<u>Submission to Essential Services Commission Inquiry into Retail Energy Prices in South Australia</u>

This submission relates to the impact of the efficacy of regulations on the pricing for electricity to South Australian consumers. However, while it relates to electricity specifically, similar factors as identified in this submission may well also pertain to the costs of gas faced by South Australian consumers.

Retail electricity consumers' bills are generally comprised of four main elements:

1. Wholesale electricity supply from generators sourced across the NEM
2. Retailing and electricity price risk (hedging/trading) management costs
3. Regulated electricity transmission and distribution costs
4. "Environmental" costs, such as SRES etc

Of these elements, the second largest cost for household consumers is that due to transmission and distribution - representing around 35 to 40% of a consumer's bill. The two businesses which own transmission and distribution assets are monopolies, and are regulated by the Australian Energy Regulator (AER). Arguably, because they are regulated under rate of return criteria set by the regulator, minimum profits are virtually guaranteed, while incentive regimes provide for the businesses to earn higher returns. The owners of these businesses face far lower risks than the risks faced by the owners of unregulated businesses in the electricity supply chain covering generation, electricity trading, and retailing, which encounter competition risk, price risk, supply risk, credit default risk, sales volume risk, and so on.

This may be satisfactory if the regulated businesses were appropriately controlled with regulatory structures that proved effective at limiting the returns that these monopoly businesses could earn given the relatively low risks they face. As will be discussed further below, the design and oversight of these regulatory regimes appear to be failing consumers. Together with incentive regimes, this has resulted in substantial added profits paid for by electricity consumers through their higher power bills.

A report by the Institute for Energy Economics and Financial Analysis (IEEFA) titled "Regulated Electricity Network Prices Are Higher Than Necessary" October 2022, has shown that network businesses are earning very healthy returns and substantially higher than would have been expected based on the AER settings applied at rate resets.

IEEFA analysis shows that this inadequacy of regulation by the AER has **resulted in each South Australian consumer on average paying around $1200 more for their electricity over the period 2014-2021 than they should have** if the networks had only earned the returns the AER expected when it set rates.

While IEEFA's analysis highlighted these "supernormal profits" for distribution businesses, the AER's own reporting shows all distribution businesses are earring profits far higher than expected, as Figure 1 attached shows.

Over the period 2014 to 2021, SA Power Networks (SAPN) has achieved financial returns that are in the top quartile of all network businesses in Australia in every year but one. This is the AER's own assessment, so one does not need to rely solely on the IEEFA analysis to see that SAPN's financial performance has been outstanding.

Indeed, SAPN's actual annual financial returns (nominal return on regulated equity as reported by the AER for the years 2014 to 2020) **have averaged almost 16%, almost double the returns expected by the AER when it approved SAPN tariffs and rates. South Australian consumers have paid for this.**

Figure 2 compares the AER's assessment of the contributors to why network businesses generally have outperformed its (ie the AER's) expectations when it set rates. Gearing, interest rates and incentive schemes are the biggest contributors.

Figure 3 looks specifically at SAPN performance using the AER's own profitability analysis as reported in July 2022. On average over the 7 years from 2014 to 2020, **SAPN's financial returns as assessed by the AER are 80% above those the regulator expected would be reasonable for a regulated business like SAPN over the period 2014 to 2020.** Excluding the one year (2017) when actual return was abnormally low, (ie close to the regulated rate!) **SAPN's financial returns have averaged double those expected by the regulator**.

Until 2021, SAPN was in part owned by an infrastructure company called SPARK, publicly listed on the ASX. As this company was required to report to its public shareholders on the financial and operating performance of its partly owned businesses, the audited financial accounts for SAPN were publicly available for scrutiny. **My own analysis of these financial records for the period 2011 to 2020** (Figures 4 and 5) **showed financial returns that were indeed extremely healthy for a low risk regulated business.** I am sure there are many businesses in the unregulated parts of the energy supply chain that would desire to have achieved such healthy returns consistently over so many years.

Independent reporting of SAPN financial performance is now no longer publicly available as SPARK has been taken over by foreign owned companies and its has been delisted. SAPN is now 100% foreign owned. All its excess profits are remitted overseas to its owners. It does not report on its financial performance to the public, the electricity consumers of South Australia.

The AER does report some financial information as supplied to it by the network businesses, but this is very limited and I have found that it makes any detailed analysis very difficult. The AER may have more information reported to it by distribution businesses, but it fails to disclose this to electricity users and the public on the basis that it is confidential. This is an unreasonable excuse. **Financial performance reporting for SAPN wasn't confidential when SPARK was listed and required to disclose it to investors, so why is it confidential now? Surely the public who pay for the services SAPN provides and underwrite their profits, have a right to see its financial reporting publicly disclosed, rather than rely on limited reporting via the AER prism?**

So I would submit in conclusion that the Minister and ESCOSA:

1. **Should pay considerable attention to the efficacy of regulation of the networks business in South Australia, and specifically SAPN, by the AER,**
2. **Should conduct a comprehensive review of network business regulation and incentive regimes, as if the AER has been applying the regulatory structures to the letter, then those structures have let SA consumers down, and**
3. **Should require the audited financial performance of SAPN to be reported to the public of South Australia annually, in at least the detail that was provided publicly previously via SPARK when it was listed.**

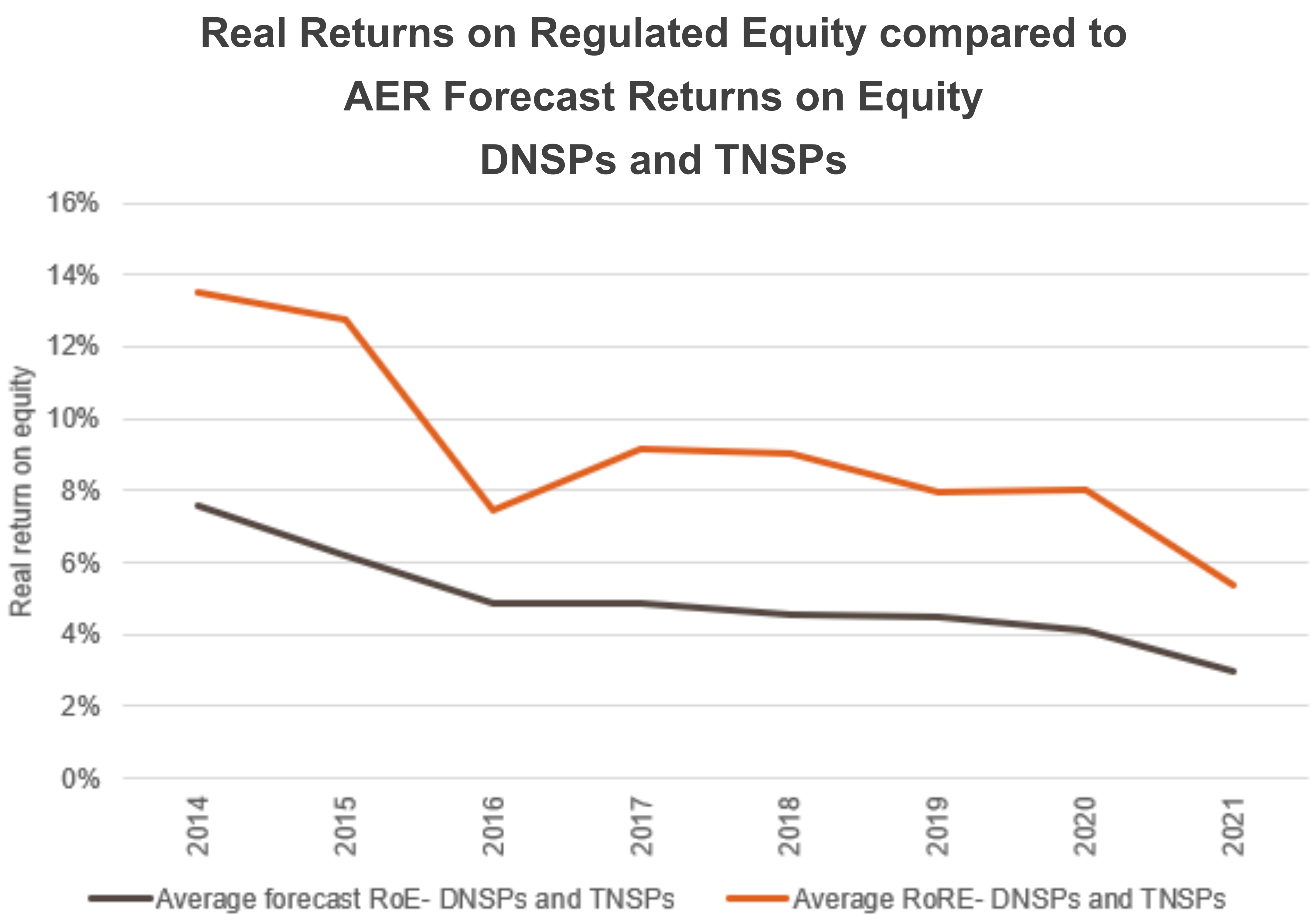
When network charges comprise such large percentage of consumers' electricity bills, I believe it is unacceptable for the current situation to continue without serious review. I urge the Minister and ESCOSA to ensure that network pricing efficacy, regulation, incentive schemes, and public financial reporting are effectively reviewed. These have all been major contributors to SA household electricity bills being higher than was warranted every year for the past decade or more. South Australian consumers have been seriously let down.

A M Stock
January 2023

Figure 1 - Real and Nominal Returns on Regulated Equity

SA Power Networks Achieves Top Quartile Returns and is Top in Some Years

On average, DNSPs and TNSPs have significantly outperformed AER forecasts of Return on Equity



Source: Financial performance data, AER analysis

AER Electricity Network Performance Report July 2022

AER Nominal Returns on Regulated Equity - DNSPs

Distributor	Year						
	2014	2015	2016	2017	2018	2019	2020
Evoenergy Distribution	7.1%	7.9%	7.4%	7.6%	8.0%	8.5%	5.3%
Ausgrid	19.7%	13.6%	3.6%	6.6%	11.0%	11.6%	8.9%
Endeavour Energy	14.5%	18.0%	5.4%	6.7%	20.0%	16.7%	13.8%
Essential Energy	16.2%	17.8%	1.7%	2.9%	4.2%	2.8%	4.4%
Energex	9.8%	11.8%	13.7%	14.9%	12.2%	9.0%	9.1%
Ergon Energy	11.4%	11.2%	8.8%	16.4%	10.5%	8.1%	8.1%
SA Power Networks	**26.2%**	**21.0%**	**14.8%**	**8.8%**	**12.8%**	**11.9%**	**15.2%**
TasNetworks (D)	11.7%	11.8%	13.4%	12.6%	8.4%	4.9%	6.1%
AusNet (D)	20.3%	23.6%	5.8%	11.9%	10.4%	11.1%	10.6%
CitiPower	10.2%	13.0%	7.8%	6.8%	9.2%	8.4%	5.7%
Jemena Electricity	13.6%	18.3%	11.3%	12.1%	10.8%	7.6%	10.5%
Powercor Australia	21.0%	21.7%	13.0%	11.0%	9.4%	8.4%	8.8%
United Energy	19.6%	26.1%	5.8%	13.2%	21.4%	20.2%	25.4%
SAPN Profitability Ranking	**1st**	**4th**	**1st**	**7th**	**3rd**	**3rd**	**2nd**

Source: AER DNSP Profitability Reporting 2022

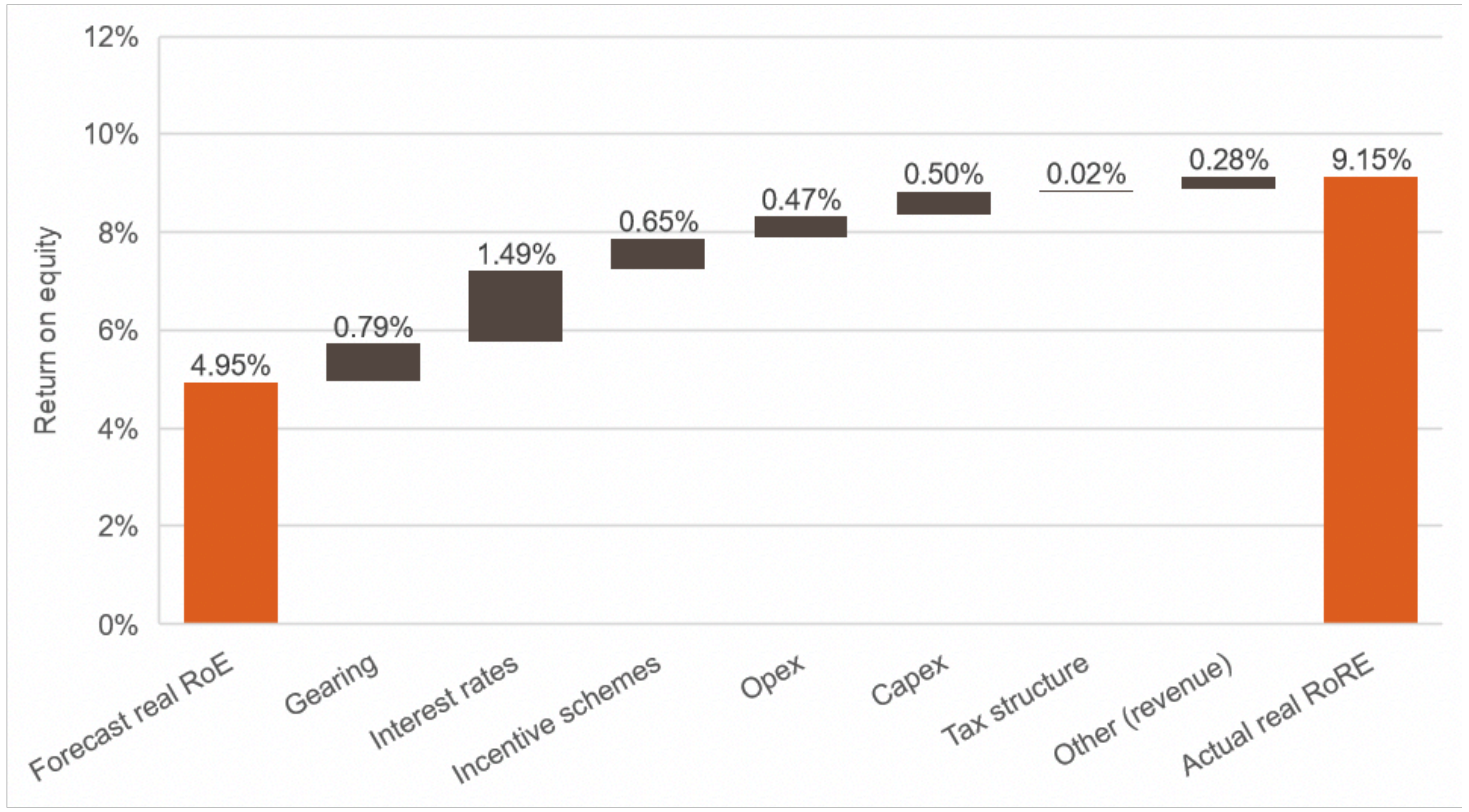
Figure 2 - AER and IEFFA Analysis of Financial Outperformance by Network Companies

AER analysis shows that its assumptions on Gearing (ie Debt:Equity ratio), Interest Rates and Incentives are the primary drivers of NSP outperformance

These are similar conclusions to those reached by IEFFA

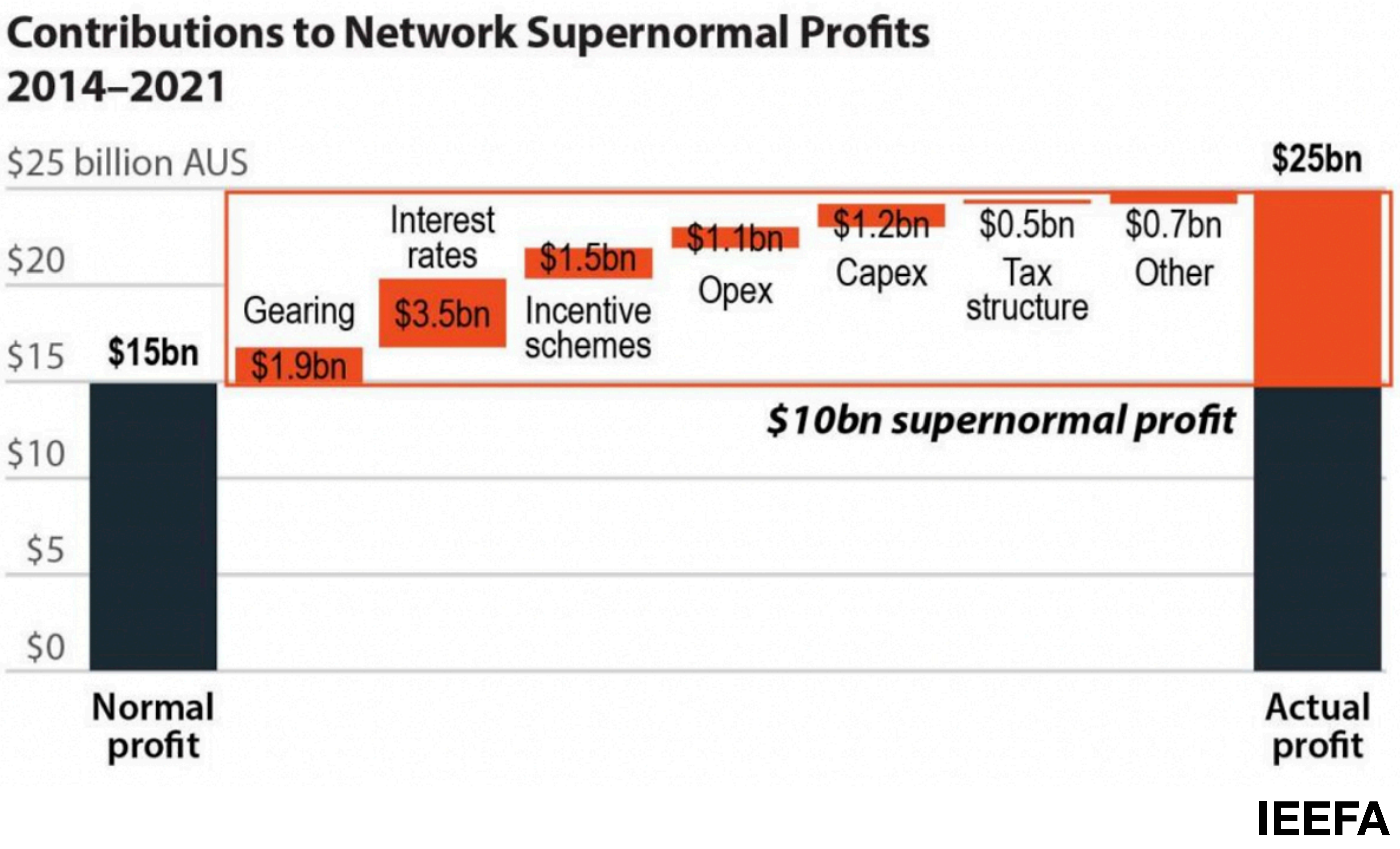
Incremental Contributions to Returns on Regulated Equity

Simple Average of all NSPs over 2014–2021



Source: AER Electricity network performance report July 2022

Extract from IEEFA Report - "Regulated Electricity Network Prices Are Higher than Necessary" October 2022



Source: AER data; IEEFA analysis.

Derived from Figure 4.6 of AER. Electricity network performance report 2022

Figure 3 - SA Power Network Actual Equity Returns 80% More Than AER's "Allowed Returns"

SAPN has historically outperformed on equity returns when compared to AER's "Allowed Return on Equity"

	SAPN Returns on Regulated Equity vs AER Allowed			
Year	Nominal Return on Regulated Equity	Allowed Return on Equity	Difference	Percentage Above Allowed
2014	26.17	11.09	15.08	136%
2015	21.01	11.09	9.92	89%
2016	14.78	7.5	7.28	97%
2017	8.81	7.5	1.31	17%
2018	12.78	7.5	5.28	70%
2019	11.92	7.5	4.42	59%
2020	15.22	7.5	7.72	103%
Source: AER DNSP Profitability Reporting			July 2022	

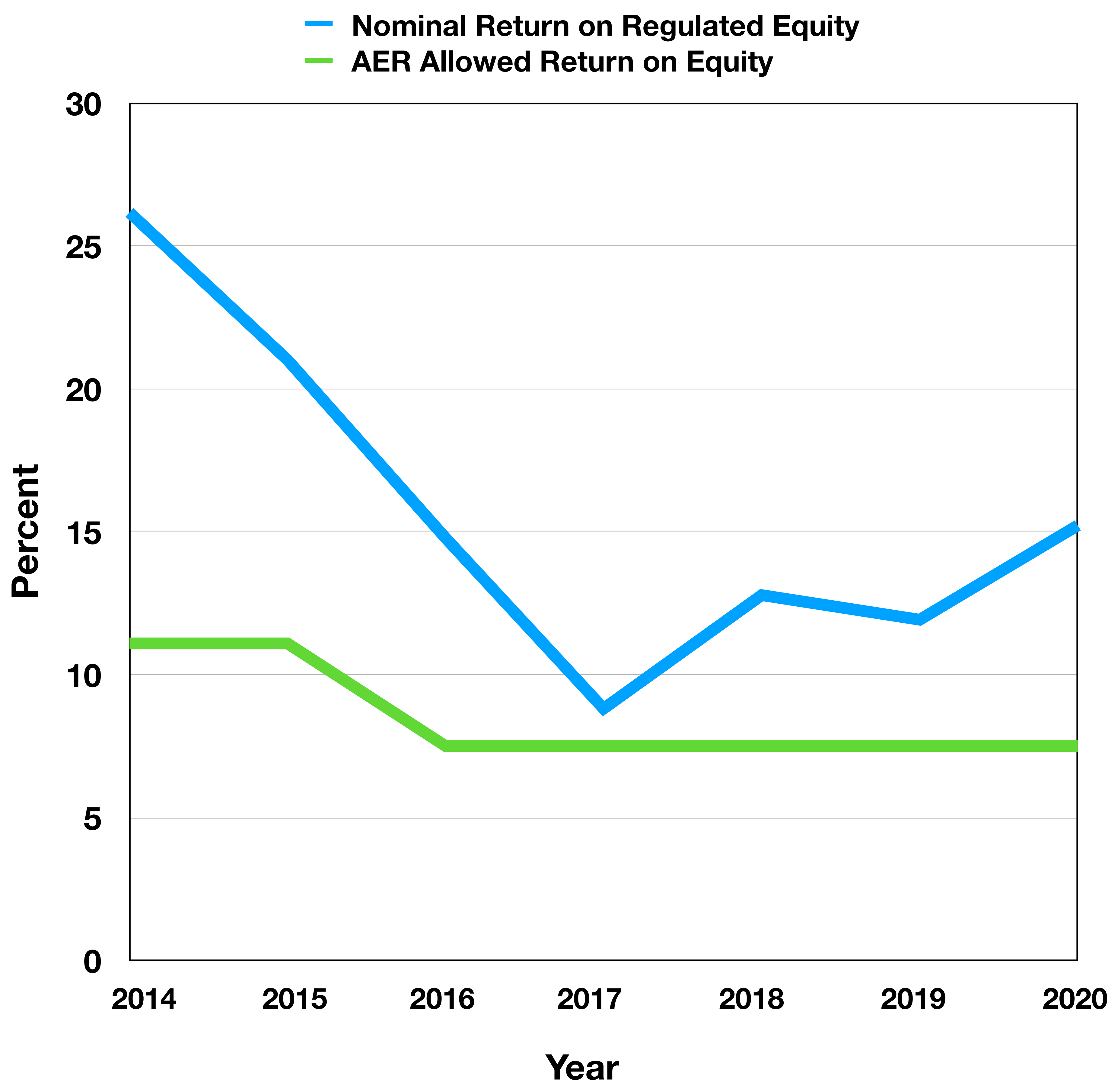


Figure 4 - SAP Power Network Cash Returns on Equity

SAPN Cash Returns Very Healthy for a Low Risk Regulated Business

Analysis of SAPN historical pre-tax cash returns on equity show similar trends to the AER's more recent analysis. The SPARK financial information on SAPN was the only public information available other than AER figures.

Two Measures of SAPN Financial Performance

Year	Post Tax Regulated Return on Equity - NPAT/Equity (ie RAB - Net Debt) AER	Pre-Tax Cash Return on Equity -EBTDA/Equity SAPN Financials via SPARK
2011	NA	23.9%
2012	NA	25.7%
2013	NA	21.9%
2014	26.2%	22.2%
2015	21.0%	18.5%
2016	14.8%	14.9%
2017	8.8%	18.2%
2018	12.8%	18.6%
2019	11.9%	20.6%
2020	15.2%	20.2%

Sources: Post Tax Regulated Return - AER DNSP Financial Performance Data July 2022
Pre Tax Return on Equity - SPARK ASX Financial Reports, Investor Presentations and Fact Books 2011 to 2020

SAPN Historical Returns on Equity

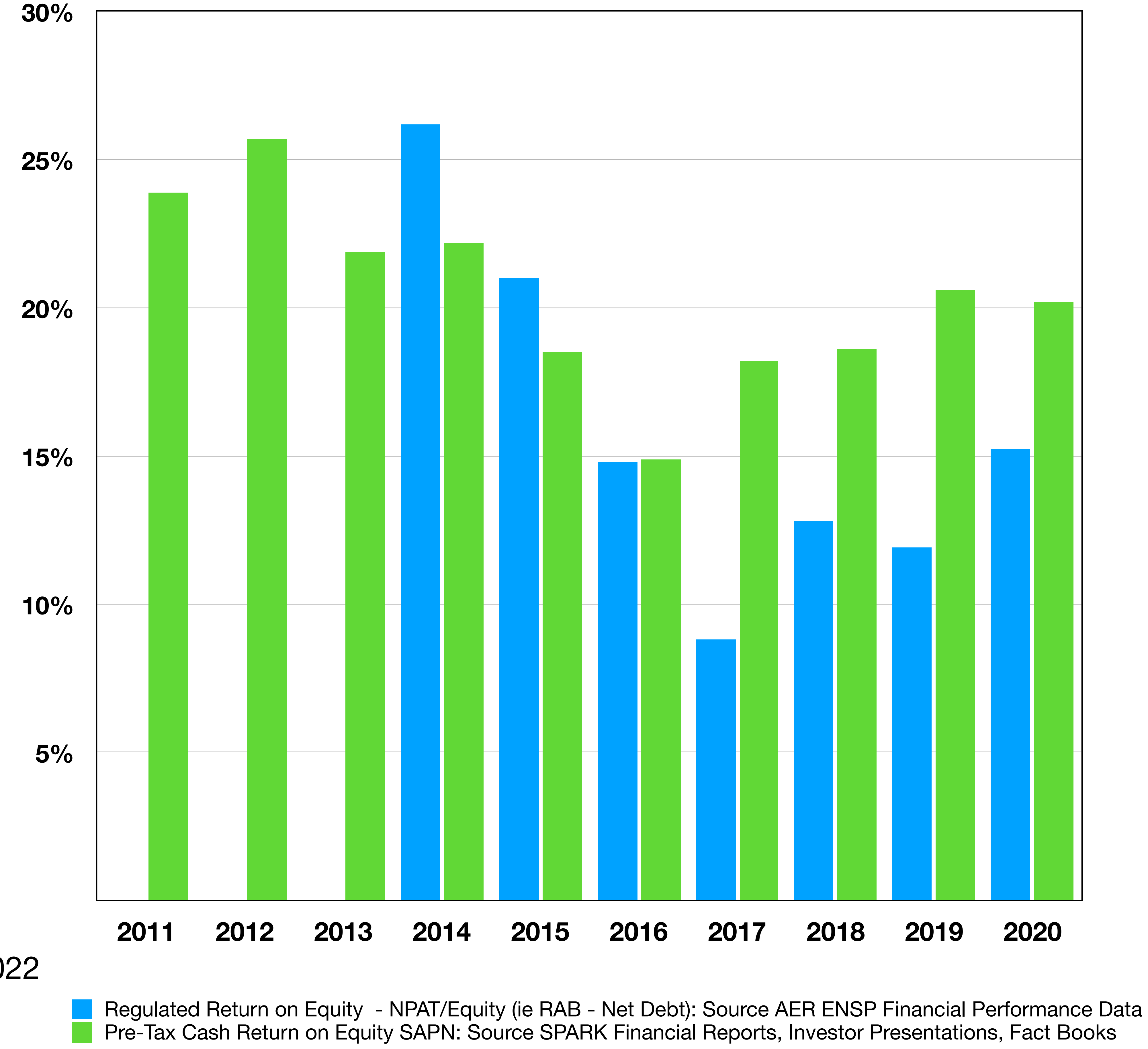


Figure 5 - Supplemental Information

SAPN Pre-Tax Returns to Equity, Cash Flow and Capital Expenditure (100% Basis)

Year Ended December	***2020***	***2019***	***2018***	***2017***	***2016***	***2015***	***2014***	***2013***	***2012***	***2011***
SAPN 100% Basis ($millions)										
Net Assets (Total Assets - Total Liabilities) = Equity	**2131.4**	**2216.6**	**2394.0**	**2369.3**	**2340.6**	**2304.8**	**2128.6**	**1967.6**	**1646.3**	**1375.5**
EBITDA	**668.1**	**690.7**	**656.1**	**653.1**	**560.3**	**676.2**	**750.2**	**710.2**	**693.3**	**585.0**
Less:										
Net Finance Expenses	137.2	138.7	123.4	124.7	138.1	177.3	205.1	206.2	198.2	184.0
Interest on Subordinated Debt	72.7	72.5	72.5	72.5	72.7	72.5	72.5	72.5	72.7	72.5
Total Finance/Interest Costs	209.9	211.2	195.9	197.2	210.8	249.8	277.6	278.7	270.9	256.5
Enerven Margin	27.1	22.8	15.3	23.7	NA	NA	NA	NA	NA	NA
EBDTA Networks Business (Proxy for Cash Flow Before Tax)	**431.1**	**456.7**	**444.9**	**432.2**	**349.5**	**426.4**	**472.6**	**431.5**	**422.4**	**328.5**
Free Pre-Tax Cash Flow Return on Equity	**20.2%**	**20.6%**	**18.6%**	**18.2%**	**14.9%**	**18.5%**	**22.2%**	**21.9%**	**25.7%**	**23.9%**
Capital Expenditure ($ million)	368.7	405.6	424.9	391.6	285.7	315.5	363.8	348.5	331.6	313.2
Free Cash After Capex ($ million)	**62.4**	**51.1**	**20.0**	**40.6**	**63.8**	**110.9**	**108.8**	**83.0**	**90.8**	**15.3**

Source: Analysis by A M Stock using SPARK ASX releases - Annual Reports, Investor Presentations and Fact Books from 2011 to 2020 when de-listed