

# BRIEFING: AER FEDERAL COURT APPEAL

## Essential Energy 2014-19 revenue determination

17 May 2017



- The outcome of an appeals process which saw the Australian Competition Tribunal (ACT) set aside parts of the Australian Energy Regulator's (AER's) final 2014-19 revenue determination for Essential Energy, and the AER subsequently initiate a judicial review in the Federal Court on the basis that its final determination should be upheld, is expected to be handed down before the end of May 2017.
- The Federal Court may:
  - reject the AER's appeal, which would enable the ACT to direct the AER to re-make its determination in accordance with the ACT's original decision; or
  - find that the ACT made legal errors – either in full or in part – when it set aside the AER's determination, and direct the ACT to reconsider its decision.
- Either of these findings has the potential to alter regulatory revenue allowances in respect of one or more categories of operating expenditure, Gamma (the impact of dividend imputation) and Cost of Debt for Essential Energy.
- While the Federal Court's decision is still unknown, any increases in allowable revenue could potentially result in increased network charges for customers.

### Background

On 27 November 2014, the Australian Energy Regulator (AER) issued its draft determination of the total revenue Essential Energy can collect between 1 July 2014 and 30 June 2019. This draft determination proposed significant cuts to Essential Energy's works program.

On 20 January 2015, Essential Energy submitted a revised proposal to the AER that called for a more progressive approach to reforming the business, while maintaining a safe and reliable network in the long term interests of customers.

On 30 April 2015, the AER released its final determination for Essential Energy for the regulatory period 2014-19. The determination delivered an immediate:

- 30 per cent reduction in operating expenditure;
- 25 per cent reduction in revenue; and
- 7 per cent reduction in capital expenditure.

Essential Energy sought a merits review of some elements of the AER's determination in the Australian Competition Tribunal (ACT) on the basis that the AER's benchmarking of operational expenditure, Gamma (impact of dividend imputation) and Cost of Debt elements of the Weighted Average Cost of Capital (WACC) calculation required further examination. Essential Energy also submitted that there should have been a transitional period to implement the significant reductions.

On 26 February 2016, the ACT handed down its decision on this appeal. The ACT found Essential Energy had successfully established grounds for review. The ACT set aside the AER's final determination and directed the AER to re-make its determination for 2014-19.

On 24 March 2016, the AER appealed a number of elements of the ACT decision to the Federal Court, contending that its final determination handed down in April 2015 was the correct outcome.

This created uncertainty around prices for the 2016-17 financial year. Essential Energy subsequently entered into an undertaking with the AER (under section 59A of the National Electricity Law) to set prices for 2016-17. This undertaking has the effect of reinstating the set aside determination for prices and all other matters for 2016-17.

The Federal Court has informed the parties to the proceedings that the decision on the AER's appeal is expected to be handed down before the end of May 2017.

### Potential outcomes

If the Federal Court rejects the AER's appeal, the ACT may direct the AER to re-make its revenue determination for Essential Energy's 2014-19 regulatory period, predominantly on the basis that the

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AER's benchmarking model made insufficient allowance for Essential Energy's customer density, which is materially lower than the majority of other Australian electricity distributors.

Alternatively, the Federal Court may find that the ACT made legal errors – either in full or in part – when it set aside the AER's determination, and direct the ACT to reconsider its decision.

Either of these findings has the potential to alter regulatory allowances for operating expenditure, Gamma and Cost of Debt for Essential Energy, and consequently result in increased network charges for customers.

If the Federal Court rejects the AER's appeal and the ACT directs the AER to re-make its revenue determination, Essential Energy will work collaboratively with the AER to help the regulator achieve this in the most efficient timeframe possible to provide clarity for customers. Essential Energy is also aware of the potential impact this decision could have on regional and rural communities and will seek to keep downward pressure network charges.

To provide pricing certainty for customers, Essential Energy and the AER have agreed to a further section 59A undertaking for the next two years (2017-18 and 2018-19), based on current revenue forecasts plus CPI. This makes it highly unlikely that customers will experience any unfavourable real price impact in the current regulatory period.

Additionally, the Australian Energy Market Commission has made a draft decision to support a proposed jurisdictional change to the National Electricity Rules that would enable revenue increases to be smoothed over the 2019-24 regulatory period.

### Potential impacts

If the Federal Court directs the AER to re-make its revenue determination, the full determination process is expected to take more than 12 months. In that situation, it is likely that Essential Energy's 2014-19 regulatory submission will not be resolved until late in 2018 or early in 2019. The section 59A undertaking referred to above will provide pricing certainty for the remainder of the 2014-19 regulatory period, in the absence of a final determination.

In the interim, Essential Energy has commenced preparing its submission to the AER detailing capital and operating plans and the revenue required to deliver services over the 2019-24 regulatory period.

Essential Energy remains committed to real network price reductions while continuing to improve safety, business efficiency, and delivering satisfactory shareholder returns.

In the event of the Federal Court directing that the ACT made legal errors and ultimately, the AER's determination of 30 April 2015 is reinstated, the program of reform already implemented by Essential Energy has delivered sufficient adjustments to enable the business to operate within the capital and operating expenditure allowances of that determination. Therefore, the impact of this outcome on the business today would be minimal.

Given the current high level of public and media interest in electricity pricing, Essential Energy has prepared the draft media statements below, with the appropriate statement to be issued proactively once the Federal Court hands down its decision. Both are provided for indicative purposes only, are not for distribution, and are based on speculative assumptions, as follows:

1. The Federal Court rejects the AER's appeal in full; or
2. The Federal Court finds that the ACT made legal errors – either in full or in part – when it set aside the AER's determination, and directs the ACT to reconsider its decision.

## 1. Federal Court rejects AER's appeal, upholds ACT decision to set aside 2014-19 Essential Energy Regulatory Determination

The Federal Court has today rejected the Australian Energy Regulator's (AER) appeal of last year's decision by the Australian Competition Tribunal to set aside the AER's 2014-19 determination for

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electricity network provider, Essential Energy. This will likely result in the Australian Competition Tribunal directing the AER to re-make its revenue determination for Essential Energy's 2014-19 regulatory period.

Chief Executive Officer, John Cleland, said Essential Energy respects the Court's decision and will work with the AER in finalising the 2014-19 determination.

"Our long-term objective has always been to transition to a business model that delivers a safe, reliable and efficient electricity network for our customers," John said.

"Essential Energy will continue to work collaboratively and cooperatively with the AER, our customers and other stakeholders to ensure the determination is re-made in the most efficient timeframe possible to provide clarity for our customers.

"We are critically aware of the potential impact this decision could have on regional and rural communities and will continue to work closely with stakeholders as we reform the business to keep downward pressure on real network charges for customers."

The Federal Court decision comes over two years after the AER issued Essential Energy's 2014-19 regulatory determination on 30 April 2015, reducing operating expenditure by 30 per cent, revenue by 25 per cent and capital expenditure by seven per cent with retrospective effect from 1 July 2014.

Essential Energy, together with Ausgrid and Endeavour Energy, appealed the AER's benchmarking methodology for operational expenditure and elements of the Weighted Average Cost of Capital (WACC) calculations. At the time, Essential Energy, Ausgrid and Endeavour Energy operated under a combined governance model, as Networks NSW. Networks NSW has since been demerged, with each of the three businesses being re-established as independent entities.

After a merits review hearing in late 2015, the Australian Competition Tribunal set aside the AER's 2014-19 regulatory determinations on 26 February 2016. The AER subsequently applied to the Federal Court for a judicial review of the Tribunal's decision.

While Essential Energy is reviewing the implications of today's decision, it will not affect network charges for 2016-17, and is unlikely to have an impact in the remainder of the current, 2014-19 regulatory period.

Essential Energy remains committed to delivering real network price reductions over time while continuing to improve business efficiency and productivity.

"We've been reforming the business in a sustainable way for several years while maintaining safety and reliability, with the objective of operating at best industry practice, achieving real reductions in network charges and providing a satisfactory return for our owners, and we will continue on that path," John Cleland said.

## 2. Federal Court directs ACT to reconsider its decision on Essential Energy 2014-19 Regulatory Determination

The Federal Court has today found in favour of an appeal by the Australian Energy Regulator (AER), and has directed the Australian Competition Tribunal to reconsider its decision in February 2016 to set aside the AER's 2014-19 determination for Essential Energy. This may ultimately result in the AER's original revenue determination for Essential Energy's 2014-19 regulatory period being reinstated.

Chief Executive Officer, John Cleland, said Essential Energy respects the Court's decision and will work with the AER to efficiently implement a reinstated determination.

"Our long-term objective has always been to transition to a business model that delivers a safe, reliable and efficient electricity network for our customers," John said. "The reforms undertaken in recent years, while challenging, have resulted in operating costs and capital expenditure at levels similar to that proposed in the 2014-19 determination, so there will be minimal short term impact from this decision.

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