank the AER, Ausgrid, Endeavour Energy and Essential Energy for productive engagement in the months following the AER's draft determination, which has influenced the revised proposal put forward by the businesses.

1.1 The context of these revenue determinations

Determining the DNSPs' revenue allowances for the 2019-24 regulatory control period (RCP) can only be made while cognisant of both the current state of the National Electricity Market (NEM) and the recent history of distribution network outcomes in NSW.

Energy consumers are currently struggling to afford high energy bills. A combination of high wholesale electricity prices, high gas prices and long-term growth in network RABs has meant that consumers have faced unusually high bills in recent years. The ACCC noted that "High prices and bills have placed enormous strain on household budgets and business viability. The current situation is unacceptable and unsustainable".[1] PIAC concurs. Through our work in the community, work with community service providers, and as observers at DNSP customer engagement events, we have heard that affordability is the key priority for energy consumers.

The history of NSW distribution determinations also plays an important part. In short, NSW consumers pay extremely high prices for their distribution networks. After a period of relatively stable electricity prices, the 2009-14 RCP saw an unprecedented increase in network investment. The ACCC have recently confirmed this to have been over-investment.[2]

In the current 2014-19 period, all three DNSPs will recover less revenue than in 2009-14. However, while it is clearly positive that this is coming down, it must be noted that it is coming down from a particularly high level. Furthermore, under the current regulatory framework, the historical increases of the Regulated Asset Bases (RAB) will continue to place upward pressure on consumers' prices for decades to come.

Our concerns are exacerbated by the fact that inflation and cost of capital are at historically low levels. Given that cost of capital is a key driver of network prices, it does not bode well for the future that electricity prices are unsustainably high even when this input is at historic lows. If or when the cost of capital increases, a second round of affordability crises will arise – absent genuine reforms to the underlying business operations.

1.2 Affordability is the key priority for consumers

This context forms the backdrop to this determination process. Through our work in the community, with community service providers, and as observers at DNSP customer engagement events, we have heard that affordability is <u>the</u> key priority for energy consumers.

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1 ACCC, *Restoring electricity affordability and Australia's competitive advantage*, June 2018, p iv.
2 Ibid, p ix.

It is no longer acceptable for DNSPs to propose, and the AER approve, large investment programs based purely on bottom-up engineering assessments. Instead, consumers need affordability to be considered as a top-down constraint on decisions by DNSPs and the AER.

Given this, PIAC contends that affordability should be the central driver of decisions by the DNSPs and the AER.

Traditionally, DNSP revenue allowances in the NEM have been determined using a 'bottom-up' process, where DNSPs propose a range of expenditure programs to be covered by the building blocks in an AER determination. Instead, what is required is also a top-down view of the proposals, where investment is constrained by an explicit focus on what consumers are willing to pay for, not just which projects are efficient in and of themselves.

This means that the DNSPs must set clear expenditure targets to deliver lower prices – now and over time – and to prioritise their projects accordingly. They must do what needs be done and do it as efficiently as possible, not do what is 'nice to do'. They must establish a capex program that recognises future changes, and not build in long-life assets that will be underutilised in the future. They must understand the trade-offs between capex for new assets and opex for maintaining existing assets. All of this must be done with the explicit purpose of improving affordability for consumers.

1.3 Affordability delivered by revised proposals

In our submission in response to the AER's issues paper and the DNSPs' revenue proposals, PIAC stated that we could neither support proposals that will increase distribution charges over the 2019-24 RCP nor support expenditure programs that result in continued RAB growth.[3] We maintain this position.

DNSPs should be proposing, and AER approving, real price decreases in order to address the current affordability crisis and cost of living pressures on consumers who are already struggling. Halting, and indeed reversing, RAB growth is, perhaps, even more important than short-term price paths. Expenditure allocated to the RAB results in higher prices paid by consumers for the life of the relevant asset, through higher return on capital and regulatory depreciation allowances. This is a major driver of the distribution charges paid by consumers and is relatively unresponsive to later reforms or efficiencies in regulatory and business practices.

PIAC is pleased that the revised proposals from all three businesses achieve real price reductions for consumers and take steps to limit RAB growth.

However, PIAC stresses that while this an important first step to addressing affordability, it remains just that – a first step towards addressing the cumulative impact on consumers from years of rising costs. Following the AER's final revenue determination, the DNSPs must continue to find efficiencies and pass these savings on to consumers. We look forward to continuing to work with the businesses on these.

3 PIAC, *Submission in response to the NSW DNSPs 2019-24 regulatory proposals and AER issues paper*, August 2018, 8-9.

2. Consumer engagement and reflecting consumer preferences

Consumer engagement is a core responsibility of network service providers (NSPs) in the energy market. The regulatory framework for monopoly energy networks is designed to replicate the conditions associated with a workably competitive market. In competitive markets, firms are required to engage with consumers constantly; to ascertain consumer preferences as they seek to provide the goods and services consumers require, at the price they are willing to pay. When consumers are not happy with the quality or price of the service, they are able to either purchase from a different firm, or not purchase it at all.

Being a natural monopoly providing an essential service, businesses like NSPs do not face these competitive pressures; consumers cannot choose a different set of poles or pipelines, nor can most cost-effectively remove themselves from the grid at this stage.

Instead, NSPs need to implement formal consumer engagement programs. These programs ensure NSPs provide network services that meet the requirements and preferences of their customers.

To this end PIAC conducted its Network Engagement Evaluation project to transparently and robustly assess the effectiveness of DNSPs' consumer engagement in the lead up to lodging their initial revenue proposals in 2018.[4] We evaluated the DNSPs' engagement with their end-use consumers (network customers) and consumer representative bodies like PIAC, Energy Consumers Australia and the Consumer Challenge Panel (consumer representatives). Overall, we found there was a significant improvement in consumer engagement by the NSW DNSPs compared with that done to support their 2014-19 proposals.

While we have not conducted the same formal assessment for the DNSPs' engagement in the preparing their revised proposals, we were nonetheless mindful of the effectiveness of this engagement.

2.1 Consumer input to the revised proposals

After lodging their revenue proposals, the three NSW DNSPs continued their engagement of consumer representatives including the CCP. This has informed the revised proposals which have been submitted to the AER.

As noted in the submission from the CCP, the businesses were encouraged to adopt a 'no surprises' approach to engagement and development of their revenue proposals. This included working to resolve many key issues prior to lodging the proposals and limit the scope and depth of issues stakeholders needed to engage on post-lodgement.

Each business approached this time differently in terms of the level and timing of engagement they have conducted. Ultimately, these have been reflected in the revised proposals. For instance:

- Essential Energy has, on top of the savings outlined in its initial proposal, found additional measures to deliver real price reductions to their customers and is investigating methods to address issues resulting from their historical and growing RAB;

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4 PIAC, *PIAC Evaluation of Consumer Engagement by NSW DNSPs 2017-18*, August 2018.

- Endeavour Energy has reversed their co-contributions policy for new developments (noting this was outside of the AER's revenue determination process but nevertheless of high concern for PIAC and other consumer advocates) and, following strong consumer support, proposed a range of cost-reflective demand tariffs; and
- Ausgrid has proposed to adopt the AER's draft opex productivity decision of 1% per annum to apply from 1 July 2020 as well as implemented a number of working groups on tariff design and capital investment.

2.2 The AER as an expert regulator

The increased engagement of consumer representatives by the businesses prior to formal lodgement of the revenue proposals has also been mirrored by increased engagement of the AER. One such example is that AER staff, in particular the capex team, have shared their concerns regarding the businesses' proposals and modelling prior to the Draft and Final Decisions, thereby allowing the businesses an opportunity to respond to those concerns and address these in their proposals. PIAC sees this as a positive development, not only in becoming more transparent with early modelling and concerns in business cases, but also in developing a less adversarial relationship.

However, PIAC submits that this early engagement of the AER and consumer representatives does not abrogate the AER's primary role in revenue determinations. The AER, as an expert regulator, must ensure that any expenditure remains prudent and efficient and that the revenue recovered from consumers remains in the long-term interests of consumers. Early engagement with the businesses should be seen as one of a number of tools at the AER's disposal to achieve this.

PIAC sees this early engagement in revenue proposals as complementing this core responsibility – and in no way replacing it.

3. Capex allowance

PIAC's over-riding concern in assessing the NSW DNSPs capex forecasts is its impact on affordability. To address the problem of past excess capex investment, and to ensure improved affordability in the future, each DNSP will need to make a very strong commitment to delivering significant capex reductions now. Only then, will prices revert to efficient levels over time.

PIAC has focused on a number of issues relating to the capex proposals from the three NSW DNSPs. Some of these are overarching issues which affect all three businesses, others are specific to a particular business – they are discussed below.

3.1 Overarching issues

Responding to network transformation

The proposals also discuss the need to adapt to a new network environment. This includes the challenge of converting the current 'one-way' network to a 'two-way' network as a result of the growth in distributed energy resources (DER). PIAC acknowledges the challenges facing the networks in this area.

The proposals, however, largely lack detail regarding the extent of the issue of two-way flows during the current regulatory period and the potential benefits to the network in terms of deferred capital investment.

In particular, where a proposal includes high levels of replacement and/or augmentation capex and IT, it is essential to consider whether the proposed investments in new assets incorporate optionality to facilitate future growth in the DER market and curb network demand growth. In the alternative, excess capex and RAB growth 'crowds out' opportunities for prudent non-network investment.

In PIAC's submission to the DNSPs' initial proposals and the AER's Issues Paper, we noted the DNSPs lacked consistency and clarity in how they would better incorporate DER. PIAC is pleased that, through their engagement with consumer representatives, revised proposals and tariff development, the three businesses have put forward an improved approach towards the treatment and integration of DER in their networks and alternatives to traditional network solutions, such as Stand-Alone Power Systems. PIAC looks forward to further collaboration between the three businesses in these matters.

ICT upgrades and expenditure

The NSW DNSPs' capex proposals demonstrate a wide range of proposed investment in non-network projects which raises questions about its underlying drivers and whether this expenditure is efficient and prudent in the current environment where affordability is the top priority of consumers.

In considering non-system capex, of particular concern for PIAC is the approach to investment in Information and Communication Technology (ICT). Relative to other investments, ICT poses a particular challenge to affordability not only because of its relatively short asset life, but also due to the importance of secure ICT infrastructure in an increasingly data-rich and digital world.

ICT is generally depreciated over 5 years or less. For instance, a $200m investment in ICT, will result (simplistically) in a $50m depreciation cost each year. The value of an ICT project must therefore be particularly carefully scrutinised in the context of a priority on affordability.

PIAC understands the importance of improving the security of the networks ICT systems against cyber attack and we support in principle the networks' proposals for greater capex investment in this area – subject to assessment of the efficiency and prudency of the proposals. However, this is not a blank cheque.

Given the increasing impact ICT will play in determining the efficiency and quality of a DNSPs' service delivery as well as the growing quantum of ICT expenditure overall, it is essential that the businesses, the AER and consumers have clear visibility of the benefits unlocked by the ICT investment against its cost.

PIAC acknowledges that demonstrating performance improvements from the technological investment is not necessarily a trivial task. Nevertheless, we commend Essential Energy for linking the proposed investment in ICT to specific and measurable results for customers.

As noted in our earlier submission, we expect that the AER to require DNSPs to clearly define measurable benefits to consumers arising from their proposed ICT investment. We also support the CCP's concerns about IT expenditure and are pleased that Ausgrid has committed in its Revised Revenue Proposal to share further granularity of customer benefits derived from IT expenditure and to support an industry wide review by the AER into IT forecasting to improve expenditure assessment.

Accepting rate of return and tax

In the past, the determination of the rate of return in particular has been an area of significant disagreement between PIAC and the DNSPs. PIAC is pleased that all three businesses will be adopting the AER's binding rate of return and the changes stemming from the AER's tax review.

Halting and reversing RAB growth

As noted in Section 1.2, affordability remains the priority for NSW consumers and a significant driver of higher distribution network charges has been the growth in the RAB over previous RCPs. An essential step in addressing the current affordability crisis is halting and, indeed, reversing the RAB growth seen in recent years. We acknowledge that, in their revised proposals, the three DNSPs have taken great strides to ensure their capex proposals do not unnecessarily increase their RABs and exacerbate the current affordability crisis facing many households.

Therefore, any capex must be well-justified in terms of consumer benefit and consumer preferences, not just whether or not it's a prudent way to manage the network as an individual business decision.

3.2 Ausgrid

Overall capex allowance

Ausgrid has conducted substantial engagement on its capex proposal and, as a result, has substantively revised it since its initial proposal – reducing it from some $3.1 billion to $2.69 billion.

PIAC supports this as an example of good consumer engagement, although it left significant room for improvement in terms of execution – with the timing of this further engagement being particularly late in the development of the revised proposal.

However, we must make a distinction between engaging on a <u>proposal</u> as opposed to negotiating a <u>regulatory outcome</u>.[5]

PIAC strongly supports the direction of the revision – clearly, $2.69 billion in capex is more affordable for Ausgrid's consumers than $3.1 billion. However, as we noted during these discussions, neither PIAC, nor any other consumer advocate, is not able to determine if $2.69 billion is more efficient than the $2.3 billion in the AER's draft determination. Only the AER can do this as noted in Section 2.2.

Addressing RAB growth

Ausgrid also states that its revised capex proposal would reduce its RAB per customer by $.9% in real terms.[6] We support this as an important step to ensuring long term affordability for consumers.

Investing in Innovation

Ausgrid has set up a series of working groups to facilitate consultation with consumer representatives on technology and innovation investment in addition to the regular customer council meetings. We support these initiatives as a means of increasing transparency and continuing consumer engagement outside of the formal revenue reset processes.

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5 For instance, even the AusNet trial with its Customer Forum seeks to negotiate the contents of AusNet's 2021-25 regulatory proposal and does not seek to negotiate the contents of the AER's decision.

6 Ausgrid, *Revised Regulatory Proposal 1 July 2019 to 30 June 2024*, January 2019, p 51.

As discussed in Section 3.1, the growing importance and quantum of ICT investment requires greater scrutiny and coordination to ensure the benefits are realised and passed on to consumers. In particular, we commend Ausgrid for holding the Network of the Future forum in November 2018 which was attended by all three DNSPs as well as consumer advocates including PIAC and other stakeholders to discuss the potential benefits to be gained through better utilisation of DER and network data. One key output of the forum was the development of the Network Innovation Advisory Committee including consultation on its proposed terms of reference.

Despite consumer support for the Network Innovation Fund the AER rejected it in its Draft Decision, noting that Ausgrid had not provided business cases for the projects and had therefore not substantiated the consumer benefits of the program. PIAC considers that the establishment of the Network Innovation Advisory Committee provides a useful mechanism to help ensure consumer benefits are, indeed, realised by the fund. As such, we support Ausgrid's proposed Network Innovation Fund.

We also support continued investigation of such matters – in particular where they are coordinated between all three of the NSW DNSPs to provide a consistent approach where appropriate such as in terms of tariffs, DER connection standards and data availability.

3.3 Endeavour

New connections policy

In response to pressure from housing developers, Endeavour Energy, prior to the revenue determination process, unilaterally implemented a change to its policy for capital contribution to new connections. This change reduced the amount paid by developers by limiting their exposure for the cost of upgrades to shared network infrastructure. The cost was instead rolled into Endeavour Energy's RAB, placing significant upward pressure on energy prices for customers in the longer term. PIAC identified this issue early in Endeavour's engagement process, and advocated for Endeavour to reverse its decision and return to the previous charging regime, in which these costs were recovered from developers and new home buyers. Given it was outside of the AER's power to impose this change, PIAC held a number of bilateral meetings with Endeavour and other consumer advocates on the matter. As noted in its revised revenue proposal, Endeavour Energy has responded by changing its capital contribution policy, at a saving to its customers of $100s of millions in the longer term.

We strongly support this decision by Endeavour Energy and commend their responsiveness to consumer input on this issue.

Overall capex allowance

Endeavour has conducted substantial engagement on its capex proposal and, as a result, has substantively revised it since its initial proposal – reducing it from some $2.2 billion to $1.7 billion. PIAC supports this as an example of good practice consumer engagement. However, we must make a distinction between engaging on a proposal as opposed to negotiating a regulatory outcome.[7]

PIAC strongly supports the direction of the revision – clearly, $1.7 billion in capex is more affordable for Endeavour's consumers than $2.2 billion. However, as we noted during these discussions, neither PIAC, nor any other consumer advocate, is not able to determine if $1.7

7 For instance, even the AusNet trial with its Customer Forum seeks to negotiate the contents of AusNet's 2021-25 regulatory proposal and does not seek to negotiate the contents of the AER's decision.

billion is more efficient than $1.6 billion, or even $1.8 billion. Only the AER can do this as noted in Section 2.2. In the AER's final decision, PIAC would like to see a stronger demonstration that this has occurred.

Western Sydney airport project

PIAC understands there has been uncertainty around the timing and sizing of the network expansion to facilitate the Western Sydney airport, including whether or not it should be treated as a contingent project. Further, we note that Endeavour Energy has stated that they:

> … have received additional information on the growth area. Both the nature and the timing of the development are now more certain. We have developed a lower cost solution that will service expected growth in the shorter term by building a single 132kV feeder (rather than two) and utilising the existing surrounding 33kV network. This option will cost $39.3 million (real, 2018-19) and provide additional time to monitor actual growth and investigate non-network solutions for servicing expected long-term growth.[8]

PIAC welcomes the additional certainty being provided to this particular project and considers that any allowance for this project, should it be included in the AER's determination, be clearly prudent and efficient as well as being necessary within the 2019-24 RCP.

3.4 Essential

We note that Essential Energy has accepted the AER's draft determination on this matter which found that Essential Energy's original capex proposal was efficient. Despite this, many of the issues which PIAC raised in our submission to revenue proposal still hold.[9] In particular we have concern that, despite the capex efficiencies Essential Energy have proposed for the 2019-24 RCP, their RAB continues to grow and their capital productivity continues to decline.

This growth in the RAB carries a significant risk to customers in the context of limited growth in customer numbers, flat or declining energy growth, and considerable uncertainty around the growth in peak demand. It also creates a significant exposure to changes in the cost of capital over the next 10-years from the historically low cost of capital that now prevails.

PIAC appreciates that the causes of much of Essential Energy's RAB growth (such as errors in the opening RAB valuation, unrealised demand and the previous NSW distribution reliability standards) lie outside this particular revenue determination.

We commend Essential Energy for their hard work, through this regulatory process and outside of it, to address and mitigate the size of its RAB and its impact on consumers. On this basis we can accept Essential Energy's revised proposal.

4. Opex allowance

As with capex, PIAC's over-riding concern in assessing the NSW DNSPs opex forecasts is its impact on affordability. While opex does not have the long-lasting effect on RAB that capex does, it remains a large component of the revenue funded by consumers in the current

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8 Endeavour Energy, *Revised Regulatory Proposal 1 July 2019 – 30 June 2024*, January 2019, pp 21-22.

9 PIAC, *Submission in response to the NSW DNSPs 2019-24 regulatory proposals and AER issues paper*, August 2018.

period, during an affordability crisis. Some of these are overarching issues which affect all 3 businesses, others are specific to a particular business – they are discussed below.

4.1 Overarching issues

AER's opex productivity assumptions

As noted in our response to the AER's issues paper and the DNSPs' revenue proposals, PIAC remains concerned about the zero opex productivity assumption included in the AER's draft determination.[10] One of the central purposes of the network regulation framework is to replicate the pressures of a competitive market on NSPs. In a competitive market, businesses plan for continuous productivity improvement. By contrast, we have been asked accept the assumption that the NSW DNSPs will achieve zero opex productivity improvements over the 2019-24 RCP.

Further, the current practice does not effectively promote the goals of the national electricity regulatory framework. A core goal of economic regulation of monopoly service providers (such as DNSPs) is to replicate the pressures these firms would face in a workably competitive market.

In such a market, firms are required to constantly reduce costs through productivity improvements or face losing market share and, eventually, going out of business. Therefore, it is not consistent with the overarching goal of the regulatory framework that DNSPs do not face a requirement to improve operational productivity. As noted in our submission to the AER's opex productivity review, PIAC, and consumers, cannot accept this.[11] Further we support the AER's draft decision in this review to implement a 1% pa opex productivity assumption for these revenue determinations.

4.2 Ausgrid

Ausgrid's revised proposal has put forward an opex allowance which is lower than the AER's draft determination.

Further, Ausgrid has proposed to adopt the AER's opex productivity review draft decision of 1% per annum and for this to apply from 1 July 2020. This has been in response to unanimous consumer feedback as noted by Ausgrid:

> Our customers told us that affordability was their number one concern. Customers have acknowledged we have made significant progress in reducing our underlying opex over the current period, but they considered there was further scope for improvement in our forecasts.
> In consultation with our customers we committed to:
> - continue to pursue productivity gains
> - challenge ourselves to achieve the AER's productivity trend from FY21
> - absorb transformation costs associated with giving effect to the changes in our capital expenditure (capex) program from the Initial Proposal, and
> - use demand management, wherever it is efficient to avoid capital investments.[12]

10 PIAC, *Submission in response to the NSW DNSPs 2019-24 regulatory proposals and AER issues paper*, August 2018, p 23.

11 PIAC, *Submission to Forecasting productivity growth for electricity distributors draft decision*, December 2018.

12 Ausgrid, *Revised Regulatory Proposal 1 July 2019 to 30 June 2024*, January 2019, p 111.

PIAC understands that Ausgrid has proposed this as a placeholder pending the conclusion of the AER's review and intends to apply the AER's final opex productivity decision. We support this strictly on the basis that 1% productivity is a minimum amount, regardless of the outcome of the AER's review.

4.3 Endeavour

PIAC is pleased that Endeavour Energy has accepted the AER's draft opex determination. We also support Endeavour absorbing the increases in insurance premiums following the 2018 Californian bushfires rather than choosing to pass these through to consumers.[13]

However, as noted previously, we cannot accept a revenue determination which does not include a positive opex productivity. We recommend the AER apply its final opex productivity decision in line with the other NSW DNSPs.

4.4 Essential

As noted earlier, PIAC considers it imperative that network revenue determinations include ongoing improvements in opex productivity. PIAC commends Essential Energy for this – being not only the first of the NSW DNSPs to offer such a dividend to consumers, but also for doing so before the AER had launched its productivity review.

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13 Endeavour Energy, *Revised Regulatory Proposal 1 July 2019 – 30 June 2024*, January 2019, pp 22.