



Draft Decision

Ausgrid 2014–19 electricity distribution determination

November 2018

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Invitation for submissions

Interested parties are invited to make submissions on this draft decision paper by 20 December 2018.

Submissions should be sent to: AusgridRemittal2014-19@aer.gov.au

Alternatively, submissions can be sent to:

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Submissions should be in Microsoft Word or another text readable document format.

We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information should:

- clearly identify the information that is the subject of the confidentiality claim
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All non-confidential submissions will be placed on our website. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy (June 2014), which is available on our website.¹

¹ <https://www.aer.gov.au/publications/corporate-documents/accc-and-aer-information-policy-collection-and-disclosure-of-information>

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1 Executive Summary

The Australian Energy Regulator (AER) regulates energy markets and networks under national energy market legislation and rules. Our network regulatory functions, which relate to energy networks in all Australian states and territories, except Western Australia, include setting the amount of revenue that monopoly network businesses can recover from customers for using networks (electricity poles and wires and gas pipelines) that transport energy.

The National Electricity Law (NEL) and Rules (NER) provide the regulatory framework governing electricity networks. Our work under this framework is guided by the national electricity objective (NEO):²

“... to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, safety, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.”

This is our remade draft decision on the distribution determination for NSW electricity distributor, Ausgrid, for the 2014-19 regulatory control period, commencing 1 July 2014 to 30 June 2019. We set out the issues we have covered, our conclusions, and our reasons for why we are satisfied the decision, on the basis of the information before us, contributes to the achievement of the NEO to the greatest degree.

If this remade draft decision becomes our final decision, the decision will provide consumers with tariff stability and predictability and will maintain distribution network charges at current levels (in nominal terms).³ Our remade draft decision is to accept Ausgrid’s Proposal, subject to certain modelling adjustments.⁴ We determine Ausgrid can recover total revenues of \$9,126.3 million (\$ nominal) from consumers over the five-year 2014-19 regulatory control period.⁵

In January 2015, Ausgrid was seeking \$12,055.4 million in revenue for the 2014-19 regulatory control period, but we approved a revenue allowance of \$8,785.2 million in our April 2015 final decision (or \$3,207.2 million less than what Ausgrid proposed). In response, Ausgrid sought limited merits review of our decision by the Australian Competition Tribunal (Tribunal).

² NEL, s. 7.

³ In May 2016, we accepted undertakings given by Ausgrid under section 59A of the NEL that set out how network revenues and tariffs will be determined in 2016–17. Ausgrid’s Network Use of System (NUoS) tariffs in 2016–17 were set at their 2015–16 approved tariffs adjusted for changes in the CPI. As of May 2017, the Full Federal Court had not yet handed down its decision, so we accepted further undertakings given by Ausgrid to establish new interim arrangements to govern the setting of network tariffs in 2017–18. As of March 2018, as the remittal process was not yet settled, we accepted further undertakings from Ausgrid for 2018-19. See *Open letter to stakeholders: Electricity network charges in the ACT and NSW from 1 July 2018*, 21 March 2018.

⁴ The modelling adjustments that we have applied to the models that support Ausgrid’s Proposal are set out in section 2.

⁵ Ausgrid, *Proposal for the remake of Ausgrid’s 2014-19 distribution determination*, 15 August 2018. In consultation with Ausgrid, we will continue to update the revenue amount for any new information until our final decision is made (e.g. actual and estimated revenues for 2017–18 and 2018–19).

Our remade draft decision for the 2014-19 regulatory control period will result in a revenue allowance of \$341.1 million (\$ nominal) above the revenue we approved in our 2015 final decision⁶ that was set aside by the Tribunal. This will lead to an estimated \$310.9 million (\$ nominal) at 30 June 2019 being returned to consumers in the 2019-24 regulatory control period.⁷ The substantive proportion of these additional revenues relate to the efficient and prudent redundancy costs that Ausgrid has incurred since our 2015 final decision in reforming its business to meet the opex expenditure targets set out in that decision.

Our remade draft decision for the 2014-19 regulatory control period has been informed by our analysis, supported by a series of stakeholder engagement processes that have occurred since the second-half of 2017 involving interested stakeholders, including consumer groups and affected distribution businesses. The purpose of these discussions has been to identify and develop a common position on key matters that, in turn, could be put to us for consideration as being in the long-term interests of consumers.

There are a number of factors behind our decision to accept Ausgrid's Proposal, subject to certain modelling adjustments, including:⁸

- we are satisfied it is likely to contribute to the achievement of the NEO to the greatest degree and is in the long-term interests of consumers
- it is consistent with our forecasts of operating expenditure (opex) and the cost of debt in light of the information before us now
- it is supported by key consumer groups following consultation undertaken by Ausgrid
- it will promote price certainty and stability for consumers
- it will provide a timely and certain resolution of Ausgrid's distribution determination for the 2014-19 regulatory control period, which will benefit both consumers and Ausgrid

We have had to remake our decision following the outcome of limited merits and judicial review processes relating to our 2015 final decision. The Tribunal remitted our decision to us, specifically requiring that we remake our decision in relation to Ausgrid's opex forecast and the rate of return with respect to the trailing average approach, and otherwise vary the distribution determination as set out in our 2015 final decision as we consider appropriate.^{9,10} To address pricing uncertainty during the period that the review processes were on foot, we accepted enforceable undertakings from Ausgrid. These undertakings set distribution network charges to increase by changes in the consumer price index (CPI) for 2016-17 and 2017-18 and remain constant for 2018-19. Under these undertakings, we estimate that

⁶ In December 2015, we subsequently approved additional revenue of \$43.2 million (\$ nominal) in respect of a positive cost pass through for restoration works conducted in response to the April 2015 storms.

⁷ The estimated \$310.9 million (\$ nominal) that is expected to be returned to customers in the 2019-24 regulatory control period is our best estimate at this point in time as we will not know the exact amount until after the 2014-19 regulatory control period.

⁸ The modelling adjustments that we have applied to the models that support Ausgrid's Proposal are set out in section 2.

⁹ See Appendix A for background on our remade decision.

¹⁰ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1. On 24 May 2017, the Full Federal Court dismissed our appeal and upheld the Tribunal's decision in relation to opex and cost of debt. It upheld the AER's appeal in relation to gamma. See Appendix A for background on our remade decision.

Ausgrid will recover \$652 million (\$ nominal) more during the 2014-19 regulatory control period than we allowed in our 2015 final decision.

On 15 August 2018, Ausgrid submitted a new Proposal to us to resolve all outstanding issues relating to the decision we need to remake.¹¹ It is a total revenue proposal of \$9,189.9 million (\$, nominal) for the five-year 2014-19 regulatory control period. This amount is \$404.7 million more than what we provided for in our 2015 final decision, after adjusting for data updates over time including the impact of actual CPI being lower than what was expected. This additional revenue of \$404.7 million contrasts against the \$1,290 million at issue (the key elements of our 2015 final decision that were disputed were approximately \$731 million for operating expenditure and \$559 million in return on debt).

Ausgrid's Proposal is based on:¹²

- our 2015 final decision, including the constituent decisions we made on opex and the rate of return (including the cost of debt)
- the revenue that Ausgrid has recovered thus far for the 2014-19 regulatory control period, up to \$652 million (\$ nominal) above our 2015 final decision (of which \$364 million is to be retained by it).

We have remade our 2015 final decision in accordance with the NEL and NER. Among other things, this means we have taken into account the revenue and pricing principles (RPP) and are satisfied that the remade decision is likely to contribute to the achievement of the NEO to the greatest degree.

It is important to draw attention to the novel circumstances that we have faced in remaking this decision. These circumstances materially differ to what we faced when we made our 2015 final decision, and what we would generally face in making a distribution determination. As a result, it is likely that this remade decision will have limited precedent value.

Specifically, we are remaking this decision at a time:

- That is more than four years into the applicable five-year 2014-19 regulatory control period.
- When we have applied interim pricing measures for the 2016-17, 2017-18 and 2018-19 regulatory years by accepting enforceable undertakings to address pricing uncertainties arising from the limited merits and judicial review processes.
- When we have information on Ausgrid's actual performance for the first three years of the five-year 2014-19 regulatory control period and updated forecasts for the remaining two years. Since our 2015 final decision, Ausgrid has embarked on a reform program that has reduced its opex to a level consistent with our 2015 final decision.
- When we have had a number of Tribunal and Federal Court processes, since the Tribunal's decision on Ausgrid, that have considered and clarified the law in relation to 'efficient financing costs' and the determination of the cost of debt, as well as opex redundancy costs.

¹¹ Ausgrid, *Proposal for the remake of Ausgrid's 2014-19 distribution determination*, 15 August 2018.

¹² *Ibid.*

- When our remade decision has the potential to create significant retail price fluctuations if it differs materially from our 2015 final decision (recognising that this prospect is to some extent alleviated by the rule made by the Australian Energy Market Commission (AEMC) on 1 August 2017 that allows us to let Ausgrid recover any additional revenues that result from our remade decision across both the 2014–19 and 2019–24 regulatory control periods).¹³
- When we have released our draft decision in response to Ausgrid’s revenue proposal for the forthcoming 2019-24 regulatory control period.
- When there is support from a range of consumer groups that Ausgrid’s Proposal is in the long-term interests of consumers.

The novel circumstances we find ourselves in also heightens the importance of us remaking our decision in a timely manner. Timely decision-making is a tenet of best regulatory practice and, in our view, is a principle that is in the long-term interests of consumers.¹⁴

Ausgrid participated in the stakeholder roundtable meeting we convened on 16 August 2017, the purpose of which was to discuss possible options for resolving outstanding remittal-related matters in a manner that is in the long-term interests of consumers.¹⁵ Some of the key themes raised by participating stakeholders, which included industry and consumer representatives, were:

- an expedited resolution of the remaking of our 2015 final decision, if possible, would provide a number of benefits for stakeholders, including greater certainty for the running of the businesses and certainty of price outcomes for consumers, compared to an extended timeframe of potentially up to 18 months for a regular determination process
- recognition that there is an increasing effort and goodwill towards better, and more clearly, aligning consumer and network business interests
- rising electricity prices have made affordability a key concern for consumers

Ausgrid also engaged with key energy consumers groups to inform its Proposal, including Energy Consumers Australia, Energy Users Association of Australia, Public Interest Advocacy Centre and the AER Consumer Challenge Panel. While noting that some consumer groups were disappointed that Ausgrid’s Proposal was not as timely as that for other NSW distribution businesses, the general consensus of these stakeholders is that Ausgrid’s Proposal is in the long-term interests of its consumers (see section 4).¹⁶

In light of the novel circumstances we are faced with, and the information before us, our remade draft decision is to accept Ausgrid’s Proposal for the 2014-19 regulatory control

¹³ AEMC, *Rule determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017, 1 August 2017*; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6*, commencing 15 August 2017.

¹⁴ Regulatory best practice is also the way in which we have committed to act in undertaking our functions and powers: AER, *Statement of Intent 2017-18*, p. 5.

¹⁵ AER, *NSW and ACT remittal roundtable (16 August 2017) summary note*, August 2017.

¹⁶ Stakeholders’ written advice on Ausgrid’s proposal is published on the AER’s website. <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/evoenergy-determination-2014-19-remittal/proposal>

period, subject to certain modelling adjustments.¹⁷ We are satisfied that this will result in a remade decision that is likely to contribute to the achievement of the NEO to the greatest degree and is in the long-term interests of consumers.

1.1 Next steps

Subject to stakeholder submissions received in response to this remade draft decision, we expect to publish our remade final decision by March 2019, as per Table 1-1.

Table 1-1 Indicative timeline for finalising Ausgrid’s 2014-19 determination

Determination process	Indicative date
AER publishes remade draft decision for consultation	22 November 2018
Stakeholder submissions on remade draft decision close	20 December 2018
AER publishes remade final decision	March 2019

1.2 Decisions for other NSW/ACT distribution businesses

We released our 2014-19 remade final decisions for Essential Energy, Endeavour Energy and Evoenergy on 31 May 2018, 20 September 2018 and 15 November 2018, respectively.^{18,19,20} Recently, we also received a proposal from Jemena Gas Networks to remake our draft decision on its 2015-20 access arrangement and expect to do so in the first quarter of 2019.²¹

In late-2017, we sought stakeholder feedback on an opex Issues Paper²² and cost of debt Position Paper²³ for the purpose of progressing the outstanding remittal decisions that we need to remake. All stakeholder submissions received in response to these papers have or will be considered when remaking our decisions.

1.3 Structure of this document

This document is structured as follows:

- Section 2 presents our remade draft decision for Ausgrid
- Section 3 presents Ausgrid’s Proposal

¹⁷ The modelling adjustments that we have applied to the models that support Ausgrid’s Proposal are set out in section 2.

¹⁸ AER, *Final Decision Essential Energy 2014-19 electricity distribution determination*, May 2018.

¹⁹ AER, *Final Decision Endeavour Energy 2014-19 electricity distribution determination*, September 2018.

²⁰ AER, *Draft Decision Evoenergy 2014-19 electricity distribution determination*, September 2018.

²¹ Jemena Gas Networks, *Proposal For The Remittal Items – Jemena Gas Networks 2015-20 Access Arrangement Final Decision*, October 2018.

²² AER, *Issues Paper – Remitted decisions for NSW/ACT 2014–19 electricity distribution determinations, Operating Expenditure*, October 2017.

²³ AER, *Position paper – Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

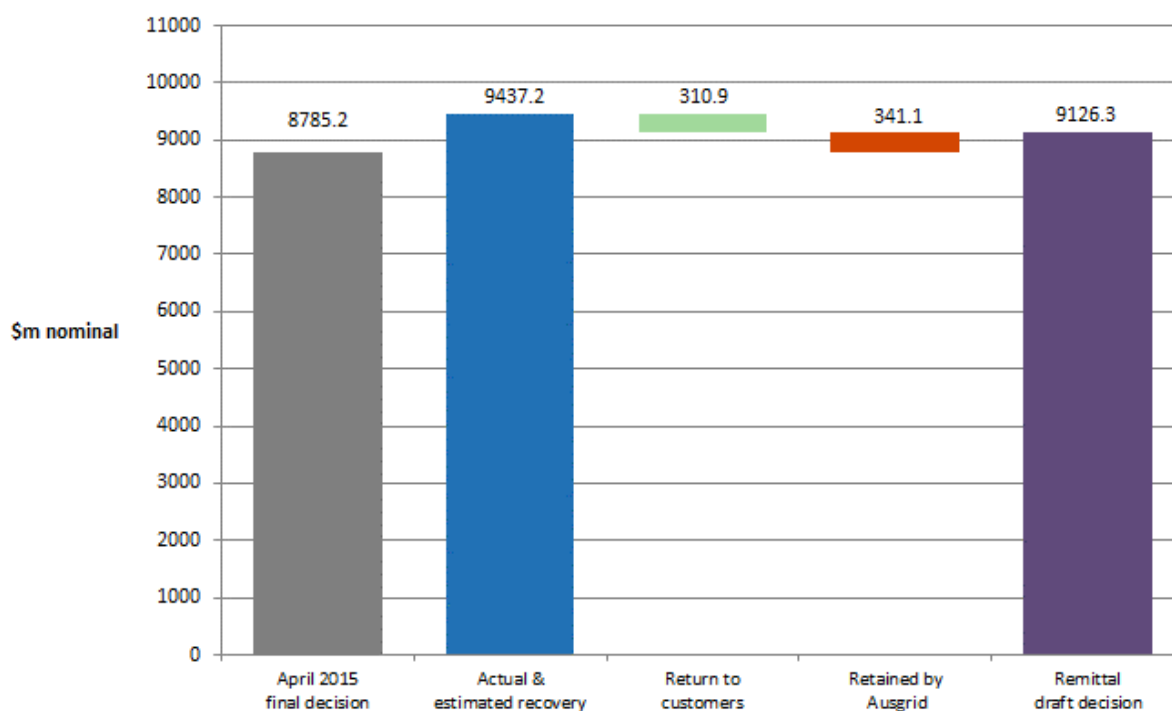
- Section 4 presents stakeholders' views on Ausgrid's Proposal
- Section 5 presents the reasons for our remade draft decision
- Appendix A presents background to our remade draft decision

2 Our remade draft decision

Our remade draft decision after remaking the constituent decisions for opex and the rate of return, as well as correcting some other minor aspects relating to our 2015 final decision in accordance with the Tribunal’s directions, is to accept Ausgrid’s Proposal, subject to certain modelling adjustments as set out below.²⁴

This means Ausgrid can recover total revenues of \$9,126.3 million (\$ nominal) from consumers over the 2014–19 regulatory control period, as illustrated at Figure 2-1.²⁵ This outcome is \$341.1 million (\$ nominal) above the revenue allowance we set for Ausgrid in our 2015 final decision. Any additional revenues in excess of this amount, currently estimated at \$310.9 million at 30 June 2019, will be returned to customers in subsequent regulatory years from 2019-20. The estimated \$310.9 million that is to be returned to Ausgrid’s customers in the next (2019-24) regulatory control period is our best estimate at this point in time, as we will not know the exact amount until after the current (2014-19) regulatory control period completes.

Figure 2-1 Comparison of AER remade draft decision to set aside 2015 final decision for 2014-19 regulatory control period (\$million, nominal)



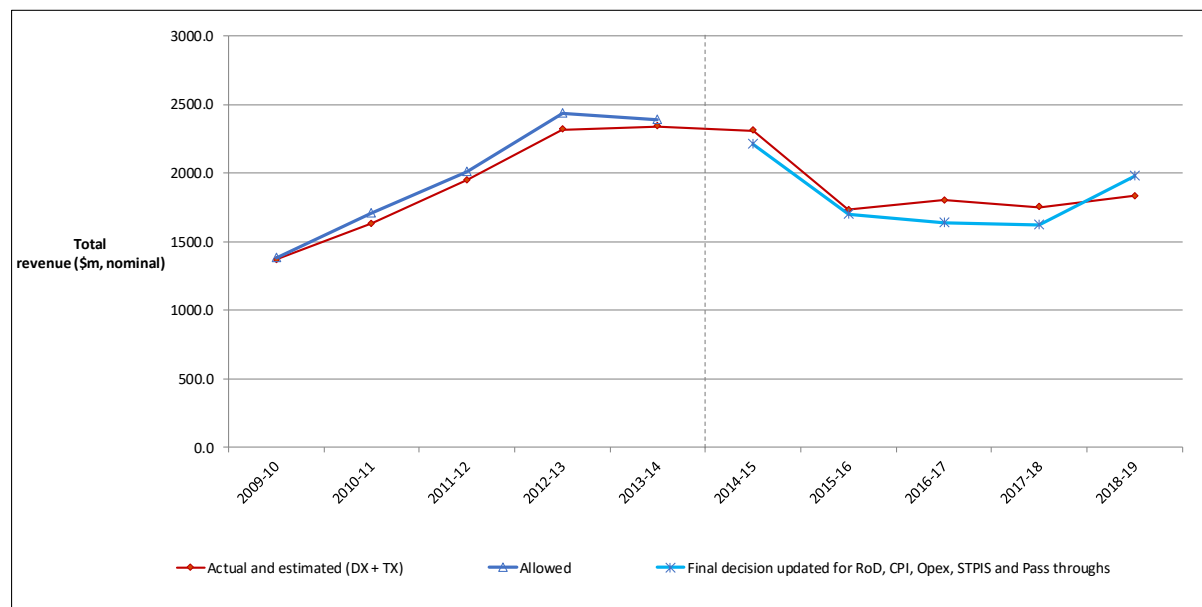
Source: AER analysis.

²⁴ Ausgrid, *Proposal for the remake of Ausgrid’s 2014-19 distribution determination*, 15 August 2018.

²⁵ Ibid. In consultation with Ausgrid, we will continue to update the revenue amount for any new information until our final decision is made (e.g. actual and estimated revenues for 2017–18 and 2018–19).

We are satisfied that this remade draft decision, taking into account the RPP, is likely to contribute to the achievement of the NEO to the greatest degree.²⁶ Figure 2-2 illustrates our overall decision.

Figure 2-2 Ausgrid’s past total revenue and AER remade draft decision total revenue allowance (\$million, nominal)



Source: AER analysis.

The network component of customers’ bills were set by our 2015 final decision and following the Tribunal’s decision, by interim pricing measures in 2016–17, 2017–18 and 2018–19.

In the 2014-15 transitional year, distribution network charges reduced, on average, by 1.7 per cent.²⁷

In 2015-16, distribution network charges fell significantly, reflecting a reduction in Ausgrid’s real revenues resulting from our 2015 final decision. At the time of our decision, this impact was estimated as a \$165 (8 per cent) reduction in the average bill for a residential customer and a \$264 (8 per cent) reduction in the bill for a small business customer.²⁸

During 2016-17 and 2017-18, distribution network charges increased by changes in the CPI, and in 2018-19 are being kept at their 2017-18 levels in nominal terms, in accordance with enforceable undertakings we accepted. The undertakings from Ausgrid addressed pricing uncertainties arising from the limited merits and judicial review processes.

As this remade draft decision will lead to an estimated \$310.9 million being returned to consumers in the 2019-24 regulatory control period, holding everything else constant, we would expect this to put downward pressure on the tariffs faced by Ausgrid’s customers.

²⁶ NEL, ss. 16(1)(d)(i) and 16(2).

²⁷ AER, *Transitional Decisions: NSW/ACT 2014-15 Factsheet*, April 2014.

²⁸ AER, *Final decision Ausgrid distribution determination - Fact Sheet*, April 2015. The analysis assumed distribution network charges made up 38 per cent of customers’ bills on average.

The modelling adjustments that we have applied to the models that support Ausgrid's Proposal are set out below. We provided and explained these modelling adjustments to Ausgrid.²⁹ In response, Ausgrid acknowledged it had no further issues with the modelling.³⁰ The net effect on Ausgrid's Proposal³¹ is a \$22.9 million reduction in the revenue that Ausgrid will retain under its Proposal – now \$9,126.3 million (\$ nominal) instead of \$9,149.2 million³² – and an increase in the amount that Ausgrid is expected to return to consumers in the next (2019-24) regulatory control period – now \$310.9 million (\$ nominal) instead of \$288 million at 30 June 2019:³³

- Correcting the inflation error by applying a corrected expected annual inflation figure of 2.42 per cent instead of 2.38 per cent (see section 5.4.2). This correction reduces the revenues Ausgrid can retain under this remittal.
- Correcting the settlement uplift of \$81 million to an end-of-period amount at 30 June 2019. This settlement amount was negotiated as an end-of-period amount, rather than a beginning-of-period amount as Ausgrid had modelled. This correction reduces the revenues Ausgrid can retain under this remittal.
- Correcting the tax treatment of the settlement uplift amount. Ausgrid's modelling approach added a tax allowance to the settlement uplift amount, which was not intended. This correction reduces the revenues Ausgrid can retain under this remittal.
- Other minor adjustments related to return on debt, the smoothing approach, and the calculation of service target performance incentive scheme (STPIS) rewards. These minor corrections have the effect of marginally increasing the revenues Ausgrid can retain under this remittal.

At the same time as releasing this remade draft decision, we have also released a separate draft adjustment determination for Ausgrid that has relevance to revenues recovered for both 2014-19 and 2019–24 regulatory control periods.³⁴ This relates to the revenues that Ausgrid earns from the provision of distribution and transmission standard control services.

Under the NER, we are required to make an adjustment determination in order to ensure Ausgrid recovers only the revenue to which it is entitled and should not receive any windfall gains or losses as a result of the appeals process.³⁵

As we discuss in section 5.4.1, we have included a distribution variation amount and a transmission variation amount in our draft adjustment determination. The estimated \$310.9 million in revenues at 30 June 2019 that Ausgrid will return to customers in the next (2019-24) regulatory control period is the residual net impact across both distribution and

²⁹ AER, *Email – RE: Ausgrid 2014-19 remittal models*, 17 October 2018.

³⁰ Ausgrid, *Email – Re: Ausgrid remittal timing*, 31 October 2018.

³¹ Ausgrid, *Proposal for the remake of Ausgrid's 2014-19 distribution determination*, 15 August 2018.

³² There were differences between Ausgrid's written Proposal and the supporting modelling it provided to the AER. We have adjusted figures (where appropriate) to be consistent with Ausgrid's written Proposal that \$288 million at 30 June 2019 is to be returned to customers in the 2019-24 regulatory control period.

³³ The estimated \$310.9 million (\$ nominal) at 30 June 2019 that is expected to be returned to customers in the 2019-24 regulatory control period is our best estimate at this point in time as we will not know the exact amount until after the 2014-19 regulatory control period.

³⁴ AER, *Draft decision, Ausgrid adjustment determination*, November 2018.

³⁵ NER, cl 8A.14.5(d).

transmission of this decision. We will incorporate the distribution and transmission variation amounts in our final decision on the 2019–24 distribution determination for Ausgrid.³⁶ As the distribution and transmission variation amounts are based on Ausgrid's estimates for the 2014-19 regulatory control period, a true-up will be required in the 2019-24 regulatory control period.

³⁶ NER, cl 8A.14.5(c)(3) and (5). We incorporated this amount in our draft decision on the 2019–24 distribution determination for Ausgrid.

3 Ausgrid's Proposal

On 15 August 2018, we received Ausgrid's Proposal for the remaking of its revenue determination for the 2014–19 regulatory control period.³⁷

It is a total revenue proposal. That is, it is not directly presented in terms of the building block components as was the case in its initial and revised regulatory proposals which preceded our April 2015 final decision (and the associated constituent decisions).

Key aspects of Ausgrid's Proposal, before our modelling adjustments as set out in section 2, are summarised below:³⁸

"...Ausgrid is proposing to retain \$519 million (\$real, FY19) and forgo \$677 million (\$real, FY19) of our estimated \$1,196 million (\$real, FY19) potential revenue recovery. This represents a \$2.85 billion (\$real, FY19) reduction on the revised proposal Ausgrid submitted on 20 January 2015.

In accordance with the undertakings agreed to and supported by key stakeholders and the AER for the FY17 to FY19 period, Ausgrid expects to collect \$807 million (\$real, FY19) above the set aside 2015 Determination. This proposal will result in \$288 million (\$real, FY19) being returned to customers via price reductions over the 5 years from FY20 to FY24.

...We are proposing to retain...\$438 million...(\$real, FY19) in relation to the opex component of the 2014-19 Remittal. This will cover 64% of the \$688 million (\$real, FY19) of costs we've incurred during the process of transforming our business...We are not proposing to recover the residual costs of about \$250 million (\$real, FY19) that we have incurred while shifting to a lower cost base.

...As part of an overall proposal to resolve the remittal Ausgrid is prepared to accept the AER's preferred cost of debt approach as outlined in its 2015 determination. This approach is consistent with the proposals that the other NSW businesses have put forward to consumers and the AER as part of their 2014-19 remittals. Ausgrid submits this in the interests of re-setting relationships with our customers and the AER.

...In addition to our proposed approach to opex and cost of debt outlined above, we are proposing to retain \$81 million (\$real, FY19) as part of an overall proposal to resolve the 2014-19 Remittal. This approach is consistent with the overall proposals that the other NSW businesses have put forward to consumers and the AER as part of their 2014-19 remittals, taking into account the respective opex and costs of debt positions of the businesses.

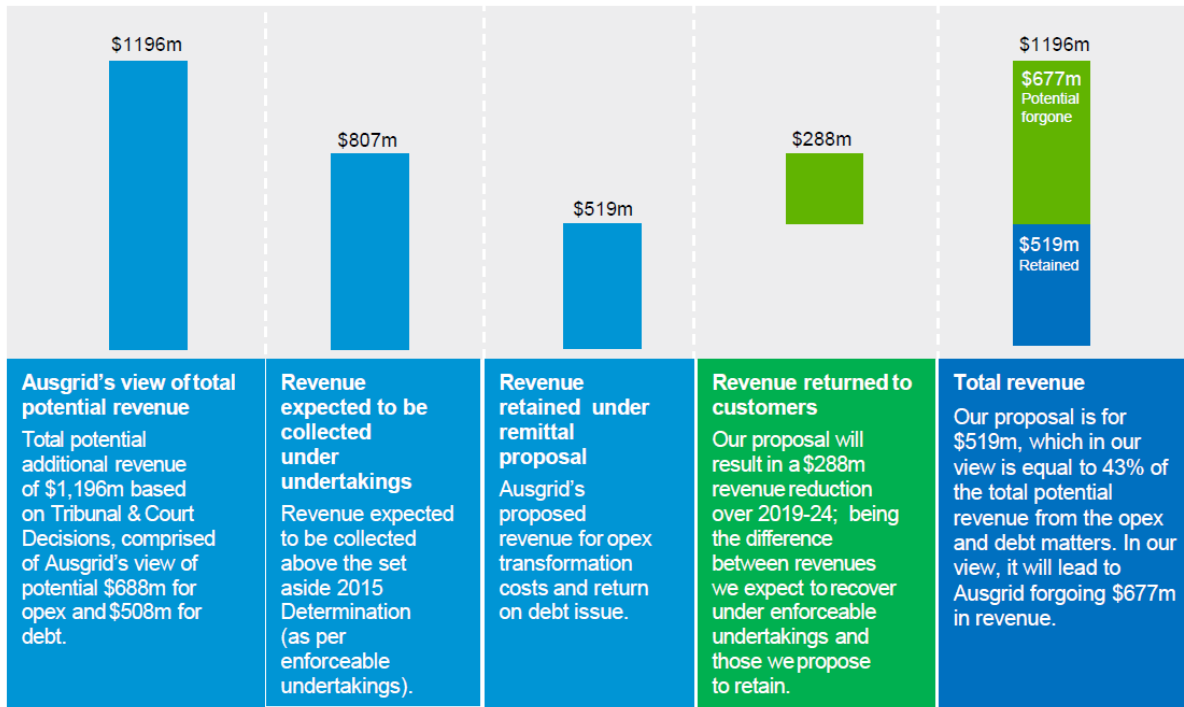
Hence we are proposing to recover a total of \$519 million (\$real, FY19) to conclude the 2014-19 Remittal process. This will result in \$288 million (\$real, FY19) being returned to customers in the form of lower bills over five years, taking effect from 1 July 2019.

...Ausgrid recognises that the 2014-19 regulatory determination has a long legal history. We consider it to be in the long term interests of customers and the business that this determination is finalised and consider it an opportunity for Ausgrid and its new management to reset the relationship with the AER, stakeholders and our customers."

³⁷ Ausgrid, *Proposal for the remake of Ausgrid's 2014-19 distribution determination*, 15 August 2018.

³⁸ Ibid. The graph, "Revenue retained and Ausgrid's view of potential revenue forgone", has been taken from Ausgrid's remittal factsheet which accompanied its remittal Proposal letter.

Revenue retained and Ausgrid's view of potential revenue forgone



Ausgrid engaged with consumer groups on a near-final version of its Proposal prior to submitting its finalised Proposal to the AER. The next section summarises stakeholders' comments on Ausgrid's Proposal.

4 Stakeholders' views on the Proposal

Following early discussions between Ausgrid and our staff on the key aspects of the decisions the Tribunal has required us to remake, Ausgrid engaged with consumer groups on a near-final version of its Proposal. Subsequently, the following consumer groups issued letters expressing their views on Ausgrid's Proposal:

- Energy Consumers Australia (ECA)
- Energy Users Association of Australia (EUAA)
- Public Interest Advocacy Centre (PIAC)
- AER Consumer Challenge Panel, Sub-panel 10 (CCP10)

The general consensus of these consumer groups is that Ausgrid's Proposal for the 2014-19 regulatory control period is in the long-term interests of its customers. The letters in their entirety are available on our website, excerpts from which are provided below.

4.1 Energy Consumers Australia

In its letter on Ausgrid's Proposal, ECA submitted:³⁹

"In forming our view of the Proposal, we have taken as our starting point the AER's 2015 determination, and then considered whether the Proposal as a whole is in the long-term interests of the consumers, such that consumers served by the Ausgrid network will not have paid more than is necessary in the period 2014-19.

We understand that the over-recovery of revenue by Ausgrid in the 2014-19 period due to the undertakings that were put in place to achieve price stability for consumers is \$807 million (in real terms), above the AER's set-aside 2015 determination. Of this amount Ausgrid proposes to:

- retain \$519 million, of which \$438 million is related to the recovery of transformation costs associated with achieving greater efficiencies in operating expenditure; and
- return \$288 million to consumers through price reductions from 1 July 2019, applying over the 2019-24 regulatory period.

On balance Energy Consumers Australia is prepared to accept Ausgrid's proposal to follow the AER's 2015 determination and return \$288 million to consumers. Consumers stand to benefit from the lower, more efficient levels of operating expenditure into the future and in lower prices from 1 July 2019.

In our view it is unfortunate that it has taken so long for this matter to be resolved with Ausgrid, particularly as it is likely to now impact on clear consideration of the 2019-24 revenue proposal currently underway."

³⁹ Energy Consumers Australia, *Proposal for the remake of Ausgrid's 2014-19 Determination*, 10 August 2018.

4.2 Energy Users Association of Australia

In its letter on Ausgrid's Proposal, EUAA submitted:⁴⁰

"We are very disappointed that the process to reach resolution has taken so long compared to the remittal process involving Essential and Endeavour. This process to get to this resolution has not served the long-term interests of consumers very well.

We would raise no objection to the AER approving the remittal details as outlined in the Proposal Letter...which, on balance, we think is in the long-term interests of consumers."

4.3 Public Interest Advocacy Centre

In its letter on Ausgrid's Proposal, PIAC submitted:⁴¹

"PIAC accepts Ausgrid's proposal to follow the AER's 2015 final determination and retain over-recovered revenue with a limit of \$519 million.

...Ausgrid has engaged with the AER, Consumer Challenge Panel and consumer advocates in making its remittal proposal. This built on Ausgrid's 2018 consumer engagement program for its 2019-24 proposal, which PIAC considers has been generally positive.

Although we do not object to the remittal proposal, we note the process has not been as timely as for either Endeavour Energy or Essential Energy. Further, PIAC has found it more difficult to accept this proposal than the other NSW distributors because Ausgrid has taken a more aggressive stance on what they should be allowed to recover.

...In PIAC's view, the approval of Ausgrid's proposal is, overall, in the long-term interests of consumers. By proposing to accept the regulator's 2015 final determination, Ausgrid will ensure their customers do not face the increase in bills associated with the full revenue allowance originally sought by Ausgrid.

...On balance, PIAC considers it reasonable for Ausgrid to recover a maximum of \$519 million over the revenue allowance set in the 2015 final determination, on the basis that:

- The AER has determined that they will allow recovery of \$438 million in the draft determination for efficient transition costs; and
- The \$81 million uplift is consistent with the Endeavour Energy and Essential Energy remittal outcomes and appears to be a lower cost than the revenue forgone for return on debt."

4.4 Consumer Challenge Panel

The AER established the CCP in July 2013 to assist us to make better regulatory determinations by providing input on issues of importance to consumers. The expert members of the CCP bring consumer perspectives to us to better balance the range of views considered as part of our decisions. In its letter on Ausgrid's Proposal, CCP10 submitted:⁴²

"Ausgrid has engaged with consumer groups about its proposal. The proposal has been disclosed by Ausgrid and discussed with consumer groups in the following meetings:

⁴⁰ Energy Users Association of Australia, *Re: Ausgrid – Determination 2014-19 – Remittal*, 14 August 2018.

⁴¹ Public Interest Advocacy Centre, *Ausgrid Remittal Proposal*, 16 August 2018.

⁴² Consumer Challenge Panel, *Ausgrid 2014–19 revenue allowance remittal proposal*, 15 August 2018.

Stakeholder Group	Dates
Bilateral discussions CCP10, ECA and PIAC	November 2017- July 2018
CCP10, ECA and PIAC	6 June 2018
CCP10, ECA, PIAC and EUAA	31 July 2018
Ausgrid's Customer Consultative Committee and CCP10	7 August 2018

CCP10 had the following involvement during this engagement process:

- we gave feedback to Ausgrid on the draft proposal generally between November 2017 and July 2018;
- we had discussions with the AER about Ausgrid's transformation costs in April-June 2018;
- we participated in preliminary feedback given to 6 June and 31 July 2018 on the draft proposal and subsequently discussed with Ausgrid how it would incorporate that further feedback into its proposal; and
- we participated in the CCC [Customer Consultative Committee] meeting on the final draft proposal on 7 August and reviewed the revised proposal and infographic prior to lodgement with the AER."

CCP10 confirms that Ausgrid made the changes requested by consumer groups in July and August and that it has taken steps to incorporate the feedback in the final proposal and the infographic.

Whilst we are relieved that when Ausgrid lodges this proposal with the AER the very difficult period of the 2014-19 determinations will be closer to being resolved, CCP10 is disappointed that it has taken 12 months to be in this position. One of the key benefits discussed at the roundtable meeting 12 months ago was to achieve an expedited process and a quicker resolution for the remittal.

...A feature of the proposal is that the revenue effects will lead to a 3.2% price reduction for consumers from 1 July 2019.

...CCP10 supports Ausgrid's proposal for resolving its regulatory allowance for 2014-19, following the remittal of that determination to the AER by the Federal Court. CCP10 believes that on balance, the Ausgrid proposal is in the long-term interests of Ausgrid's customers.

...In our view consumers will benefit:

- from the certainty provided by the resolution of the proposed price path
- from the removal of the risk for consumers from the reopening of the contentious issues from the Federal Court decision, particularly in regard to debt costs
- on an ongoing basis from the reductions in operating expenditure that Ausgrid has achieved and
- from the continuation of reduction in network prices into 2019-24 once the ENA Act [NSW Electricity Network Assets (Authorised Transactions) Act 2015] ceases to apply to Ausgrid.

The Ausgrid proposal notes that \$438 million of the \$519 million it proposes to retain were costs it incurred as part of a business wide transformation program. In order to reach our decision, we have relied on information from the AER that it believes the \$438 million transformation costs were efficiently incurred by Ausgrid and were consistent with the obligations imposed on Ausgrid by the ENA Act and its EBA [Enterprise Bargaining Agreement]. On this basis it is our opinion that the benefits outweigh the costs, in aggregate, for consumers from this proposal.

We commend Ausgrid and its new shareholders for taking this opportunity to finally resolve the 2014-19 revenue determinations...We encourage Ausgrid to continue to develop a more transparent and embedded consumer engagement program as part of its 2019-24 proposal and into the future.”

5 Reasons for our remade draft decision

Our reasons for arriving at our position in this remade draft decision are set out below. The steps we took to arrive at our position are:

- remake the constituent decisions for opex and the return on debt in accordance with the Tribunal's directions and reasons (as clarified by the Full Federal Court (Court))
- identify any other aspects of our April 2015 final decision that may be appropriate to vary, as a consequence of remaking the constituent decisions for opex and the return on debt
- consider Ausgrid's Proposal, as well as each of the consumer groups' letters on the Proposal
- of all the possible outcomes available, decide whether we are satisfied that the position we have arrived at, taking into account the RPP, is likely to contribute to the achievement of the NEO to the greatest degree⁴³

5.1 Our approach

As is the case with making any distribution determination, there may be several possible overall decisions that we could potentially make that will, or are likely to, contribute to the achievement of the NEO. In these circumstances, the NEL directs us to make the decision that we are satisfied will, or is likely to, contribute to the achievement of the NEO to the greatest degree.⁴⁴

Determining whether any particular decision will, or is likely to, contribute to achieving the NEO is a matter of regulatory judgment which involves assessing the decision as a whole, having regard to stakeholder views, taking into account the RPP and complying with the specific requirements of the NER. Implicit in this task is recognising that a distribution determination is more than just the sum of its constituent decisions or component parts as determined in accordance with Chapter 6 of the NER.

5.1.1 The novel circumstances we face

The approach we have applied in remaking this draft decision has necessarily been influenced by the novel circumstances that we face now. These are novel circumstances because they materially differ from those we faced when we made our 2015 final decision, and what we would generally face in making a distribution determination. As a result, it is likely that this remade draft decision will have limited precedent value.

Specifically, we are making this remade draft decision at a time:

- that is more than four years into the applicable five-year 2014-19 regulatory control period

⁴³ NEL, ss. 16(1)(d)(i) and 16(2).

⁴⁴ Ibid.

- when we have applied interim pricing measures for the 2016-17, 2017-18 and 2018-19 regulatory years by accepting enforceable undertakings to address pricing uncertainties arising from the limited merits and judicial review processes
- when we have had a number of Tribunal and Federal Court processes, since the Tribunal's decision on Ausgrid, that have considered and clarified the law in relation to 'efficient financing costs' and the determination of the cost of debt, as well as opex redundancy costs
- when we have information on Ausgrid's actual performance for the first three years of the five-year 2014–19 regulatory control period and updated forecasts for the remaining two years
- when our decision has the potential to create significant retail price fluctuations if it differs materially from our 2015 final decision⁴⁵
- when we have released our draft decision in response to Ausgrid's revenue proposal for the forthcoming (2019-24) regulatory control period
- when there is support from a range of consumer groups that Ausgrid's Proposal is in the long-term interests of consumers

5.1.2 Assessing the overall decision

Ultimately, assessing whether this remade draft decision achieves the NEO to the greatest degree involves us exercising our judgment to determine whether the overall decision will promote efficiencies in relation to investment, and the operation and use of Ausgrid's network that is in the long-term interests of consumers. This involves us balancing the various, and at times competing, factors referred to in the NEO. We must also take into account the RPP in determining how the NEO may be achieved to the greatest degree.⁴⁶

This is the same approach that we applied in making our 2015 final decision. As we stated in that decision:⁴⁷

"Energy Ministers have provided us with a substantial body of explanation that guides our understanding of the NEO. The long-term interests of consumers are not delivered by any one of the NEO's factors in isolation, but rather by balancing them in reaching a regulatory decision.

...The NEL and NER aim to remedy the absence of competition by providing that we, as regulator, make decisions that are in the long-term interests of consumers. In particular, we might need to require the distributors to offer their services at a different price than they would choose themselves. By its nature, this process will involve exercising regulatory judgement to balance the NEO's various factors.

⁴⁵ Recognising that this prospect is to some extent alleviated by the rule made by the AEMC on 1 August 2017 that allows us to let Ausgrid recover any additional revenues that result from our decision across both 2014–19 and 2019–24 regulatory control periods. See AEMC, AEMC, *Rule determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017, 1 August 2017*; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6*, commencing 15 August 2017.

⁴⁶ See NEL, s. 16(2). As affirmed by the Federal Court in *Australian Energy Regulator v Australian Competition Tribunal (No 2)* [2017] FCAFC 79, [36].

⁴⁷ AER, *Final decision, Ausgrid distribution determination 2015–16 to 2018–19, Overview*, April 2015, pp. 52-53.

It is important to recognise that there are a number of plausible outcomes that may contribute to the achievement of the NEO. The nature of decisions under the NER is such that there may be a range of economically efficient decisions, with different implications for the long-term interests of consumers. At the same time, however, there are a range of outcomes that are unlikely to advance the NEO to a satisfactory extent. For example, we do not consider that the NEO would be advanced if allowed revenues encourage over-investment and result in prices so high that consumers are unwilling or unable to efficiently use the network. This could have significant longer term pricing implications for those consumers who continue to use network services.

Equally, we do not consider the NEO would be advanced if allowed revenues result in prices so low that investors are unwilling to invest as required to adequately maintain the appropriate quality and level of service, and where customers are making more use of the network than is sustainable. This could create longer term problems in the network and could have adverse consequences for safety, security and reliability of the network.”

This approach was also affirmed by the Tribunal in its reasons of 26 February 2016:⁴⁸

“The ultimate objective reflected in the NEO and NGO [National Gas Objective] is to direct the manner in which the national electricity market and the national natural gas market are regulated, that is, in the long-term interests of consumers of electricity and natural gas respectively with respect to the matters specified. The provisions proceed on the legislative premise that their long-term interests are served through the promotion of efficient investment in, and efficient operation and use of, electricity and natural gas services. This promotion is to be done ‘for’ the long-term interests of consumers. It does not involve a balance as between efficient investment, operation and use on the one hand and the long-term interest of consumers on the other. Rather, the necessary legislative premise is that the long-term interests of consumers will be served by regulation that advances economic efficiency.”

In considering whether this remade draft decision is likely to contribute to the achievement of the NEO to the greatest degree, in respect of our assessment of Ausgrid’s Proposal, we note that there are potentially a range of possible outcomes that may meet the Tribunal’s directions.

5.2 Assessment of Ausgrid’s Proposal

As set out in section 3, Ausgrid’s Proposal for a revenue forecast for the 2014-19 regulatory control period is summarised as follows:^{49, 50}

“... Ausgrid is proposing to retain \$519 million (\$real FY19) and forego \$677 million (\$real FY19) of our estimated \$1,196 million (\$real FY19) potential revenue recover. This represents a \$2.85 billion (\$real FY2019) reduction on the revised proposal Ausgrid submitted on 20 January 2015.”

In light of the novel circumstances we are faced with, and the information before us, we are satisfied that accepting Ausgrid’s Proposal, subject to certain modelling adjustments as set out in section 2, will result in an outcome that is likely to contribute to the achievement of the NEO to the greatest degree.

⁴⁸ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT1, [77].

⁴⁹ Ausgrid, *Proposal for the remake of the Ausgrid’s 2014-19 distribution determination*, 15 August 2018.

⁵⁰ Excluding the modelling adjustments we set out in section 2 and have incorporated in our remade draft decision.

Key reasons for our decision to accept Ausgrid's Proposal, subject to certain modelling adjustments as set out in section 2, are outlined below.

First, remaking the opex and cost of debt constituent decisions reveals a result that is consistent with revenues that we arrived at in our 2015 final decision with allowance for some additional efficient costs Ausgrid has incurred above this level. This is discussed in sections 5.3.1 and 5.3.2, respectively. This result aligns with Ausgrid's Proposal that is, in part, premised on the revenue forecast set in our 2015 final decision. In summary:

- Ausgrid is undertaking reforms so that by 2018-19 it will continue to provide safe and reliable electricity services to its consumers while incurring a level of opex that is in line with the opex forecasts set out in our 2015 final decision. In light of the Tribunal's direction and information now available to us, a proportion of the opex incurred over the 2014-19 period that is above this 2018-19 level (i.e. transformation costs) is determined to be efficient and has been included in our opex forecast.⁵¹
- Recent Tribunal and Court processes have clarified the law in relation to 'efficient financing costs' and the determination of the cost of debt. A revenue neutral transition from the on-the-day approach to a trailing average approach is appropriate and consistent with the achievement of the allowed rate of return objective (ARORO) and will contribute to achieving the NEO.

Second, the novel circumstances we find ourselves in heightens the importance of us remaking our decision in a timely manner. Timely decision-making is a tenet of best regulatory practice and, in our view, is a principle that is in the long-term interests of consumers.⁵² Resolving the uncertainty created by the limited merits and judicial review processes in a timely manner, by expediting this remittal process where possible compared to an extended timeframe of potentially up to 18 months for a regular determination process, is supported by several consumer groups and Ausgrid (particularly in light of its 2019-24 regulatory proposal which is currently under review).⁵³ We note that some consumer groups were disappointed that Ausgrid's Proposal was not as timely as that for other NSW distribution businesses (see section 4).

If this remade draft decision becomes our final decision, it will resolve this uncertainty and addresses the crucial issue of price stability, which informs consumers of their budgetary and investment decisions on the use of electricity services. Price stability, or minimising price volatility, is also in the long-term interests of consumers and is one of the primary reasons we accepted the enforceable undertakings that Ausgrid gave to us to govern prices for the 2016–17, 2017–18 and 2018–19 regulatory years.⁵⁴ It is also one of the primary reasons that, on 1 August 2017, the AEMC made a rule to avoid significant retail price

⁵¹ Ausgrid's 'transformation costs' include redundancy, stranded labour and career transition program costs incurred as part of the transformation program implemented to reduce its opex to a level consistent with our 2015 final decision.

⁵² Regulatory best practice is also the way in which we have committed to act in undertaking our functions and powers: AER, *Statement of Intent 2017-18*, p. 5.

⁵³ For example, several participants expressed support to expedite this remittal process at the NSW and ACT remittal roundtable we held on 16 August 2017: AER, *NSW and ACT remittal roundtable summary note*, p. 4. Also, section 4 of this decision summarises the views of consumer groups on Ausgrid's Proposal and they have expressed similar views.

⁵⁴ See AER, *Open letter to stakeholders: Electricity network charges in the ACT and NSW from 1 July 2017*, 19 April 2017; and *Open letter to stakeholders: Electricity network charges in the ACT and NSW from 1 July 2018*, 21 March 2018.

fluctuations following the remaking of our decision by enabling us to allow Ausgrid to recover any additional revenues that result from remaking our decision, across both the 2014–19 and 2019–24 regulatory control periods.⁵⁵

To that end, we agree with the following statement of the AEMC in its rule determination:⁵⁶

“A significant revenue adjustment could result from the remaking of the proponents’ distribution determinations for the current regulatory control period. This may lead to consumers experiencing a large network price increase or decrease between 2018–19 and 2019–20. This price volatility may lead some consumers to make inefficient budgetary decisions on energy spending, or inefficient investment decisions on the use of electricity services. The Commission has considered whether minimising price volatility would be in the long-term interests of consumers in this case.”

Third, we consider that, given the novel circumstances for this decision, a revenue settlement allowance of \$81 million (\$ nominal) as at 30 June 2019 above our remade opex and cost of debt constituent decisions, which we also note is supported by consumer groups as summarised below, is likely to contribute to the achievement of the NEO to the greatest degree. In support of this, Ausgrid notes that:⁵⁷

“This proposal will lead to a 3.2 per cent reduction, in real terms (i.e. excluding the impacts of inflation), in our [network costs’] share of electricity bills from 1 July 2019...In addition to the price reduction, this proposal delivers further benefits to customers including:

- locking in \$100 million (realFY19) p.a. savings achieved over the last five years as a result of our transformation program, involving headcount reductions of almost 3,000 people, which translates to a \$76 p.a. reduction on a per customer basis
- Ausgrid and its shareholders absorbing \$250 million (real\$ FY19) of the transformation costs incurred while shifting to a lower cost base
- maintaining Ausgrid’s commitment to the incentive framework needed to invest in cost reduction programs in the future, allowing further cost reductions to be passed onto customers in future regulatory periods
- Ausgrid accepting the AER’s proposed approach to the return on debt from the 2015 determination
- bringing to an end a long running matter giving customers ongoing price certainty.”

In coming to this revenue allowance, we have considered the following factors:

- It represents an outcome that quantifies and appropriately balances the risk and uncertainty of a protracted decision process faced by affected stakeholders, including consumers. This is in the context where stakeholders have stated a clear preference for

⁵⁵ AEMC, *Rule Determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017*, 1 August 2017; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6*, commencing 15 August 2017.

⁵⁶ AEMC, *Rule Determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017*, 1 August 2017, pp. 11 and 12; see also p. 16.

⁵⁷ Ausgrid, *Proposal for the remake of the Ausgrid’s 2014-19 distribution determination*, 15 August 2018, pp 1-2.

us to remake the decision in a timely manner and to resolve uncertainty in light of the novel circumstances described above.

- It provides greater certainty and price stability for customers for the remainder of this and over the next regulatory period.

We have given weight to the expressions of support from the ECA, EUAA, PIAC and CCP10 in respect of Ausgrid's Proposal, as set out in section 4. Notably, given the circumstances, each of these stakeholders considers that this revenue allowance results in an outcome that is in the long-term interests of Ausgrid's customers.⁵⁸ For example, CCP10 stated:⁵⁹

"CCP10 believes that on balance, the Ausgrid proposal is in the long-term interests of Ausgrid's customers. We understand that this involves Ausgrid retaining up to \$519m in revenue, some of which would otherwise be returned to consumers, but this needs to be considered in the context of the overall proposal and the specific circumstances of the NSW Electricity Network Assets (Authorised Transactions) Act 2015 (ENA Act) and Ausgrid's Enterprise Bargaining Agreement (EBA)."

The implications for our control mechanism constituent decisions for the 2014-19 and 2019-24 regulatory control periods are discussed in section 5.4.1.

Overall, we consider that Ausgrid's revenue Proposal represents an efficient level of expenditure necessary for it to provide safe and reliable electricity services to its consumers. As we discussed in section 5.1.2, the approach we have applied in this remade draft decision involves us exercising our judgment to determine whether the overall decision will promote efficiencies in relation to investment, and the operation and use of Ausgrid's network that is in the long-term interests of consumers. In other words, the long-term interests of consumers are served by us identifying how the level of electricity supply services delivered by Ausgrid so far during the 2014-19 regulatory control period may be done at least cost to the consumer.

As the Tribunal has previously stated:⁶⁰

"The national electricity objective provides the overarching economic objective for regulation under the Law: the promotion of efficient investment in the long-term interests of consumers. Consumers will benefit in the long run if resources are used efficiently, i.e. resources are allocated to the delivery of goods and services in accordance with consumer preferences at least cost. As reflected in the revenue and pricing principles, this in turn requires prices to reflect the long run cost of supply and to support efficient investment, providing investors with a return which covers the opportunity cost of capital required to deliver the services."

Ausgrid's Proposal as accepted in this draft decision, subject to certain modelling adjustments, is:

- \$2,929.1 million (\$ nominal) less than its January 2015 revised regulatory proposal

⁵⁸ Energy Consumers Australia, *Proposal for the remake of Ausgrid's 2014-19 Determination*, 10 August 2018; Energy Users Association of Australia, *Re: Ausgrid - Determination 2014-19 – Remittal*, 14 August 2018; Public Interest Advocacy Centre, *Ausgrid Remittal Proposal*, 16 August 2018; Consumer Challenge Panel, *Ausgrid 2014-19 revenue allowance remittal proposal*, 15 August 2018.

⁵⁹ Consumer Challenge Panel, *Ausgrid 2014-19 revenue allowance remittal proposal*, 15 August 2018, p.2.

⁶⁰ *Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3, [15].

- represents a reduction in its opex of around \$342.3 million (\$2013–14), or approximately 13 per cent, relative to its January 2015 revised regulatory proposal

We also note that Ausgrid has made the commitment that its recurrent opex for 2017-18 (i.e. its actual opex less non-recurrent transformation costs) will be consistent with our 2015 final decision, and this level of opex will form the base year for its opex forecast for the 2019-24 regulatory control period.⁶¹

5.3 Remaking the operating expenditure and return on debt constituent decisions

The Tribunal’s directions that we are to comply with in remaking our decision for Ausgrid are as follows:⁶²

- “(a) the AER is to make the constituent decision on opex under r 6.12.1(4) of the National Electricity Rules in accordance with these reasons for decision including assessing whether the forecast opex proposed by the applicant reasonably reflects each of the operating expenditure criteria in r 6.5.6(c) of the National Electricity Rules including using a broader range of modelling, and benchmarking against Australian businesses, and including a ‘bottom up’ review of Ausgrid’s forecast operating expenditure;
- (b) the AER is to make the constituent decision on return on debt in relation to the introduction of the trailing average approach in accordance with these reasons for decision;
- ...
- (d) the AER is to consider, and to the extent to which it considers appropriate to vary the Final Decision in such other respects as the AER considers appropriate having regard to s 16(1)(d) of the National Electricity Law in the light of such variations as are made to the Final Decision by reason of (a)-(c) hereof.”

The rules in the NER and provisions in the NEL that govern our assessment of opex and debt remain unchanged on remittal.

In the following sections, we set out our remade constituent decisions for opex and the cost of debt, as well as the implications for our control mechanism constituent decisions for the 2014-19 and 2019-24 regulatory control periods.⁶³

⁶¹ Ausgrid, *Ausgrid’s Regulatory Proposal 1 July 2019 to 30 June 2024*, April 2018, pp.131–132.

⁶² Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT1. Note direction (c) is omitted following the Court’s decision in relation to gamma: *Australian Energy Regulator v Australian Competition Tribunal (No 3)* [2017] FCAFC 80, [738]-[784].

⁶³ At the same time as releasing this remade draft decision, we have released a separate draft adjustment determination for Ausgrid that has relevance to both 2014-19 and 2019-24 regulatory control periods. See AER, *Draft decision, Ausgrid adjustment determination*, November 2018.

5.3.1 Operating expenditure constituent decision

Operating expenditure (opex) refers to operating, maintenance and other non-capital expenses. Forecast opex for prescribed distribution services is one of the building blocks that typically make up a service provider’s total revenue requirement.

In our April 2015 final decision, we estimated total forecast opex for Ausgrid for the 2014-19 regulatory period of \$1,992.9 million (\$2013–14).⁶⁴ This was \$686.4 million (or 26 per cent) lower than Ausgrid's January 2015 revised proposal of \$2,679.3 million (\$2013–14).

For the remaking of our 2015 decision, Ausgrid is proposing \$2,337.1 million (\$2013-14) in total opex. This consists of \$1,992.9 million (\$2013–14) in ‘underlying’ or recurrent opex that it states will allow it to continue to operate a safe and reliable network.⁶⁵ This level of opex is consistent with our 2015 final decision. Ausgrid’s proposal also includes \$344.1 million (\$2013–14) in non-recurrent ‘transformation’ costs, including redundancy, stranded labour and career transition program costs it has incurred to improve the efficiency of its business.⁶⁶ Ausgrid states that these non-recurrent costs should be included in our remade opex forecast as they were necessary to comply with the ‘legal obligations’ the business has faced under its workplace agreements and the Electricity Network Assets (Authorised Transactions) Act 2015 (NSW) (ENAAT Act).⁶⁷

For the reasons set out in sections 5.3.1.1 and 5.3.1.2 below, we are satisfied that Ausgrid’s proposed opex forecast is consistent with the opex criteria. Table 5-1 sets out this opex forecast.

Table 5-1 AER 2014-19 remade draft decision opex forecast (\$million, 2013–14)

	2014–15	2015–16	2016–17	2017–18	2018–19	Total
Total opex forecast	507.5	491.9	505.8	428.2	403.6	2337.1

Our approach to remaking this decision

In making our 2015 final decision, we found that the actual opex incurred by Ausgrid in its proposed base year of 2012–13 was materially greater than what a prudent and efficient network service provider would incur in delivering safe and reliable network services to customers.⁶⁸ As a result, Ausgrid’s actual opex for this year could not be used as a basis to forecast opex for the 2014-19 regulatory control period.

⁶⁴ AER *Final Decision Ausgrid distribution determination 2015–16 to 2018–19, Attachment 7 – Operating expenditure*, April 2015, pp. 7-8.

⁶⁵ Ausgrid, *Ausgrid’s Regulatory Proposal 1 July 2019 to 30 June 2024, April 2018*, pp. 118 and 131.

⁶⁶ Ausgrid, *Proposal for the remake of Ausgrid’s 2014-19 distribution determination*, 15 August 2018. Ausgrid has not included transformation costs incurred in 2018–19 in its remittal proposal.

⁶⁷ *Ibid.* The ENAAT Act commenced on 4 June 2015: ENAAT Act, s. 2. Schedule 4 of the ENAAT Act, amongst other things, prohibits forced redundancies and changes to the terms of the operator’s EAs between 1 July 2015 and 31 July 2020.

⁶⁸ *Ibid.* pp. 7-9.

Consistent with the NER, we estimated a base year of opex for Ausgrid and an alternative opex forecast.⁶⁹ We relied on one of our economic benchmarking models (the Cobb Douglas Stochastic Frontier Analysis (SFA) Model) to estimate our substitute base opex amount. We also noted that, based on the information available to us at the time, any costs incurred by Ausgrid in transitioning from its higher level of opex to a lower level consistent with our 2015 final decision could not be included as part of an opex forecast that reasonably reflected the opex criteria.⁷⁰

The Tribunal found that our decision to reject Ausgrid's opex forecast was not in error.⁷¹ However, the Tribunal determined that we erred in the emphasis we placed on the Cobb Douglas SFA benchmarking model in arriving at our substitute estimate. This decision was subsequently upheld by the Federal Court.

As the Tribunal refers to in its directions, we must remake our opex decision under clause 6.12.1(4) of the NER. This means we must either accept a distributor's proposed opex forecast, or reject it and determine our own substitute estimate.

Clause 6.5.6 of the NER sets out the opex objectives, opex criteria and opex factors that we must consider when making our constituent decision on opex. In summary, we must identify a level of forecast opex that is efficient and prudent and at a level that meets or manages expected demand and sustainably maintains the quality, reliability and security of supply and the safety, reliability and security of the network.

Our approach for remaking this decision has been informed by the Tribunal's directions to us, and the new and updated information available to us since our 2015 final decision (in particular, Ausgrid's actual and estimated opex for the current regulatory period). We have also been informed by our extensive consultation with Ausgrid and consumer representatives, which has included:

- a stakeholder roundtable in August 2017
- the publication of an Issues Paper in October 2017
- submissions to the Issue Paper received in October and November 2017
- letters from consumer representatives (including ECA, EUAA, PIAC and CCP10) in support of Ausgrid's Proposal in August 2018.

In this context, and considering all the information available to us, our remade opex forecast consists of two components:

- an estimate of a prudent and efficient level of recurrent (or underlying) opex⁷² that Ausgrid would need for the safe and reliable provision of electricity services — see section 5.3.1.1

⁶⁹ NER, cll. 6.5.6(d) and 6.12.1(4)(ii).

⁷⁰ AER, *Final Decision, Ausgrid distribution determination 2015–16 to 2018–19, Attachment 7 – Operating expenditure*, April 2015, pp. 7-40–7-46.

⁷¹ Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT1.

⁷² Underlying opex excludes non-recurrent costs including transformation costs.

- an estimate of any non-recurrent costs (including transition costs) above this level of underlying opex that can be considered efficient and prudent costs consistent with the opex criteria — see section 5.3.1.2⁷³

5.3.1.1 Our assessment of efficient recurrent opex for 2014-19

This section provides our view on the prudent and efficient level of recurrent opex that Ausgrid would need for the safe and reliable provision of electricity services over the 2014-19 period.

In reaching our view, we have primarily relied on Ausgrid's actual costs over the first three years of the 2014-19 regulatory control period and its opex estimates for the last two years. This information was not available to us at the time of our April 2015 decision or the Tribunal and Federal Court decisions. Specifically, we examined changes in Ausgrid's actual and forecast opex between 2012–13 and 2018–19, and considered the extent to which its opex efficiency has increased or decreased relative to its 2012–13 level.⁷⁴

The revealed data shows that after 2012–13, Ausgrid's opex increased and peaked in 2014-15 (the first year of the current period). It then declined in each subsequent year, such that by 2018-19 (the last year of the current period), Ausgrid's opex is forecast to be significantly below its 2012-13 opex and at a level consistent with our 2015 final decision (see Figure 5-1).

Ausgrid states that it will be able to sustain this 2018–19 level of opex over the 2019–24 regulatory control period. To this end, it had proposed its 2017–18 opex excluding transition costs (a level of opex that is consistent with its 2018–19 target opex) as the base year for its 2019-24 revenue forecast.⁷⁵

Ausgrid appears to have responded to the strong incentives imposed by our regulatory regime, including the use of economic benchmarking, to reduce its opex over the current regulatory period.

Having regard to the Tribunal's directions, we have cross-checked the above finding using two supplementary tools to test the efficiency of Ausgrid's 2018–19 opex target. These are:

- Benchmark modelling of Ausgrid's opex forecasts for 2017–18 and 2018–19 with, and without, transition costs. This shows that Ausgrid's 2018–19 opex target represents a significant improvement in opex productivity relative to its 2012–13 level, and relative to that of the other electricity networks' productivity levels as measured in 2016.
- Category level cost analysis that examines the underlying drivers of Ausgrid's opex since 2012–13. The analysis shows that around two-thirds of the opex incurred in the current period above Ausgrid's 2018–19 opex target is attributable to transition costs. The remainder is due to higher levels of maintenance, emergency management and

⁷³ In line with our 2015 final decision and the Tribunal and Federal Court decisions, we will use the term 'transition costs' to describe restructuring costs incurred in transitioning from a higher level of opex to a lower level of opex.

⁷⁴ In April 2015, we found that Ausgrid's 2012–13 opex (proposed as its base year for the 2014–19 period) was materially inefficient and this decision was upheld by the Tribunal in its 2016 decision.

⁷⁵ Ausgrid, *Ausgrid's Regulatory Proposal 1 July 2019 to 30 June 2024*, p.130.

overhead costs in 2014–15 and 2015–16. The decrease in Ausgrid’s 2018-19 opex target level is being achieved through significant and sustained cost reductions in maintenance, emergency management and overheads opex, and subsequent decreases in transition costs.

Taken together, the results of the revealed cost, benchmarking and category analysis indicate that Ausgrid’s 2018–19 opex target reasonably reflects an efficient and sustainable level of opex consistent with the opex criteria.

We outline in more detail below our consideration of Ausgrid’s proposed opex using the revealed costs information, benchmarking results and category level cost analysis.

Revealed and forecast costs

This section examines Ausgrid’s revealed costs between 2012–13 (its proposed base year for its 2014–19 revenue proposal) and 2018–19 (the end of the regulatory period).

As outlined in our Expenditure Assessment Forecast Guideline, our preferred approach for forecasting opex is to use the revealed cost approach.⁷⁶ This is because opex is largely recurrent and stable at a total level between regulatory periods. Underpinning this revealed cost approach is the incentive-based regulatory regime established in Chapter 6 of the NER. Incentive regulation is designed to encourage network businesses to improve their efficiency over time. Where a distributor is responsive to the financial incentives under the regulatory framework, the actual level of opex it incurs should provide a good estimate of the efficient costs required for it to operate a safe and reliable network and meet its relevant regulatory obligations. So long as we do not identify any material inefficiency in a distributor’s revealed costs or a change in the costs associated with the business’ operating environment,⁷⁷ our preference is to rely on revealed costs in assessing the distributor’s proposed opex forecast, and if necessary, in determining a substitute estimate.⁷⁸

At our stakeholder roundtable meeting in August 2017, the distribution businesses stated they had faced a strong incentive to reduce costs over the current 2014-19 regulatory control period given that our opex forecasts were significantly below the businesses’ actual costs at the start of the period.⁷⁹ In its Proposal, Ausgrid recognised that this uncertainty incentivised it to achieve the ‘quickest’ transition to a level of opex it believed would be consistent with our final opex forecast.⁸⁰ In this context, Ausgrid has also stated:⁸¹

“[it] had no certainty that it would be able to recover the transformation costs incurred. This uncertainty provided strong incentives to deliver the transformation at the lowest possible cost.”

Figure 5-1 shows Ausgrid’s actual opex up to 2016–17 and its opex forecasts for 2017–18 and 2018–19. The transition cost component of total opex is shown in light blue.

⁷⁶ AER, *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p.31.

⁷⁷ Step changes provide for increases where this is not the case.

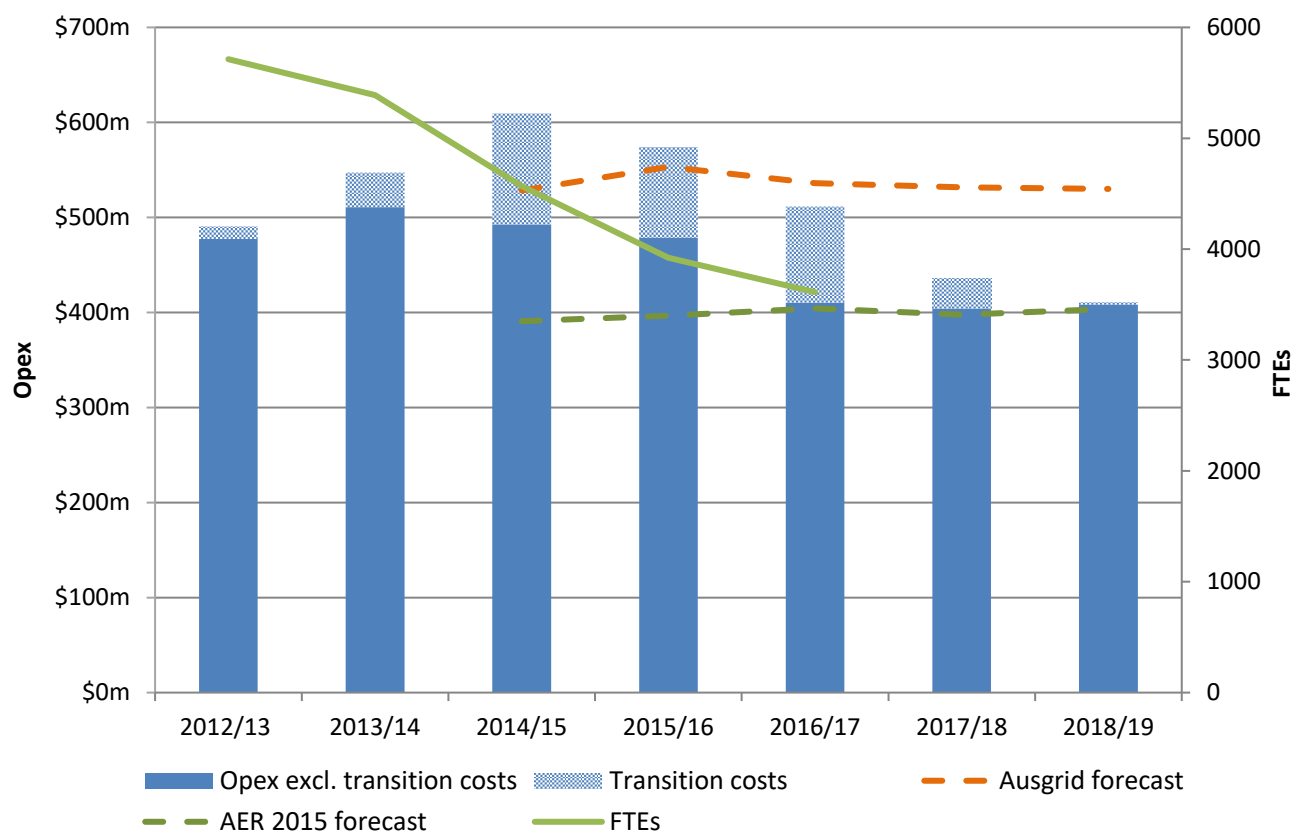
⁷⁸ AER, *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013, p.22.

⁷⁹ AER, *NSW and ACT remittal roundtable (16 August 2017) summary note*, August 2017

⁸⁰ Ausgrid email, 24 May 2018.

⁸¹ Ibid.

Figure 5-1 Ausgrid's actual and forecast opex, Ausgrid and AER opex forecasts, and movement in Ausgrid's full time equivalent (FTE) employees (\$2013-14)



Source: AER 2015 final decision; Annual and Reset RINs; Ausgrid response to AER information request; Annual reports.
 Note: Actual opex has been normalised by excluding metering and ancillary costs prior to 2014–15. Opex for 2017-18 and 2018-19 is based on Ausgrid targets. Transition costs are a sub category of total opex.

Figure 5-1 shows Ausgrid's total opex increasing after 2012–13 (the base year of Ausgrid's original 2014–19 revenue proposal), peaking in 2014–15, then declining in each subsequent year of the 2014–19 regulatory control period. By 2018–19 (the last year of the current period), Ausgrid's opex forecast is significantly below its 2012–13 opex and at a level consistent with our 2015 final decision.

Over the first three years of the current period (2014–15, 2015–16 and 2016–17), Ausgrid's opex was above its 2012–13 level and our 2015 final decision opex forecast. This was primarily due to transition costs incurred by Ausgrid as it restructured and downsized its workforce. Over this same period, Ausgrid was able to reduce its total opex by approximately 20 per cent. In its regulatory proposal for the forthcoming (2019–24) regulatory control period, Ausgrid states that it has achieved its opex savings through a two-stage transformation program which, which amongst other things, has included:⁸²

- improved safety performance and practice

⁸² Ausgrid, *Ausgrid's Regulatory Proposal 1 July 2019 to 30 June 2024*, April 2018, p.123.

- re-aligning structure and capability to meet future growth and goals
- rebalancing the size of office to field resources
- greater efficiencies and improved prioritisation in the field
- rolling out new, safer ways of working
- improving efficiency in field, reinvest in capital program delivery
- delivering better and more consistent customer service
- improving corporate process and cost efficiency
- investing in new technology.

In its Proposal, Ausgrid notes that its transformation program has allowed it to reduce its underlying costs in the current period without compromising safety or reliability:⁸³

“Over the 2014-19 regulatory period ... Ausgrid embarked on a transformation program that is on track to deliver substantial, recurrent savings for our customers....

The transformation program we have undertaken has been multifaceted, spanning cultural change, process improvements and a re-alignment of our structure and capabilities required to deliver lower prices for customers without impacting the reliability of our service.

Part of this program has also included improving the productivity of our workforce, whilst ensuring there is no compromise in safety or reliability, and actively supporting staff impacted by this change. Since the peak in 2010/11, we have reduced our full-time equivalent employees by almost 3000 people.”

The impact of the transformation program is evident in Figure 5-1, which shows the size of transition costs incurred and the magnitude of the reduction in Ausgrid’s underlying cost base. Ausgrid estimates total transition costs over the 2014-19 period at \$346.6 million (\$2013–14) or about 64 per cent of the \$545.2 million (\$2013–14) in opex it has incurred above our 2015 final decision.

This suggests that, while Ausgrid is incurring significant costs over the current period above our 2015 final decision opex forecast (particularly transition costs), it is responding to the incentives imposed by the regulatory regime and the use of economic benchmarking by reducing operational costs. These results lend support to our 2015 final decision opex forecast, which forms the basis of Ausgrid’s Proposal, as being an efficient level of opex that reasonably reflects the opex criteria.

⁸³ Ausgrid, *Proposal for the remake of Ausgrid’s 2014-19 distribution determination*, 15 August 2018, p. 2.

This is further supported by statements from Ausgrid’s revenue proposal for the forthcoming (2019-24) regulatory control period, where it states that it will be able to sustain the cost savings achieved in its underlying opex in the current period over the next five-year regulatory period.⁸⁴

“For our proposed base year opex [in Ausgrid’s 2019-24 revenue proposal], we used our estimated underlying opex for 2017/18 [excluding all non-recurrent costs including transformation costs]...

Our base year opex is in line with the AER’s opex forecast for 2017/18 and is consistent with the AER’s view of efficient costs, as outlined in the AER’s 2015 Determination. We consider this is representative of our efficient recurrent opex requirements for 2019–24.

Our proposed base year reflects the outcome of our transformation program, which has allowed us to significantly reduce our opex.”

Ausgrid also notes that the cost savings achieved in this period should have ongoing benefits for electricity consumers in the next period.⁸⁵

“As a result of this transformation program, our annual opex cost base is today 19% lower than it was five years ago. This is equal to a saving of around \$100 million per year in real terms and, by 2017/18, translates to a \$76 p.a. reduction on a per customer basis.”

In summary, Ausgrid states that the implementation of its transformation program is allowing it to achieve efficiencies, which by 2018–19 will enable it to operate a safe and reliable network at a recurrent level of opex that is consistent with our 2015 final decision, and is sustainable over the 2019–24 regulatory period. In the following sections, we test this finding with additional benchmarking and bottom-up costs category analysis.

Benchmarking analysis

The Tribunal directed us to use a broader range of modelling and benchmarking against Australian businesses in remaking our opex constituent decision.⁸⁶ This was in the context of the approach taken in our 2015 final decision, which relied on a specific benchmarking technique (the Cobb Douglas SFA econometric model) as a tool for determining the level of efficient base opex for our forecast.

We acknowledge the Tribunal’s directions, however, under these novel circumstances it is not practical to revise our economic benchmarking analysis in time to support the remaking of our opex decision. The benchmarking techniques and data we utilised in our 2015 final decision were developed following an extensive public consultation process as part of our Better Regulation program during 2013. Any substantive revisions would therefore involve a considerable amount of re-development work and time to consult with industry, consumer groups and other interested stakeholders, further delaying resolution of all outstanding remittal-related matters for Ausgrid.

⁸⁴ Ausgrid, *Ausgrid’s Regulatory Proposal 1 July 2019 to 30 June 2024*, April 2018, p. 131.

⁸⁵ Ausgrid, *Proposal for the remake of Ausgrid’s 2014-19 distribution determination*, April 15 2018, p. 2.

⁸⁶ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT1, direction 1(a).

At our stakeholder roundtable meeting in August 2017, a number of stakeholders agreed there is a significant role for benchmarking in network regulation and supported its further development. At the meeting, stakeholders also expressed a clear preference for us to remake our decisions in a timely manner and recognised that revisiting our benchmarking would not be possible without further delaying the remaking of our opex decisions.⁸⁷

We now also have available to us a range of revealed and forecast cost data – Ausgrid’s actual opex for the first three years of the current period and its opex targets for the last two years – which we have primarily relied on in remaking our opex decision. This data was not available to us at the time of our 2015 final decision, nor the Tribunal and Federal Court decisions.

To address the Tribunal’s direction in the context of the remittal, we have used benchmarking analysis, beyond the Cobb Douglas SFA model, updated with new data, and applied it to test the efficiency of Ausgrid’s 2018–19 opex forecast. We have relied upon our most recent benchmarking report and additional benchmarking analysis from Economic Insights that we commissioned for this decision. More detail about our economic benchmarking techniques are set out in our annual benchmarking reports.⁸⁸

Figure 5-2 compares Ausgrid’s opex multi-lateral partial factor productivity (MPFP) (the red line) to that of other networks over time. The chart uses Ausgrid’s actual opex up to 2016-17 and its opex forecasts for 2017–18 and 2018–19, and MPFP results for all other networks up until 2016 (from our most recent published benchmarking report).

Figure 5-2 shows that Ausgrid’s opex productivity (including transition costs) was lowest in 2014-15, the first year of the current regulatory period, then improves in each subsequent year up to 2018–19.

Its opex productivity over 2015–16 and 2016–17, while improving, remained at or below the level it achieved in 2012–13. This ranked the business as one of the least productive networks in the National Electricity Market – in 13th place in 2015-16 and 12th place in 2016-17. Over 2017–18 and 2018–19, the last two years of the current period, opex productivity is forecast to increase significantly – by 19 per cent and 6 per cent, respectively. This represents a significant improvement relative to its own 2012–13 level. It would also be an improvement relative to other network businesses’ as measured in 2016 – lifting Ausgrid’s ranking from 12th place in 2016–17 to 9th place in 2018–19.

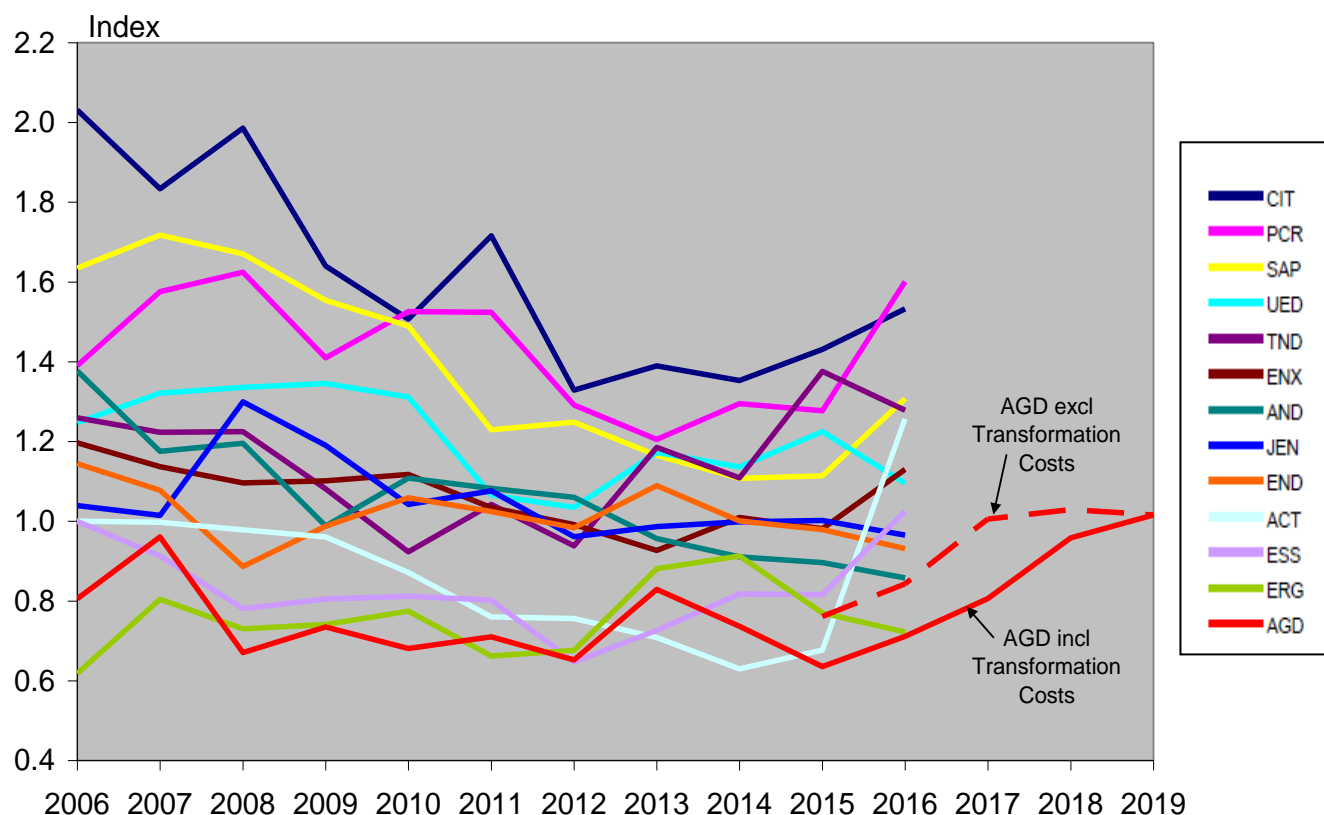
To understand the impact of transition costs on Ausgrid’s opex efficiency over time, we have also estimated Ausgrid’s opex MPFP without transition costs (the broken red line in Figure 5-2). The results shows that transition costs have reduced Ausgrid’s opex productivity over the current period, particularly in the first four years as transition costs increased total opex.

These benchmarking results support the view that Ausgrid’s opex productivity is improving over the current period and its 2018–19 opex forecast is not materially inefficient.

⁸⁷ Consumer stakeholders have expressed support for ongoing use of benchmarking and we are committed to refining our benchmarking tools.

⁸⁸ AER, Annual benchmarking report– Electricity distribution network service providers, November 2017. Available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/annual-benchmarking-report-2017>.

Figure 5-2 Distribution Network Service Provider Opex Multi-lateral Partial Productivity for FY2006-2016, with Ausgrid forecast to 2019



Source: Economic Insights Memorandum, 6 August 2018, Assessment of Ausgrid’s proposed base year opex.

Note: Year references (i.e. 2016) refer to financial years (i.e. 2015–16). Ausgrid’s transformation costs include redundancy, stranded labour and CTP costs incurred in the current period in transitioning from a higher level of opex to a level consistent with our April 2015 decision. Transformation costs are referred to as transition costs in this decision in line with our April 2015 final decision and the Tribunal and Federal Court decisions.

Opex category analysis

The Tribunal and the Court did not specify the form of bottom-up assessment we need to undertake in remaking our opex decisions. The Court stated that the form and scope of bottom-up review to use is a matter for us to consider.

Generally, a bottom-up approach involves a detailed review that assesses discrete opex projects, items or categories of opex, involving reliance on engineering and managerial expertise, economic analysis, or more granular forms of benchmarking (for example, at the category analysis level). In order to assess whether the total opex forecast is consistent with the NER requirements, aggregating the relevant items is necessary.

Where available evidence indicates that revealed costs are likely to reflect a prudent and efficient level of opex, and are at a sustainable level that will maintain the safety and reliability of services in the long-term interests of consumers, a bottom-up assessment may be minimal in scope and nature. In cases where the revealed costs do not reflect a prudent and efficient level of opex that meets the opex criteria, we may undertake a more comprehensive and detailed bottom-up assessment.

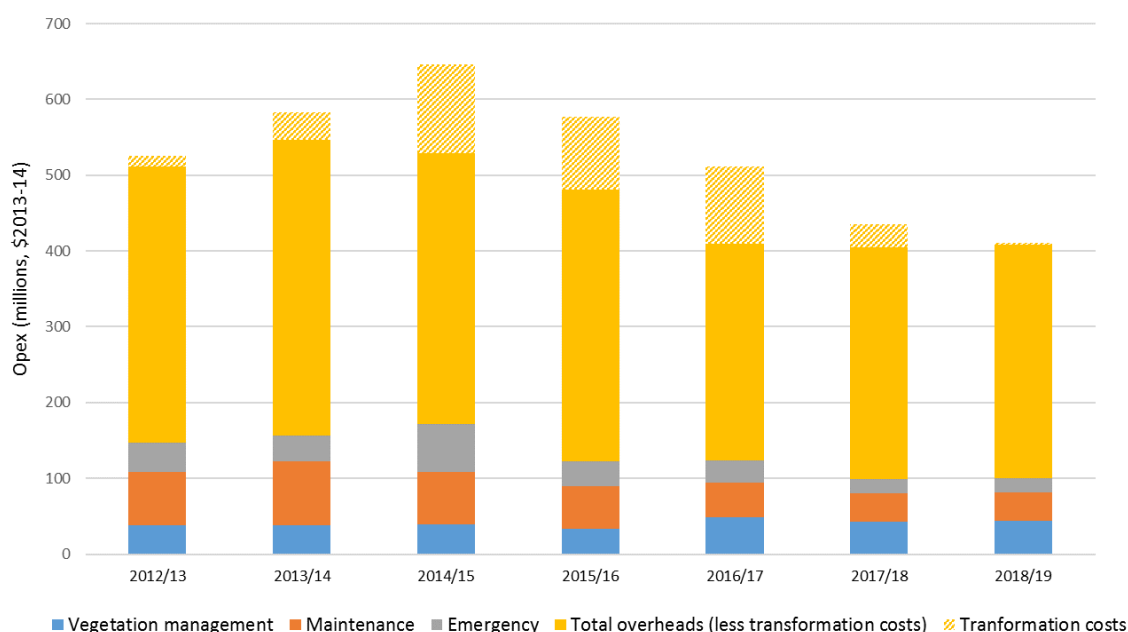
The revealed and forecast costs analysis and the benchmarking results indicate that Ausgrid's 2018-19 opex is likely to not be materially inefficient. Consequently, we have undertaken a limited bottom-up analysis that examines some of the drivers of reductions in Ausgrid's opex between 2012–13 and 2018–19 as an additional test of the efficiency of its opex.⁸⁹

Figure 5-3 shows the breakdown of Ausgrid's major opex cost categories using actual data up to 2016–17 and forecast data for 2017–18 and 2018–19. Between 2012–13 to 2018–19, total opex is forecast to decrease by approximately 22 per cent (\$2013–14). This decrease is driven by reductions in opex categories, including:

- emergency services – reduced by 53 per cent
- maintenance – reduced by 46 per cent
- total overheads (including transition costs) – reduced by 18 per cent

Over the same period, vegetation management costs are forecast to increase by around 15 per cent.

Figure 5-3 Ausgrid's opex cost breakdown (\$millions, \$2013–14)



Source: Category Analysis and Reset RINs and Ausgrid data request.

Note: Transition costs are a subcomponent of Total Overheads. Data for 2017–18 and 2018–19 are forecasts. This data has not been normalised like figure 5-1 because we do not have that information at the category level.

In our 2015 final decision, we found that Ausgrid had high labour costs because it had too many staff and had engaged permanent staff in preference to contractors for the 2009-14

⁸⁹ At our remittal stakeholder roundtable meeting in August 2017, a number of stakeholders noted there may need to be a greater emphasis on detailed reviews in key opex areas such as labour and vegetation management costs. AER, NSW and ACT remittal roundtable (16 August 2017) summary note, August 2017.

period of transitory capex work.⁹⁰ These staff became stranded labour due to the restrictions on involuntary redundancies imposed by Ausgrid's enterprise bargaining agreement.⁹¹ These views were informed by a review conducted by Deloitte Access Economics.⁹²

Since then, Ausgrid has noted that its transformation program has enabled it to downsize its workforce and improving labour productivity, and this has allowed it to reduce opex in line with our 2015 final decision while ensuring its continues to deliver safe and reliable electricity services.

"Phase 1 of the transformation program was launched in 2015 and focussed on laying the foundations for our future success. This was achieved through a series of initiatives to 'right-size' our workforce and increase efficiency and productivity in the field, in order to deliver sustainable reductions in our cost base without compromising safety or reliability.

We introduced phase 2 of our transformation program in 2017 to drive further efficiency and operational effectiveness and to help us meet the AER's opex forecast in order to provide a stable and sound cost base for the future. We implemented additional transformation initiatives to further reduce the size of our workforce, improve the efficiency of our capital investments, improve labour productivity, increase blended delivery, drive efficient network support costs, and streamline back-office operations. We also negotiated a new competitive enterprise agreement, implemented a new management structure and invested in our key capabilities to ensure that the significant cost reductions we have achieved are sustainably embedded within our cost base moving forward."⁹³

Our category analysis also shows that in implementing its transformation program and achieving these efficiencies in recurrent opex, Ausgrid has incurred significant non-recurrent transition costs (including redundancy, stranded labour and career transition program costs).

Figure 5-3 shows Ausgrid's actual transition costs from 2012–13 to 2016–17 and forecast transition costs for 2017–18 and 2018–19. Ausgrid incurred \$116.6 million in transition costs in 2014–15, \$95.3 million in 2015–16 and \$101.5 million in 2016–17 (\$2013–14). These costs coincided with a reduction in Ausgrid's workforce over these three years of almost 1000 full time equivalent (FTE) employees and a decline in its recurrent opex (excluding transition costs) of approximately 23 per cent.⁹⁴ Ausgrid forecasts that it will reduce its transition costs to \$30.7 million in 2016–17 and to \$2.5 million by 2018–19 (\$2013–14), while maintaining the cost savings achieved in its recurrent opex.

This category analysis shows that while Ausgrid has incurred significant one-off transition costs in the current regulatory period, it has been able to achieve and sustain lower costs in recurrent opex categories (i.e. emergency services, maintenance and overheads). The

⁹⁰ AER, *Final Decision Ausgrid distribution determination 2015–16 to 2018–19, Attachment 7 – Operating Expenditure*, April 2015, pp. 7-25.

⁹¹ AER, *Final Decision Ausgrid distribution determination 2015–16 to 2018–19, Attachment 7 – Operating Expenditure*, April 2015. The NSW ENAAT Act enacted by the NSW Parliament on 4 June 2015 after our April 2015 final decision, prohibits Ausgrid management from undertaking involuntary redundancies or amending the terms of its 2012 enterprise bargaining agreement 2015 until 1 July 2020.

⁹² Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis*, November 2014, pp. i-v; Deloitte Access Economics, *NSW Distribution Network Service Providers Labour Analysis: addendum to 2014 report*, April 2015, pp. ii–vii.

⁹³ Ausgrid, *Ausgrid's Regulatory Proposal 1 July 2019 to 30 June 2024*, April 2018, p.122.

⁹⁴ *Ibid.* p.124.

maintenance of lower recurrent opex and the decrease in transition costs is forecast to allow Ausgrid to reduce its opex by 2018–19 to a level that is consistent with our 2015 final decision, and to maintain this level of opex over the next regulatory control period without compromising safety or reliability.

This provides further supporting evidence, in addition to the revealed cost and economic benchmarking analysis, that Ausgrid's 2018–19 opex forecast is not materially inefficient, and is consistent with a sustainable level of recurrent opex a prudent operator would require to deliver safe and reliable electricity services.

5.3.1.2 Our assessment of efficient non-recurrent costs for 2014-19

In this section, we consider what costs, if any, above the level of recurrent opex we have estimated in section 5.3.1.1 can be considered efficient and prudent costs consistent with the opex criteria, and so included in our opex forecast.

Ausgrid has submitted that it be allowed to recover the 'efficient and prudent' transition costs that it has incurred from 2014–15 to 2017–18 under the transformation program undertaken to downsize its operations in line with our 2015 final decision opex forecast.⁹⁵ Ausgrid argues that it has had to incur these transition costs to comply with 'legal obligations' under its workplace agreements and the NSW ENAAT Act.⁹⁶

Table 5-2 shows Ausgrid's transition costs broken down by category and financial year. Ausgrid estimates it will incur \$344.1 million (\$2013–14) in transition costs over the first four years of the current period, including.

- \$251.5 million of redundancy costs to pay surplus workers who have accepted voluntary redundancies (VRs) and left the business
- \$88.4 million of stranded labour costs to pay the wages and benefits of surplus workers who chose to not take a VR but who cannot be made forcibly redundant under the *Electricity Network Assets (Authorised Transactions) Act 2015 (NSW) (ENAAT Act)*⁹⁷
- \$4.2 million of career transition program (CTP) costs – Ausgrid operates the CTP to support, retrain and assist stranded labour whilst the employees search for alternative employment.

⁹⁵ Ausgrid email 24 May 2018.

⁹⁶ Ibid.

⁹⁷ The ENAAT Act commenced on 4 June 2015: ENAAT Act, s. 2. Schedule 4 of the ENAAT Act, amongst other things, prohibits forced redundancies and changes to the terms of the operator's EAs between 1 July 2015 and 31 July 2020.

Table 5-2 Ausgrid’s transition costs 2015–18 (\$2013–14)

Cost type	2014–15	2015–16	2016–17	2017–18	Total
Voluntary redundancy	106.1	77.4	34.3	33.7	251.5
Stranded Labour	10.5	16.7	65.8	-4.6	88.4
Career transition program		1.2	1.4	1.6	4.2
Total	116.6	95.3	101.5	30.7	344.1

Source: AER data request to Ausgrid.

Notes: Ausgrid has not included transition costs incurred in 2018–19 in its remittal proposal.

Our position in this remade draft decision is that we are satisfied that a forecast opex allowance for the 2014–19 regulatory control period which includes Ausgrid’s proposed \$344.1 million (\$2013-14) in transition costs reasonably reflects the opex criteria. In coming to this position, we have taken into account the opex factors and the RPP, the Tribunal’s directions and reasons, and the new information about Ausgrid’s costs that are now available to us.⁹⁸

In undertaking our assessment, we have considered two key issues:

- First, whether these transition costs are of the kind that a prudent operator would incur and could be included in a forecast opex allowance. Our position is that, in the circumstances, this is the case.
- Secondly, whether the quantum of transition costs is efficient and prudent such that they reasonably reflect the opex criteria. Based on the information available to us, these amounts incurred by Ausgrid appear to be efficient.

We recognise that our position in this remade draft decision appears to be a departure from that in our 2015 final decision. Our position in the NSW and ACT 2015 final decisions, as well as before the Tribunal and Court, was that transition costs (such as the costs of making redundancy payments to reduce labour levels and terminating contracts early) could not be provided for as part of an opex allowance that reasonably reflects the opex criteria.⁹⁹

In the final decision for Ausgrid, we stated:¹⁰⁰

“As outlined in the [Expenditure Forecast Assessment] Guideline, if the prudent and efficient opex allowance to achieve the opex objectives is lower than a service provider’s current opex, we would expect a prudent operator would take the necessary action to improve its efficiency and prudence. We would expect a service provider (including its shareholders) to bear the cost

⁹⁸ NER, cl 6.5.6(c) and 6.5.6(e); NEL, ss 7A(2)(a) and 7A(3).

⁹⁹ AER, Final decision, *Ausgrid distribution determination 2015–16 to 2018–19, Attachment 7 – Operating expenditure*, April 2015, pp. 7-40–7-46.

¹⁰⁰ *Ibid.* pp. 7-21, 7-22.

of any inefficiency or imprudent actions. To do otherwise, would mean electricity network consumers would fund some costs of a service provider's inefficiency or imprudent actions.

Accordingly, if our opex forecast is lower than a service provider's current opex we would generally not consider it open to us to provide a transition path to the efficient allowance. This approach is reflected in the NER, which provides that we must be satisfied that the opex forecast reasonably reflects the efficient costs of a prudent operator given reasonable expectations of the demand forecast and cost inputs to achieve the expenditure objectives.”

Underlying this position was our view that in identifying the outcome that best achieves the NEO, it is important to recognise that in-principle, the regulatory framework under Chapter 6 of the NER distinguishes between those operations and costs which are endogenous to, or within the control of, the regulated business from those which are exogenous. This recognises that the risks associated with matters that are endogenous to a regulated business are best managed and borne by the regulated business, not consumers. In general, we maintain this in-principle view of how the regulatory framework operates, and the way in which this affects how we should continue to discharge our functions and powers.

Based on the facts before us at the time of the 2015 final decision, we concluded that providing transition costs were not necessary for Ausgrid to recover at least its efficient costs and safety and reliability operate its network.

However, three intervening events have since occurred which now means that this remade draft decision departs from our position in the 2015 final decision:

- first, the Tribunal’s direction to reconsider transition costs, the subsequent Full Federal Court case and the merits and judicial review cases concerning SA Power Networks
- second, we now have information on Ausgrid’s actual costs for the first three of the five regulatory years of the 2014–19 regulatory control period, as well as information on how the business is managing its transformation program
- third, the NSW ENAAT Act commenced on 5 June 2015, which among other things, prohibits Ausgrid from changing the terms of its EBA (including redundancy terms) until 31 June 2020.

In not accepting our position on transition in the 2015 final decision, the Tribunal specifically concluded:¹⁰¹

“Due to the Tribunal’s findings on opex, the Tribunal does not, in the circumstances, need to determine whether these contentions by Networks NSW, ActewAGL and Ergon are correct. When the AER revisits and redetermines the opex allowance, it will have to consider the costs involved in transitioning. It will do so at a time, and in relation to revenue streams, which will require it to make a fresh decision. The Tribunal is anxious not to inhibit the AER at this point in exercising its discretion in that regard.”

The Tribunal’s position, which was subsequently upheld by the Full Federal Court, and read in light of the recent merits and judicial review cases concerning SA Power Networks, has

¹⁰¹ Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT1, [494].

identified three findings that are now relevant to remaking our opex decision and the consideration of non-recurrent transition costs.

First, whether a decision, such as agreeing to an enterprise bargaining agreement (EBA or EA), is an endogenous managerial decision of a distributor, or exogenous and not within the control of the distributor, does not itself determine whether transition costs should be provided to allow a distributor to recover a particular kind of cost. It is simply one consideration that must be taken into account in light of all the available information before us. This follows from the Tribunal's position to not accept our use of the Cobb Douglas SFA model and our reasons to not provide transition costs on the basis that they were an endogenous managerial decision. To this end the Tribunal stated:¹⁰²

"As Networks NSW submit, Ausgrid, Essential and Endeavour are bound by the EBAs and remain bound by them and they should not be viewed as an endogenous managerial choice. At least not in circumstances where the AER has quite radically shifted from an itemised bottom-up approach to assessing opex to benchmarking total opex per se – particularly where that benchmarking has not been exposed to the rigors of the consultation the NEL and NER envisage for such a radical change.

... having regard to the regulatory prescriptions, the Tribunal does not accept that it may, by the use of the EI model, simply select the measurement of efficiency which it did in this respect without regard to the obligations under the EBAs as they presently exist. Over time, and probably during the new current regulatory period, any such inefficiencies as the AER considers to exist may progressively be reduced by the reduction in employee numbers to what the AER considers to be the efficient number, and any allowances under the EBAs (as they expire) which the AER considers to be inefficient may also by the same elapse of time be reduced to an efficient level."

The Tribunal's position was subsequently confirmed by the Full Federal Court and the Tribunal again in the merits review case concerning SA Power Networks.¹⁰³ Specifically, the Full Federal Court stated:

"The Tribunal went on to consider the AER's conclusion that the EBAs were endogenous and, therefore, to be ignored. The Tribunal rejected an approach that simply characterised an obligation as endogenous and to be ignored or as exogenous and to be considered, and said that a closer analysis was required. We think this was what the Tribunal was saying when it referred to the pressure placed on the NSW service providers by the Ministerial licence conditions and their response to it and, that that having happened, to the Fair Work Act being an exogenous factor. Leaving aside precisely what is meant by an endogenous matter and exogenous matter, we do not think that the Tribunal erred in finding error in this approach of the AER. The distinction might be a useful one, but it should not be used in a way which precludes an examination of all the facts and circumstances."

Second, an EBA agreed to under the *Fair Work Act 2009 (Cth)* is not an instrument that constitutes a 'regulatory obligation or requirement' under the NEL. It follows that recovery of wage increases and redundancy payments, solely by complying with the terms of an EBA is not a sufficient reason for those costs to form part of an opex forecast. This issue of whether

¹⁰² *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT1, [434] and [436].

¹⁰³ *Australian Energy Regulator v Australian Competition Tribunal (No 2)* [2017] FCAFC 79, [370]; *Application by SA Power Networks* [2016] ACompT 11, [541] and [542].

an EBA agreed to under the *Fair Work Act 2009 (Cth)* is a 'regulatory obligation or requirement' was considered by the Tribunal. But as the Full Federal Court confirmed later, this was not decided by the Tribunal.¹⁰⁴ In any case, the recent cases of merits and judicial review cases involving SA Power Networks have confirmed that an EBA, for the reason that it does not materially affect the provision of standard control services, is not a regulatory obligation or requirement under the NEL.¹⁰⁵

Finally, we note the finding of the Tribunal and the Full Federal Court in the merits and judicial review cases concerning SA Power Networks that compliance with an EBA is not necessary to "maintain the safety of the distribution system through the supply of standard control services" in accordance with clause 6.5.6(a)(2) of the NEL. Relevantly, the Full Federal Court stated:¹⁰⁶

"First, the provision still requires that SAPN demonstrate that the EA is necessary to 'maintain the safety of the distribution system through the supply of standard control services'. As explained in the earlier consideration of cl 6.5.6(a)(2) and s 2D, there must be a direct connection between the EA and the delivery of standard control services. That connection is the labour employed to deliver those services, not the mechanism chosen to provide that labour."

We must decide the transition costs issue in light of this Tribunal direction and the information now available to us.¹⁰⁷ Since our 2015 final decision, a range of new and updated information on the actual operation of Ausgrid's transformation program is also available. This includes the types and quantity of transition costs incurred over the first three years of the current period and Ausgrid's forecasts for these costs for the last two years, as well as information on how Ausgrid has managed voluntary redundancies and stranded labour under its career transition program. Further, we now have information on the impact of the 2015 ENAAT Act on Ausgrid's transformation program and transition costs.

The approach we have applied in considering transition costs and in remaking this draft decision has been influenced by the novel circumstances that we face now. These circumstances materially differ to what we faced when we made our 2015 final decision, and what we would generally face in making a distribution determination. Ultimately, whether we include transition costs remains a matter for us to determine against the opex criteria, taking into account the RPP and in a way that forms part of an overall decision that we are satisfied will, or is likely to, contribute to the achievement of the NEO to the greatest degree.¹⁰⁸ Whilst the Tribunal has stated that it is anxious not to inhibit us exercising our discretion in this regard,¹⁰⁹ we have assessed Ausgrid's Proposal against the opex criteria in response to the

¹⁰⁴ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT1, [427]; see also *Australian Energy Regulator v Australian Competition Tribunal (No 2)* [2017] FCAFC 79, [367]; and *Application by SA Power Networks* [2016] ACompT11, [528].

¹⁰⁵ *Application by SA Power Networks* [2016] ACompT 11, [521]-[529]; and *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3, [385].

¹⁰⁶ *Application by SA Power Networks* [2016] ACompT 11, [545]; and *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3, [397]-[399].

¹⁰⁷ NEL 6.12.1(4)

¹⁰⁸ NEL, cll 6.5.6(c) and 6.5.6(e); NEL, ss 7, 7A(2)(a), 7A(3) and 16.

¹⁰⁹ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1, [494].

Tribunal's directions, including the three findings and reasoning identified above, and the information now available to us.

The next two sections outline our analysis of the prudence and efficiency of transition costs.

Are transition costs the kind of costs a prudent operator would incur?

As we discussed above, Ausgrid's forecast opex in 2018–19 has reached a level that is consistent with the forecast opex allowance made in our 2015 final decision. We have considered whether it was necessary for Ausgrid to incur the kinds of transition costs it incurred to arrive at this level of opex.

Ausgrid has submitted that to achieve its 2018–19 opex forecast, it has had to incur \$344.1 million (\$2013-14) in transition costs to restructure its operations and downsize its workforce.¹¹⁰ Ausgrid states that it has had to incur these costs to comply with the legal obligations it faces under its 2012 Enterprise Agreement (EA), the associated Redeployment and Redundancy Policy and Memorandum of Understanding (MOU) on Salary Maintenance, and the ENAAT Act (in effect from 1 June 2015 to 31 July 2020).¹¹¹

Ausgrid submitted that the combined effect of these obligations has been to:

- mandate the key processes it has had to follow in downsizing its workforce (for example, the EA and Redeployment and Redundancy Policy include terms related to processes for identifying surplus workers, offering VRs and providing retraining and support services)
- establish the level of benefits it must pay to workers who accept a VR and to stranded labour who do not accept a VR and participate in the CTP (for example, the EA and Redeployment and Redundancy Policy set out the level of VR benefits payable while the MOU requires Ausgrid to maintain the salaries of stranded labour)
- prevent Ausgrid from renegotiating its employment terms and conditions, including ones related to redundancies and surplus workers, until 1 July 2020 (this is prohibited under the ENAAT Act).¹¹²

Ausgrid states that the type and level of transition costs that it has had incurred in reducing its opex have been mandated by these legal obligations, and consequently, these costs are necessary and prudent costs that are consistent with the opex criteria.¹¹³

In support of its proposition, Ausgrid provided us with information on how it has operated its transformation program, including the redundancy, stranded labour and career transition program (CTP) components. Box 5.1 summarises this information.

¹¹⁰ Ausgrid email 24 May 2018

¹¹¹ Ibid.

¹¹² Ibid.

¹¹³ Ibid.

Box 5.1: Summary of Ausgrid's implementation of its transformation program

This box summarises the operation of, and level of entitlements paid under, Ausgrid's transformation program, including its voluntary redundancy (VR), stranded labour and career transition programs (CTP) from 2014–15 to 16 May 2018. Ausgrid entered into a new EA on 16 May 2018. The key terms in this new EA relating to the transformation program are also summarised here.

Operation of the voluntary redundancy and stranded labour programs

Ausgrid's VR program involves:

- determining which personnel are excess to requirements (Ausgrid assessed its workers against the skill sets and capabilities required under its future operating requirements)
- offering employees found to be excess to future requirements (surplus workers) a VR
- surplus workers either accept a VR offer, are paid their entitlements and exit the company, or decline the VR offer and are classified as stranded labour and placed in the career transition program (CTP)

Stranded labour (surplus employees who do not take up the offer of a VR) are retained in the CTP until they:

- are placed in temporary internal vacancies which match their skill set where possible (Ausgrid states that this ensures surplus employees are utilised and limits costs associated with hiring additional external employees)
- accept a VR, paid out their VR entitlements and exit the business (Ausgrid states that stranded labour in the CTP can choose to accept a VR at any time)

Voluntary redundancy entitlements

Ausgrid benefits paid for a standard VR include:

- statutory notice of date of termination (4-5 week's pay)
- severance pay at the rate of 3 weeks per year of continuous service
- accrued but untaken leave
- an incentive payment ranging from 2-8 weeks' pay for early acceptance of the offer of VR (within 2 weeks of an offer being made)

Stranded labour entitlements

Surplus employees who do not accept a VR and participate in the CTP retain the salary and benefits of their previous (surplus) position. Ausgrid provides a range of retraining, job seeker and other support services to assist these employees find alternative employment.

While employees in the CTP are required to undertake temporary duties within Ausgrid where possible, they return to the CTP once the work is completed. Any future VR payment

is calculated based on the salary of their original (surplus) position.

‘Mix and match’ voluntary redundancy program

Ausgrid operates a limited ‘mix and match’ VR program, which allows surplus employees to take positions vacated by ongoing employees who choose to leave the company. This program reduces the risk that Ausgrid would incur unnecessary transformation costs by recruiting a new employee externally when a qualified surplus employee in the CTP would be able to fill the position.

Apprentice and Graduate programs

Ausgrid states it has also ‘adjusted the intake of new employees through the Apprentice and Graduate Engineer programs in anticipation of the reduced capital program’.

New voluntary redundancy entitlements (from 16 May 2018 onwards)

Ausgrid’s 2018 EA came into effect on 16 May 2018 and maintains the terms outlined above. The 2018 EA includes additional terms to those outlined above with the aim of increasing the uptake of VRs by surplus employees. These changes include:

- a one-off incentive payment of \$75,000, in addition to the current incentive payment of 2-8 weeks’ pay, for acceptance of a VR within two weeks of an offer (note: all other VR entitlements remain the same)
- greater flexibility in the CTP to allow better utilisation of excess labour in temporary positions in the business
- a capped number of forced redundancies to be allowed from 1 July 2020 (up to 250 surplus workers per annum (note: forced redundancies will not receive the incentive payment of \$75,000 or the 2-8 week early acceptance payment)).

Source: Ausgrid email, 24 May 2018.

We have compared Ausgrid’s operation of its transformation program, as outline in Box 5.1 above, with the obligations it has faced under its 2012 EA, Redeployment and Redundancy Policy, MOU on Salary Maintenance and the NSW ENAAT Act. We find that:

- The types of VR costs Ausgrid has incurred are consistent with the obligations it faces under its 2012 EA and Redundancy and Redeployment Policy.
- The types of stranded labour and CTP Ausgrid has incurred in managing surplus workers who chose not to accept a VR are consistent with its obligations under its 2012 EA, Redundancy and Redeployment Policy and MOU on Salary Maintenance. In particular, the requirements that Ausgrid offer surplus workers retraining, study leave or subsidies for course fees, reemployment assistance services and salary maintenance.
- The ENAAT Act has had the effect of locking in the obligations in Ausgrid’s EA and associated workplace agreements as they relate to VR, stranded labour and CTP costs from 1 July 2015 to 31 July 2020. This has prevented Ausgrid from altering its

employment agreements during the current period to allow it to avoid these types of transition costs.

This supports the view that it was necessary for Ausgrid to incur these kinds of transition costs under its employment agreements to arrive at a level of opex in 2018-19 that is consistent with the opex forecast in our 2015 final decision. Nothing before us suggests that Ausgrid would have been able to achieve this level of opex without incurring these kinds of transition costs.

In response to our October 2017 issues paper, CCP10 provided some support for the inclusion of transition costs of these sorts as part of the remitted decision:¹¹⁴

“There will be long-term benefits to consumers flowing from appropriate short-term overspend on opex, including paying for redundancies. We also note from the revealed costs, that during the period the businesses have or will reduce their costs to achieve the AER forecast opex. On this basis CCP10 believes that it would be in consumers long-term interests to bear some portion of this opex overspend.”

CCP10 also stated:¹¹⁵

“Our principal position is that consumers should not pay for redundancies that have not led to long term savings. This underpins our strongly held opinion that only businesses that have reached the AER’s efficient opex level at end of year 4 and have a demonstrated relationship between the cost of redundancies and opex cost reductions should be eligible to recover and of these transition costs from consumers.”

In the context of Ausgrid’s actions since our 2015 final decision, the enactment of the ENAAT Act and the Tribunal’s direction to us, we consider Ausgrid’s transition costs are of a kind, in the circumstances, that can be characterised as costs required by a prudent operator to achieve the opex objectives, or alternatively as cost inputs that would be reasonably expected to achieve the opex objectives.¹¹⁶ Our reasons here do not rely on the instrument in which these costs have been incurred as being characterised as a regulatory obligation or requirement under the NEL.

At the time of our 2015 final decision, we did not have available to us the Tribunal’s direction, information on Ausgrid’s revealed costs or details on how the transformation program operated. The ENAAT Act had also not been enacted. The Tribunal directed us to have regard to these costs. We have formed the view that, had Ausgrid not incurred these kinds of transformation costs, it is likely it would not have arrived at the level of opex that it has to date and is forecasting to achieve by 2018–19. It has therefore been necessary for Ausgrid to incur these costs in order for it to arrive at a level of opex consistent with an opex forecast that we are satisfied reasonably reflects the opex criteria.

¹¹⁴ Consumer Challenge Panel, *CCP10 Response to AER Issues Paper: Remitted decisions for NSW/ACT 2014-19 electricity distribution determinations operating expenditure*, 30 November 2017, p. 19

¹¹⁵ *Ibid.* p. 4

¹¹⁶ NER, cll 6.5.6(c)(2) and 6.5.6(c)(3). Our reasons here do not rely on the instrument through which these costs have been incurred (i.e. the EA or the associated workplace agreements) being characterised as a regulatory obligation or requirement under the NEL, or the proposition that Ausgrid had to incur these costs to maintain the safety of the distribution system through the supply of standard control services.

Allowing Ausgrid to recover these kinds of costs is therefore also consistent with providing it with a reasonable opportunity to recover at least the efficient costs it incurs in providing direct control network services.

Is the quantum of transition costs efficient and prudent?

Having determined that the kind of transition costs that Ausgrid has incurred have been necessary for it to achieve the opex objectives, we now consider whether the quantum of \$344.1 million (\$2013–14) is efficient and that which a prudent operator would incur for the purposes of the opex criteria. This is consistent with CCP10’s submission that:¹¹⁷

“We believe that redundancy costs be applied to a business’s approved opex expenditure provided the redundancies are prudent or efficient. If there is any doubt about the efficiency of the redundancy costs then the risk of this should lie with the business rather than with consumers and the AER should impose a cap on the amount of redundancy costs to be borne by consumers.”

In examining whether Ausgrid’s transformation costs are efficient, we have considered the incentives it has faced in incurring these costs over the current period. In Ausgrid’s circumstances over the 2014–19 regulatory control period, we consider it has faced a strong incentive to minimise its transition costs within the confines of its legal obligations. During the 2014–19 regulatory control period so far, Ausgrid has faced uncertainty around its final revenue allowance and the final outcome of the appeals process. Faced with this uncertainty, Ausgrid implemented a reform program to reduce its own costs.

This is consistent with Ausgrid’s submission that the uncertainty around the level of costs it would eventually be allowed to recover has incentivised it to achieve the ‘quickest’ transition to a level of opex it believed would be consistent with our 2015 final decision opex forecast.¹¹⁸ In this context, Ausgrid has stated:¹¹⁹

“[it] had no certainty that it would be able to recover the transformation costs incurred. This uncertainty provided strong incentives to deliver the transformation at the lowest possible cost.”

Ausgrid also states in its Proposal that the level of transition costs it has incurred in reducing its opex to a level consistent with our 2015 final decision were determined by the legislative and regulatory obligations and constraints it has faced.¹²⁰ In particular, Ausgrid notes its 2012 EA and associated employment agreements set the level of entitlements it has been required to pay out when a surplus employee accepts a VR or is maintained as stranded labour in the CTP (see Box 5.1 above). Ausgrid further notes that the ENAAT Act prohibits it from amending its workplace agreements until 30 June 2020 and so prevents it from attempting to reduce the level of transition costs it is obligated to incur when offering voluntary redundancies or maintaining stranded labour.¹²¹

¹¹⁷ Consumer Challenge Panel, *CCP10 Response to AER Issues Paper: Remitted decisions for NSW/ACT 2014-19 electricity distribution determinations operating expenditure*, 30 November 2017, p. 4

¹¹⁸ Ausgrid email, 24 May 2018.

¹¹⁹ *Ibid.*

¹²⁰ Ausgrid, *Proposal for the remake of Ausgrid’s 2014-19 distribution determination*, 15 August 2018, p. 3.

¹²¹ *Ibid.*

Consistent with the statements made by the Tribunal, we have had regard to the obligations under Ausgrid's EA that was in place at the time of its transformation program. It is our view that the level of redundancy and stranded labour costs have been determined by Ausgrid's workplace agreements, and that under the constraint of the ENAAT Act, Ausgrid has been unable to amend these agreements to reduce these costs. This supports the view that Ausgrid's transition costs are unlikely to be greater than the level necessary to achieve its targeted opex reductions.

We have also considered what actions Ausgrid has taken to manage its workforce and operational requirements during the transition period to ensure transition costs are unlikely to be greater than the level necessary to achieve its targeted opex reductions. Ausgrid has provided information on policies and processes it has implemented to minimise unnecessary transition costs as it has downsized its workforce.¹²²

First, Ausgrid has adopted processes to ensure that it does not designate staff otherwise needed for operational requirements as surplus workers. To identify which workers were surplus to the business' requirements, Ausgrid undertook a desktop assessment and merit-based interview process that assessed workers' skill sets and capabilities against the business' future operational needs. Staff found to meet future operational needs were reconfirmed in positions while workers who did not were offered a VR and assigned to the CTP.¹²³ Ausgrid notes that this approach has helped to ensure its transformation program avoided unnecessary costs while maintaining the right capabilities for the future.¹²⁴

Second, Ausgrid has submitted that it has established processes to allow surplus workers in the CTP to be redeployed back into the business to meet resourcing needs as they arise. These processes include:¹²⁵

- requiring surplus workers to undertake temporary duties within the business wherever possible, then return to the CTP once the work is completed
- allowing surplus workers with the appropriate skills to be permanently redeployed back into the business where a role becomes vacant through other means (such as internal transfer or the creation of a new position)
- a 'mix and match' VR program, which allows employees offered a VR to take positions vacated by ongoing employees who choose to leave the company

Ausgrid notes that these processes are:¹²⁶

“...prudent management action[s] that ensure surplus resources are appropriately utilised and also limits the engagement of external resources – which delivers cost savings to the company.”

¹²² Ausgrid email 24 May 2018.

¹²³ Ausgrid email 24 May 2018.

¹²⁴ Ibid.

¹²⁵ Ausgrid emails 17 and 24 May 2018

¹²⁶ Ibid.

Third, Ausgrid states that it has put in place incentives to reduce overall transition costs by encouraging surplus workers to take VRs rather than remain in the CTP where they are paid a maintained wage and offered ongoing training and support. Ausgrid notes that while it cannot force redundancies, it has facilitated the take up of VRs through early sign up bonuses and by allowing stranded labour to take up a VR at any time. Ausgrid states that, in the context of the legal obligations it faces through its EA and associated workplace agreements, VRs are the lowest cost pathway to downsizing its workforce.¹²⁷

Fourth, Ausgrid states that it has taken various steps to ensure its CTP costs were minimised. Table 5-3 shows Ausgrid's actual and forecast CTP costs for the first four years of the current period by type and whether the costs were incurred internally by Ausgrid or externally through contractors. Approximately 60 per cent of CTP costs (\$3.0 million, nominal) are for external services engaged to provide support and training services for surplus staff, including contracting:

- career transition advisors
- providers of job seeking services to assist workers find new work, including interview and CV training, careers advice, job search assistance, and employee mental and physical wellbeing services
- providers of technical training to reskill workers, including technical training (PV system installation, environmental management, materials handling), psychometric testing and profiling, IT proficiency, vehicle and industrial equipment operator training, and fees for university and TAFE diplomas and certifications.

These external costs are for specialist HR services (such as retraining, tertiary education courses, job seeking advice and support, and psychological testing and support services), which Ausgrid is unlikely to have in-house. This supports a finding that it was likely to be necessary and prudent for Ausgrid to contract these services externally. The external CTP costs were paid to contractors engaged through a competitive tender process indicating these costs likely reflected prevailing markets prices for these services.

This information supports the view that these external CTP costs are efficient and what a prudent operator would incur in the circumstances.

¹²⁷ Ibid. To test this proposition, we reviewed Ausgrid's workplace agreements and compared the costs of paying a surplus worker VR benefits with the costs of maintaining the worker in the CTP program then subsequently paying out a VR. This analysis shows that in all likely scenarios, VRs are a lower costs pathway to retiring a worker.

Table 5-3: Ausgrid’s career transition program (CTP) costs, FY16–18

Cost types	Internal/external	Millions \$ nominal
Labour		
Permanent Ausgrid Staff (1)	Internal	1.0
Labour hire (2)	External	0.8
Internal allocations (3)	Internal	0.5
Total labour		2.3
Non-labour		
Contracted services (4)	External	2.3
Training, staff development (5)	External	0.3
Other (6)	Internal	0.0
Total non-labour		2.8
Allocated costs		
Total overhead (7)	Internal	0.8
Total CTP costs		5.8
Standard control services (SCS) component of CTP costs		
	SCS Internal	1.9
	SCS External	3.0

Source: Ausgrid email 19 April 2018

Notes: Total standard control services CTP costs (Total SCS CTP costs) are the costs Ausgrid is seeking to recover. The internal/external split is calculated using Total CTP cost data. Ausgrid provided Total SCS CTP cost data and advised the same internal/external applies. FY18 data is based on 9 months of actual data and 3 months of forecast data. Definitions of categories: 1. Employees responsible for operational management and supervisory support at career transition locations at Sydney, Wallsend and Tuggerah; 2. Temporary or fixed term contactors provided by labour hire organisations (Chandler Macleod and Gail Whipper) fulfilling Career Transition Advisor roles, plus Head of the Career Transition Program, also contracted; 3. Recharged cost of ad-hoc internal labour support provided by other Ausgrid divisions; 4. Cost of outsourced services including: Outplacement services mainly provided by Randstad e.g. interview and CV training, careers advice, job search assistance; Employee mental and physical wellbeing services provided by Optum; 5. Cost related to third party training providers, including: Specialist technical training e.g. PV system installation, environmental management, materials handling; Psychometric testing and profiling; IT proficiency; Vehicle and industrial equipment operator training; University and TAFE fees (diplomas and certifications); 6. Sundry costs including stationary, IT consumables, printing and postage, travel expenses, safety equipment and work wear; 7. Allocated central overhead costs e.g. Property, ICT, Finance and HR recharged to CTP based on volumetric cost drivers (e.g. headcount, ICT hardware).

Approximately 40 per cent of CTP costs (\$1.9 million, nominal) are internal costs that Ausgrid attributes to:

- direct staffing by Ausgrid employees of the three career transition centres
- an estimate of the costs of providing Ausgrid staff and resources (HR, legal, admin services etc.) to supervise and operate the CTP program.

Given Ausgrid’s obligations under its EAs to provide the CTP services, the risks associated with significant workforce downsizing, and its general duty of care under workplace legislation, it appears prudent and reasonable that Ausgrid have some of its own staff involved in delivering and supervising the CTP program. Given the size of business-wide

restructure, it also appears prudent and reasonable that Ausgrid would incur some internal costs above and beyond its standard operating budgets in managing a one off transformation program.

This information supports the view that these internal CTP costs are not inefficient and what a prudent operator would incur in the circumstances.

5.3.2 Return on debt constituent decision

The allowed rate of return provides a network service provider a return on capital that a benchmark efficient entity would require to finance (through debt and equity) investment in its network.¹²⁸ The return on capital building block is calculated as a product of the rate of return and the value of the regulatory asset base (RAB). The rate of return is discussed in this section.

Ausgrid's revenue Proposal has implicitly adopted our return on capital allowance that we set in our 2015 final decision (with minor updates for updated return on debt data). This was based on a transition to a trailing average methodology for calculating the return on debt.

Since our 2015 final decision, having regard to the decisions of the Tribunal and Court, we have revised our general approach to determining the return on debt. We now apply a revenue neutral transition when moving from the on-the-day methodology for estimating the cost of debt to a trailing average methodology. The basis for this revenue neutral transition is discussed in more detail later.

While our approach, and the reasoning to support it, has changed since the 2015 final decision, the revenue outcome of our new approach is approximately the same as in that decision.¹²⁹ Ausgrid's Proposal is consistent with our new approach to determining the return on debt.

The revised rate of return allowance for this remade draft decision is set out in Table 5-4. These numbers reflect our 2015 final decision with respect to the return on equity and the gearing ratio and a revenue neutral transition calculated using partially updated debt yield data from the Reserve Bank of Australia (RBA)¹³⁰ and fully updated data from Bloomberg. The RBA data has been updated for the pre 5 June 2018 RBA revisions only, due to the unique circumstances described in section 5.3.2.5. They also reflect the debt averaging periods we determined to use in our 2015 final decision.

¹²⁸ The term 'network service provider' relates to service providers that provide gas and electricity transmission and distribution services.

¹²⁹ We note a very small change in revenue occurs due to the use of updated debt yield data (pre 5 June 2018 updates).

¹³⁰ Reserve Bank of Australia, Letter to AER, *Revisions to statistical table F3*, 4 July 2018.

Table 5-4 Ausgrid draft decision return on debt and return on capital (\$million, 2013-14) and percentage debt portfolio rate of return¹³¹

	2014-15	2015-16	2016-17	2017-18	2018-19	Total
Draft decision debt portfolio rate of return	6.51%	6.41%	6.26%	6.10%	5.93%	
Draft decision return on debt	545.1	541.0	533.8	525.3	513.6	2658.8
Draft decision return on capital	941.3	940.7	937.5	932.6	923.7	4675.9

5.3.2.1 The NER requirements

We must determine a rate of return such that it achieves the allowed rate of return objective (ARORO).¹³² The ARORO is that the rate of return is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of its regulated services (its standard control service in the case of electricity distributors).¹³³ Therefore, each remade debt decision must contribute to achieving the ARORO.

Other legislative requirements relevant to remaking our debt decision include the NEO, the RPP and any interrelationships with other related components of a distribution determination. The NEO is relevant because we are required to make a distribution determination that will, or is likely to, contribute to the achievement of the NEO to the greatest degree.¹³⁴ The RPP are relevant because we must take them into account in exercising this type of decision-making power.¹³⁵ We must also take into account any interrelationships between our remade debt decision and any other related component of a distribution determination.¹³⁶

¹³¹ These numbers reflect the final decision including annual debt updates using data prior to the 5 June 2018 RBA update.

¹³² NER ss. 6.5.2(b), 6A.6.2(b).

¹³³ NER ss. 6.5.2(c), 6A.6.2(c).

¹³⁴ NEL, ss. 7 and 16(1)(d).

¹³⁵ The RPP that are directly relevant to remaking our debt decision are set out at NEL, ss. 7A(2), 7A(3), 7A(5), 7A(6) and 16(2).

¹³⁶ NEL, s. 16(1)(c).

5.3.2.2 The Tribunal's decision

On 26 February 2016, the Tribunal handed down its decisions.¹³⁷ The Tribunal instructed us to remake the constituent decision on the return on debt in relation to the introduction of the trailing average in accordance with the Tribunal's reasons for its decisions without giving a clear clarification of the directions for the remittal.¹³⁸ The Tribunal found us in error in our definition of a benchmark efficient entity as a “regulated” entity. The Tribunal also found us in error in our construction of NER rule 6.5.2(k)(4), based on the information available to the Tribunal at that time.

5.3.2.3 Judicial Review

On 24 March 2016, we applied to the Federal Court for judicial review of the Tribunal's decisions. On 24 May 2017, the Court dismissed our appeals on the return on debt and opex and upheld the Tribunal's decisions in relation to these issues. It upheld the AER's appeal in relation to the value of imputation credits (gamma).¹³⁹

We have carefully considered the full reasoning of the Court in considering what to do to achieve the ARORO, NEO and RPP in this decision. Of relevance, in relation to the Court's decision:

- the Court clarified that a benchmark efficient entity is not necessarily either regulated or unregulated
- the important characteristic of a benchmark efficient entity is that it has a similar degree of risk to the service provider with respect to the provision of its regulated services
- a change in debt estimation methodology does not necessarily result in any impacts for a benchmark efficient entity

In relation to both the decisions of the Tribunal and Court, we also make the following observations:

- The decisions of the Tribunal and Court were not focussed on the interpretation of “efficient financing costs” in the ARORO. We consider this to be an important factor.
- Neither decision removes the requirement to apply a debt methodology that we consider will achieve the relevant legislative objectives for each of the respective service providers affected by the remittals.
- Neither decision requires the use of a trailing average methodology for determining the cost of debt in this remittal.

¹³⁷ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT1; *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT2; *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT3; *Application by ActewAGL Distribution* [2016] ACompT4.

¹³⁸ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT1, direction 1(b); *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT2, direction 1(b); *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT3, direction 1(b); *Application by ActewAGL Distribution* [2016] ACompT4, direction 1(b); *Application by Jemena Gas Networks (NSW) Ltd* [2016] ACompT5, direction 1(a).

¹³⁹ *Australian Energy Regulator v Australian Competition Tribunal (No 3)* [2017] FCAFC 80.

In subsequent decisions involving other parties, the Tribunal and Full Federal Court have made various findings and comments which are also relevant to these matters. In particular, both the Tribunal and Federal Court have made comments about our new approach to estimating the return on debt that help to clarify how the Tribunal's decision for Ausgrid should be interpreted.¹⁴⁰ This is discussed in more detail below.

5.3.2.4 Other relevant legal processes

Other legal decisions that we have had regard to in our remade draft decision are:

- the decision of the Australian Competition Tribunal for SA Power Networks and the subsequent decision of the Full Federal Court on the appeal of this decision¹⁴¹
- the decisions of the Australian Competition Tribunal for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd¹⁴²

The decisions of the Tribunal for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd are particularly important as they are directly concerned with the application of our new approach to estimating the return on debt.

After the Tribunal handed down its decisions for Ausgrid, we reconsidered our approach to debt estimation methodology. The new approach, which we adopted in our decisions for ActewAGL (Gas) Distribution and Jemena Electricity Networks, does not rely upon a conceptualisation of a benchmark efficient entity as a regulated entity. It recognises that different service providers may have a different benchmark efficient entity. The new approach also does not rely on a change in methodology impacting a benchmark efficient entity to justify our revenue neutral transition. Our new approach does not rely upon an assessment of historical financing practices. Instead, it considers the efficient financing costs (being the costs of equity and debt) in a forward looking manner. Our new approach was subject to review by the Tribunal.

The Tribunal upheld our new approach. It explained more clearly how each of the Tribunal's and Court's decisions should be read together consistently. It provided clarification for the earlier Tribunal's decision on the directions of the Tribunal for the remittal that were previously unclear to us. We consider these decisions support a revenue neutral transition when moving to a trailing average methodology based on our new approach, or the continuance of an on-the-day methodology for determining the cost of debt, to achieve the NEO.

An important aspect of the decisions for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd is the consideration in those decisions of the interpretation of the "allowed rate of return objective" (or ARORO) and the meaning of "efficient financing costs".¹⁴³ We consider these decisions support our ex ante interpretation of efficient financing costs.

¹⁴⁰ See, for example, *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3 at [295].

¹⁴¹ *Application by SA Power Networks* [2016] ACompT 11; *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3.

¹⁴² *Application by ActewAGL Distribution* [2017] ACompT 2.

¹⁴³ *Ibid.*

These decisions and our view on them are covered in further detail in our debt Position Paper on our remitted debt decisions.¹⁴⁴

On 18 January 2018, the Full Federal Court handed down its decision on *SA Power Networks v Australian Competition Tribunal*.¹⁴⁵ This was a review brought by SA Power Networks from a decision of the Tribunal.¹⁴⁶ The Full Federal Court noted that the Court had not had the benefit of hearing a number of issues in relation to Ausgrid's review that had been subsequently put to it in *SA Power Networks vs Australian Competition Tribunal*. In particular, the Court stated:

"We would add that the present proceeding has raised a number of issues that were not advanced by the parties in *AER v Australian Competition Tribunal* [i.e. the Ausgrid case]. The Full Court's observation at [572] of *AER v Australian Competition Tribunal* that there were no impacts in the form of hedging contracts that needed to be unwound was made in the context of the facts of that case and the submissions that were advanced by the parties at that time. No wider consideration of the possible 'impacts' of a change in methodology to estimate the return on debt was advanced or addressed. We do not regard *AER v Australian Competition Tribunal* as in any way confining the 'impacts' to which the AER might have regard when applying r 6.5.2(k)(4)."

We consider this Full Federal Court decision also supports our new revenue neutral debt transition approach which we propose to apply in this remitted debt decision.

5.3.2.5 Our approach to debt in this remitted debt decision

In remaking our debt decision, we are moving to a trailing average approach to estimating the return on debt from our previous on-the-day methodology. We will apply a revenue neutral transition in moving to this methodology. As noted by the Tribunal in its decision for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd, our revenue neutral transition is effectively a combination of the on-the-day methodology and trailing average methodology.

The only change in application we are making in comparison to our 2015 final decision is in undertaking our calculations to use the updated Bloomberg debt series data and partially updated RBA debt data (as available prior to 5 June 2018).¹⁴⁷ The RBA has made three changes to its yield curve estimates over the relevant period and Bloomberg has removed a period of data from publication. Given the timing of the third RBA update and the remittal process discussed further below, we have used data reflecting the Bloomberg update and the first two RBA updates in making this draft decision.

The most recent round of RBA data updates were published on 5 June 2018, and involved a back-casting of yield curve estimates covering the 2014-19 period.¹⁴⁸ We understand a

¹⁴⁴ AER, *Position paper – Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

¹⁴⁵ *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3.

¹⁴⁶ *Application by SA Power Networks* [2016] ACompT 11.

¹⁴⁷ We note that while our application of a revenue neutral transition to a trailing average is mathematically the same as our 2015 final decision, our reasoning has changed and is entirely based on the reasoning as set out in our APA VTS final decision.

¹⁴⁸ Reserve Bank of Australia, Letter to AER, *Revisions to statistical table F3*, 4 July 2018.

primary driver of the update was to reflect improvements in the methodology used by the RBA to convert bonds issued in US dollars into Australian dollar-equivalent terms.

We consider that, on balance, it would not be in the long-term interests of consumers to apply the 5 June 2018 RBA debt update at this juncture, given the particular circumstances before us.

As noted in section 5.1.1, the approach we have applied in remaking this draft decision has necessarily been influenced by the novel circumstances that we face now. They are materially different from those that we faced when we made our 2015 final decision, and what we would generally face in making a distribution determination. For example, this is highlighted by the fact that we are four years into the applicable five-year 2014-19 regulatory control period. In fact, under a separate process, we have already started publically consulting on our draft decision in respect of Ausgrid's revenue determination for the 2019-24 regulatory control period. In this respect, we also note that the recently updated RBA data has not been applied in our other remade decisions covering the 2014-19 regulatory control period, including our remade decisions for Essential Energy, Endeavour Energy and Evoenergy.

Stakeholders have told us they would like regulatory certainty and resolving the outstanding remittals in a timely manner will provide this certainty. Certainty is of benefit to both consumers and the network businesses and, therefore, will contribute to the NEO. To a large degree, this explains the concerted effort by all parties during pre-lodgement discussions – in all the remittals – to agree the key financial parameters which, in turn, could be developed into a proposal by the relevant network business – in this case, Ausgrid – and put to us for consideration and further stakeholder consultation under the regulatory determination process.

The consultation process on Ausgrid's Proposal occurred in good faith, based on the best available information at the time. We note that the most recent RBA data update released on 5 June 2018 occurred after a period in which substantial pre-lodgement engagement on the key financial parameters of Ausgrid's Proposal had already taken place with its key stakeholders, including consumer groups and our officers.

In summary, given the novel circumstances, the late timing of the 5 June 2018 RBA data update, the good faith in which parties have sought resolution of the remittal, and the broad stakeholder support for Ausgrid's Proposal, on balance, we consider that not applying the most up to date RBA data (as updated on 5 June 2018) to this remade draft decision is the outcome that contributes to the NEO to the greatest degree. We will consider all stakeholder submissions received on this issue, and other issues more generally, before publishing our final decision in the new year.

5.3.2.6 Stakeholder submissions on our cost of debt Position Paper

On 21 December 2017, we published a cost of debt Position Paper.¹⁴⁹ It set out our proposed approach to our remitted debt decision. On 22 January 2018, we published links to

¹⁴⁹ AER, *Position paper – Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

the decision of the Full Federal Court in *SA Power Networks v Australian Competition Tribunal (No 2)* [2018] FCAFC 3 and invited interested parties to comment on the decision and/or our view that it supported our proposed position to the remitted debt decisions in their submissions to our debt Position Paper. All parties to the Tribunal litigation were notified of the debt Position Paper and the Full Court's decision via email on 21 December 2017 and 22 January 2018, respectively.

In response to the debt Position Paper, we received submissions from CCP10, Evoenergy, Jemena Gas Networks, PIAC and ECA. We have had regard to these submissions in making this remade draft decision.

5.3.2.7 Reasons for our draft decision

For the reasons set out in our debt Position Paper¹⁵⁰ on our remitted debt decisions and in our APA VTS final decision, we consider a revenue neutral transition to a trailing average debt estimation methodology will lead to an allowed rate of return that will achieve the ARORO and contribute to the achievement of the NEO to the greatest degree. This rate of return will both reflect ex ante efficient financing costs and result in an approximately zero NPV investment outcome which is important to achieving efficient investment incentives. A revenue neutral transition will also substantially eliminate any wealth impact on Ausgrid from changing the debt estimation methodology.

We rely on the reasoning in our APA VTS decision in making this draft decision for Ausgrid, as set out in Attachment 3 of our APA VTS determination.¹⁵¹ This includes an explanation of how our approach has changed in response to relevant legal decisions. We also rely on our explanation and reasoning as set out in the debt Position Paper on our remitted debt decisions in making this draft decision.¹⁵²

In relation to the timing of the initial debt averaging period (for the commencement of the trailing average), we have used the initial averaging period set out in our 2015 final decision for the introduction of the trailing average. We also have used the debt averaging periods for the later years of the regulatory control period, as set out in our 2015 final decision, because we consider these will lead to a rate of return that achieves the ARORO and contribute to the achievement of the NEO. All averaging periods were chosen in advance of their commencement and we consider their use should result in an ex ante efficient return on debt allowance. We consider choosing averaging periods after the periods have finished (or post commencement) is generally inappropriate due to the potential incentive on various stakeholders to advocate for averaging periods that give particular results.

¹⁵⁰ Ibid.

¹⁵¹ AER, *Final Decision APA VTS gas access arrangement 2018 to 2022, Attachment 3 - Rate of return*, November 2017. This decision discusses and applies substantively identical provisions for rate of return as those applicable to electricity distribution.

¹⁵² AER, *Position paper – Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement*, December 2017.

We also consider our overall approach will lead to an overall allowed rate of return that will achieve the ARORO and contribute to achieving the NEO because:

- the return on equity we determined in our 2015 final decision was upheld on appeal as was the gearing ratio and we consider these values remain appropriate
- our combination of the yield from two debt series we used to estimate the return on debt in the 2015 final decision, a simple average of yields estimated from the Bloomberg and RBA yield curves, was upheld on appeal in the Tribunal and we consider remains appropriate
- we consider the overall allowed rate of return estimated using our return on debt, return on equity and gearing estimates will result in an allowed rate of return that will achieve the ARORO and contribute to achieving the NEO

As noted earlier, we have had regard to the submissions on our debt Position Paper in making this remade draft decision.

5.4 Other aspects of the 2015 final decision to be varied

5.4.1 Control mechanism

The control mechanisms for standard control services were not a subject of Ausgrid's appeal of our April 2015 final decision.¹⁵³ However, if this remade draft decision becomes our final decision, the decision has implications for the operation of the control mechanism for standard control services for the 2019–24 regulatory control period.

The Tribunal's directions that we are to comply with in remaking our decision includes:

“(d) the AER is to consider, and to the extent to which it considers appropriate to vary the Final Decision in such other respects as the AER considers appropriate having regard to s 16(1)(d) of the National Electricity Law in the light of such variations as are made to the Final Decision by reason of (a)-(c) hereof.”

This remade draft decision is \$341.1 million (\$ nominal) above our 2015 final decision. This \$341.1 million figure comprises both distribution standard control services and transmission standard control services. At present, we estimate \$310.9 million at 30 June 2019 will be returned to consumers in the next (2019-24) regulatory control period. This amount represents the estimated net difference in revenues Ausgrid has recovered over the 2014-19 regulatory control period and those we have now determined it should have recovered across both distribution and transmission standard control services over that period.

In order to effect the additional \$341.1 million (and only that amount) for the 2014-19 regulatory control period, we have made our draft decision adjustment determination that accompanies this remade draft decision.¹⁵⁴

¹⁵³ The control mechanism for Ausgrid's standard control services is the revenue cap. However, different revenue cap formulae apply to Ausgrid's distribution standard control services and transmission standard control services. AER, *Final decision: Ausgrid distribution determination 2015–16 to 2018–19: Attachment 14 – Control mechanisms*, April 2015, pp. 19–21.

¹⁵⁴ AER, *Draft decision, Ausgrid adjustment determination*, November 2018, pp. 6–7.

We will require a true-up in the 2019-24 regulatory control period to ensure Ausgrid does not recover any additional revenue above the \$341.1 million for the 2014-19 regulatory control period. This is because we will not know what Ausgrid's actual standard control services revenue for the 2014-19 regulatory control period will be until after this regulatory control period expires.¹⁵⁵ We will ensure Ausgrid earns no more than this amount through the design of the control mechanism for standard control services for the 2019-24 regulatory control period. We consider there are several options for enforcing the 2014-19 remade final decision through the control mechanisms for the 2019-24 regulatory control period. Any amounts recovered above that allowed in this decision will be returned to customers in the 2019-24 regulatory control period and determined as part of Ausgrid's 2019-24 distribution determination.¹⁵⁶

A revenue cap will apply to Ausgrid's standard control services in the 2019-24 regulatory control period for both distribution and transmission standard control services.¹⁵⁷ At this stage, we are likely to maintain the general properties of the control mechanism from our 2015 final decision, including the 'unders' and 'overs' accounts for distribution standard control services and designated pricing proposal charges. With this in mind, if this remade draft decision becomes our final decision, we consider there are several options for enforcing the decision through the control mechanisms for the 2019-24 regulatory control period. Any amounts recovered above that allowed in the decision will be returned to customers in the next (2019-24) regulatory control period and determined as part of Ausgrid's 2019-24 distribution determination.

5.4.2 Inflation error adjustment

In the course of its review of our decisions of the Victorian electricity distributors and ActewAGL's gas decision, the Tribunal identified an error in how inflation was estimated.¹⁵⁸ The Tribunal made note of the error in its decision and left it to the AER to determine how best to address the error.¹⁵⁹ The error affected not only the decisions under that review, but the 2015 final decisions for the NSW and ACT distributors. The error had not been picked up during the review of the 2015 NSW and ACT decisions.

The error results from an incorrect geometric average calculation undertaken on the annual inflation rates; resulting in an incorrect (lower) inflation rate of 2.38 per cent instead of 2.42 per cent. Correcting the error would result in a downward revenue adjustment with a nominal NPV unsmoothed of approximately \$23 million compared to our 2015 final decision.

¹⁵⁵ The \$310.9 million at 30 June 2019 to be returned by Ausgrid to customers in the 2019-24 regulatory control period is based on estimates, rather than actual revenue.

¹⁵⁶ In performing the true-up, we will have regard to the remade final decision, our final decision adjustment determination, and Ausgrid's out-turn revenues for the 2014-19 regulatory control period (and any other relevant considerations).

¹⁵⁷ AER, *Framework and approach Ausgrid, Endeavour Energy and Endeavour Energy: Regulatory control period commencing 1 July 2019*, July 2017, pp. 41 and 52–54.

¹⁵⁸ File Nos: ACT 3, 4, 5, 6, 7, 8 of 2016: <http://www.competitiontribunal.gov.au/current-matters/tribunal-documents>

¹⁵⁹ For example, see ACT, Application by ActewAGL Distribution [2017] ACompT 2, 17 October 2017, p i-iii.

On 15 December 2017, we notified Ausgrid (and other NSW/ACT distribution businesses) in writing, stating that we were considering whether it is appropriate to correct the affected determinations when remaking our decisions.¹⁶⁰

Ausgrid stated in letter dated 8 February 2018:¹⁶¹

“We acknowledge that there may be benefits in combining the AER’s 2014-19 remake determination with the process of correcting the inflation calculation error. Unfortunately, however, it appears that this change cannot be made as part of the remake of the 2014-19 determination, since the inflation calculation error was not part of the Competition Tribunal’s decision, nor is it a consequential change arising from the remake of the opex or debt decisions.”

And,

“If there was a change to the 2.38% CPI estimate applied via the 2014-19 remake determination, or through some other means, our view is that it may be appropriate to also take into account the best information available. Specifically, the 2014-19 estimate of inflation was intended to provide the best estimate at the time the AER made its decision. However, we now have the actual out-turn inflation that will be applied to determine CPI-adjusted revenues for each year of the 2014-19 regulatory period and for the roll forward of the regulatory asset base. Ausgrid suggests therefore that if any changes were made to the forecast of inflation, it would be appropriate to take actual CPI data into account.”

Ausgrid estimated outturn inflation at 1.91 per cent and that the impact of this (being 47 basis points) lower than the AER’s initial estimate of 2.38 per cent would be to reduce the actual nominal return on capital provided through the regulatory framework by approximately \$330 million compared to the expected return on capital at the start of the regulatory control period. It considers adjusting the inflation figure from 2.38 per cent to 2.42 per cent would reduce the actual nominal return on capital by a further \$23 million, bringing total under-compensation to \$353 million.

Ausgrid also raised a number of matters it had raised during a review of the regulatory treatment of inflation completed in 2017. We have considered Ausgrid’s submissions but we are of the view that the correction to the inflation error should be addressed in our decision. We have therefore used an inflation forecast of 2.42 per cent. This corrects for the mathematical error (as explained in our 15 Dec 2017 letter to Ausgrid) that resulted from an incorrect geometric average calculation undertaken on the annual inflation rates.

In response to Ausgrid’s specific arguments in its letter of 8 February 2018, we make the following comments:

- We consider the full 2014-19 AER determination for Ausgrid was set aside and remitted to the AER.
- We consider the proposed correction is within the scope of the directions in paragraphs (a) to (c) of the Tribunal’s orders, with particular reference to paragraph (c).

¹⁶⁰ AER, *Proposed correction to an inflation calculation error impacting ActewAGL distribution determination 2014-19*, 15 December 2017.

¹⁶¹ Ausgrid, *Response to AER correspondence of 15 Dec 2017 – Proposed correction of an inflation calculation error impacting Ausgrid distribution determination 2014-19*, 8 February 2018.

- Even if that were not the case, the AER considers that the directions do not expressly, or by implication, limit the scope of the remittal to those issues identified in those paragraphs.
- We consider the Tribunal decision indicates the Tribunal did not intend to limit the scope of the remittal to the AER or to prevent the AER from making a determination that is consistent with the relevant laws.
- In the event we did not have power to correct for the inflation error in the remittal, we would make the remittal determination using the prior inflation number of 2.38 per cent and immediately correct the error via revoking and substituting the remade determination under clause 6.13 of the NER, as there would be a material error in the determination.
- The use of outturn inflation is not appropriate in the way proposed by Ausgrid under the regulatory framework. The nominal allowed return in this remittal decision incorporates expectations of inflation. Therefore, the framework requires temporarily consistent expectations of inflation. The fact that outturn inflation was lower does not reflect under-compensation. It reflects ex post inflation risk that Ausgrid faced and is fully compensated for bearing ex-ante under the regulatory framework.
- The AER remains of the view the ex-ante treatment of inflation in the regulatory framework is appropriate for the reasons set out in its final decision on the inflation review.

5.4.3 Minor correction to our 2015 final decisions

On 20 May 2015, we published an open letter notifying our intention to correct several errors in our April 2015 final decision once any appeal to that decision is resolved.¹⁶² If this remade draft decision becomes our final decision, and as part of the decision for Ausgrid, we will refer and give effect to that open letter published on our website. The letter sets out our proposed correction for the following errors in our 2015 final decision:

1. Inaccurate description of metering in Appendix A to the Overview

- In April 2015, we released our 2014-19 distribution determination for Ausgrid. In May 2015, we agreed with Ausgrid that Appendix A to the Overview of the determination contained an inaccurate description of metering services classification. This description did not align with the (accurate) description in Attachment 16 (alternative control services) of the determination. We also agreed with Ausgrid that it would be inappropriate to revoke and substitute the determination to correct the error at that time, and that we would amend the error once any appeal in relation to our distribution determination was resolved. In practice, throughout this regulatory control period, we have been applying the correct classification of metering services, as reflected in Attachment 16 of the 2014-19 determination, through the enforceable

¹⁶² AER, *AER letter to Ausgrid about correcting errors in distribution determination 2015–16 to 2018–19*, 20 May 2015.

undertakings and annual pricing proposal processes. Accordingly, as there is no residual error to correct, we consider this matter as resolved and closed.

2. Inaccurate public lighting prices

- In practice, throughout this regulatory control period, we have been applying correct public lighting prices through the enforceable undertakings and annual pricing proposal processes. Accordingly, as there is no residual error to correct, we consider this matter as resolved and closed.

3. Parameter missing for control mechanism

- This matter has been superseded by the proposed approach to resolving this remittal for Ausgrid. Please refer to section 5.4.1.

If this remade draft decision becomes our final decision, to ensure the relevant legal documents accurately reflect our decisions, the correction set out in the open letter shall form part of our decision for Ausgrid's remitted determination and supersede the errors we had identified in our 2015 final decision.

Appendix A

Background on our remade draft decision

The AER is required to determine the revenue allowance for distributors under the National Electricity Rules (NER).

As part of the transitional arrangements for major changes to national rules for the regulation of distributors made in November 2012, the Australian Energy Market Commission (AEMC) deferred the full regulatory determination process for NSW and ACT distributors' 2014-19 regulatory control period. On 16 April 2014, as part of the transitional arrangements, we determined a placeholder revenue allowance for the 2014-15 transitional regulatory control period.

In May 2014, we received the NSW and ACT distributors' regulatory proposals for the 2014-19 regulatory control period, after which the full determination process commenced. We assessed the revenue allowances for the whole 2014-19 regulatory control period, and trued up any difference between the placeholder revenue allowance and revenue requirement for the transitional year.

2015 final decisions for the 2014-19 regulatory control period

On 30 April 2015, we published final decisions for the 2014–19 NSW and ACT electricity distribution determinations. In these decisions:

- We did not accept the distributors' proposed opex forecasts, and instead substituted our own alternative opex forecasts. We found the actual opex incurred by Ausgrid, Endeavour Energy and Evoenergy (formerly ActewAGL) in their proposed base year of 2012-13 was materially greater than what a prudent and efficient network service provider would incur in delivering safe and reliable network services to customers, and therefore these revealed costs could not be used as a basis to forecast opex for the 2014-19 regulatory control period. In the case of Endeavour Energy, we did not find any evidence of material inefficiency in the actual opex it incurred in its proposed base year, but if the proposed significant opex increase for vegetation management costs were included, then we would not be satisfied that the total forecast opex would reasonably reflect the opex criteria.
- We did not accept the distributors' proposed method for estimating allowed returns on debt. In relation to the debt transition, we did not accept the distributors' proposal to immediately use a trailing historical average. Instead, we used a transition that started from an on-the-day based estimate of the cost of debt and transitioned this to a trailing average over ten years.

Limited merits review

On 17 July 2015, the distributors sought limited merits review of our final decisions by the Australian Competition Tribunal (Tribunal). The Public Interest Advocacy Centre (PIAC) also applied for review of our NSW final decisions. Additionally, the Commonwealth Minister for

the Environment and Energy intervened. The key areas under review were opex, the cost of debt and the value of imputation credits (gamma).

On 26 February 2016, the Tribunal handed down its decisions. It remitted our decisions to us to be remade, in accordance with its orders on:¹⁶³

- Opex (and for Evoenergy, the implications of this for the Service Target Performance Incentive Scheme):¹⁶⁴ the Tribunal found it was open to us not to accept the distributors' opex forecasts, but had a number of concerns with how we derived our alternative opex forecasts.¹⁶⁵ In particular, the Tribunal considered that we relied too heavily on the results of a single benchmarking model to derive our alternative opex forecasts.¹⁶⁶
- Cost of debt: the Tribunal instructed us to remake the constituent decision on return on debt in relation to the introduction of the trailing average in accordance with the Tribunal's reasons for its decisions without giving a clear clarification of the directions for the remittal.¹⁶⁷

Judicial review

On 24 March 2016, we applied to the Full Federal Court (Court) for judicial review of the Tribunal's decisions on the value of imputation credits (gamma), return on debt and opex. The crux of our argument was that the Tribunal misinterpreted the scope of the reviewable errors in s 71C of the National Electricity Law (NEL).

On 24 May 2017, the Court dismissed our appeal and upheld the Tribunal's decision in relation to opex and cost of debt. It upheld the AER's appeal in relation to gamma — by consent, following the Court's decision, the parties agreed that paragraph 1(c) of the Tribunal's direction to the AER be set aside (together with consequential reference to paragraph (d)).

Undertakings provided by distributors

During the time the appeal processes were underway, all of the distributors submitted their annual pricing proposals consistent with our final decisions for the 2015–16 regulatory year, which we approved.¹⁶⁸ However, following the Tribunal's decision and our subsequent

¹⁶³ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1; *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2; *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 3; *Application by ActewAGL Distribution* [2016] ACompT 4.

¹⁶⁴ The Tribunal upheld the distributors' challenges to the AER's allowances for returns on debt, the value it set for gamma (which was later set aside by the Federal Court in judicial review) and Evoenergy's (formerly ActewAGL) Service Target Performance Incentive Schemes.

¹⁶⁵ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1.

¹⁶⁶ *Ibid.*

¹⁶⁷ *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1, direction 1 (b); *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2, direction 1 (b); *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 3, direction 1 (b); *Application by ActewAGL Distribution* [2016] ACompT 4, direction 1 (b).

¹⁶⁸ In May 2014, the NSW/ACT distributors had submitted to us their 2014–15 annual pricing proposals for their respective networks. We assessed these proposals for compliance with Part 1 of the NER and our 2014–15 placeholder distribution determinations. Subsequently, we approved each of the distributors' 2014–15 pricing proposals.

judicial review application, there was considerable uncertainty regarding the effect of the Tribunal's decision on pricing and non-price matters, undermining stability and transparency for consumers, retailers and the distributors.

We addressed this uncertainty in May 2016 by accepting enforceable undertakings given by the distributors under section 59A of the NEL that set out how network revenues and tariffs will be determined in 2016–17.¹⁶⁹ Evoenergy, Ausgrid, Endeavour Energy and Essential Energy's Network Use of System (NUoS) Tariffs in 2016–17 were set as their 2015–16 approved tariffs, adjusted to include changes in the consumer price index (CPI) in 2015-16.¹⁷⁰

As of May 2017, the Court had not yet handed down its decision, so we accepted further undertakings given by the distributors to establish new interim arrangements to govern the setting of network tariffs in 2017–18.¹⁷¹ Evoenergy, Ausgrid and Endeavour Energy's NUoS Tariffs in 2017–18 were also set as their 2015–16 approved tariffs, adjusted to include changes in the CPI in 2015–16 and 2016–17.¹⁷² Essential Energy undertook to continue to apply the terms of, including the price path determined in, our April 2015 final decision, for 2017–18 and 2018–19, and to account for and give effect to the new tariff structure statements from 1 July 2017.

As of March 2018, as the remittal process was not yet settled, we accepted further undertakings from NSW and ACT distributors for 2018-19.¹⁷³

The effect of these undertakings is that the revenues recovered by the distributors during 2016–17, 2017–18 and 2018-19 are likely to differ from that which they are entitled to recover after we remake our decisions. On 1 August 2017, the AEMC made a rule that allows us to let the distributors recover such differences over both the 2014–19 and 2019-24 regulatory control periods.¹⁷⁴ The intent is to minimise the potential for significant fluctuations in retail prices that consumers may experience from one period to the next. The rule allows us to make revenue adjustments to smooth revenue across, or allocate it between, these regulatory control periods. Such adjustments are given effect through the pricing proposal and distribution determination processes.

¹⁶⁹ Ausgrid, *Ausgrid enforceable undertaking*, May 2016. Endeavour Energy, *Endeavour Energy enforceable undertaking*, May 2016. ActewAGL, *ActewAGL enforceable undertaking*, May 2016. Endeavour Energy, *Endeavour Energy enforceable undertaking*, May 2016.

¹⁷⁰ Network Use of System (NUoS) Tariffs traditionally include distribution use of system tariffs and transmission use of system (TUoS) tariffs. We included TUOS tariffs in the undertakings to ensure price stability and predictability.

¹⁷¹ Ausgrid, *Ausgrid enforceable undertaking*, May 2017. Endeavour Energy, *Endeavour Energy enforceable undertaking*, March 2017. ActewAGL, *ActewAGL enforceable undertaking*, May 2017. Endeavour Energy, *Endeavour Energy enforceable undertaking*, May 2017.

¹⁷² These enforceable undertakings also obliged the ACT and NSW distributors to continue to provide network services consistent with the non-price terms and conditions of their 2015–19 electricity distribution determinations.

¹⁷³ *Open letter to stakeholders: Electricity network charges in the ACT and NSW from 1 July 2018*, 21 March 2018.

¹⁷⁴ AEMC, *Rule determination: National Electricity Amendment (Participant derogation - ACT DNSP revenue smoothing) Rule 2017, 1 August 2017*; AEMC, *National Electricity Amendment (Participant derogation - ACT DNSP revenue smoothing) Rule 2017 No. 7, commencing 15 August 2017*; AEMC, *Rule determination: National Electricity Amendment (Participant derogation - NSW DNSPs revenue smoothing) Rule 2017, 1 August 2017*; AEMC, *National Electricity Amendment (Participant derogation - NSW DNSPs Revenue Smoothing) Rule 2017 No. 6, commencing 15 August 2017*.

The remittal task – remaking our decisions for 2014-19

Following the Court’s decision, the Tribunal’s directions that we are to comply with in remaking the decision are as follows:¹⁷⁵

- “(a) the AER is to make the constituent decision on opex under r 6.12.1(4) of the National Electricity Rules in accordance with these reasons for decision including assessing whether the forecast opex proposed by the applicant reasonably reflects each of the operating expenditure criteria in r 6.5.6(c) of the National Electricity Rules including using a broader range of modelling, and benchmarking against Australian businesses, and including a ‘bottom up’ review of Ausgrid’s forecast operating expenditure;
- (b) the AER is to make the constituent decision on return on debt in relation to the introduction of the trailing average approach in accordance with these reasons for decision;
- ...
- (d) the AER is to consider, and to the extent to which it considers appropriate to vary the Final Decision in such other respects as the AER considers appropriate having regard to s 16(1)(d) of the National Electricity Law in the light of such variations as are made to the Final Decision by reason of (a)–(c) hereof.”

¹⁷⁵ Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT1. Note direction (c) is omitted following the Court’s decision in relation to gamma: *Australian Energy Regulator v Australian Competition Tribunal (No 3)* [2017] FCAFC 80, [738]-[784].