# Appendix 2.02

# Interrelationships between draft decision components

## Revised 2016-21 Access Arrangement Proposal

## Response to the AER's draft decision

January 2016

# Interrelationships between draft decision components

The NGL requires the AER, in making its determination on access arrangement proposals, to take account of the interrelationships between the components of its decision.[1] A decision on one aspect of the proposal can have implications for one or more other elements of the decision, and the overall decision. These interrelationships must be taken into account to ensure that the NGO preferable decision is made.

We observe that while the AER identifies some relevant interrelationships in its draft decision, it has not given full and proper consideration to all the relevant interrelationships. This is illustrated by reference to our analysis of interrelationships in our June 2015 submission.[2]

In the June 2015 submission we included a table showing the interdependencies between the elements of the proposal. This table is reproduced in part in Table 1 below.[3] We have expanded the table to include comments on the implications of the draft decision.

**Table 1 Interrelationships and implications of the draft decision**

| Elements of the proposal | Interrelationships | Implications of the draft decision |
|---|---|---|
| Cost of capital | The WACC has implications for the ability of AAD to fund its proposed expenditure programs.<br><br>Changes to any component of the WACC proposal will have implications for other WACC components and the revenue building blocks. For example, a change in the return on equity will impact the return on capital, depreciation and tax payable revenue building blocks. A change in the return on debt assumption will have similar effects due to the interrelations between the WACC and the capital base. | The AER has rejected our proposed WACC of 7.15% and replaced it with a WACC of 6.09%.<br><br>The AER has not properly addressed the implications this will have for AAD's ability to fund its proposed expenditure programs, and AAD's ability to continue to deliver the strong reliability performance that it has delivered over the current period, and that consumers continue to demand.<br><br>The AER's draft decision on the cost of capital is also a significant driver of the value of the true-up (or revenue reconciliation) for 2015/16. The AER has retrospectively applied its rate of return draft decision to 2015/16.<br><br>In addition, we do not accept the AER's suggestion in the draft decision that there is an interrelationship between the method for transitioning to the trailing average approach to estimating the return on debt and the equity beta. |

[1] NGL section 28(1)(b)(ii).

[2] ActewAGL Distribution 2015, *2016-21 Access arrangement information – Overview*, June, pp. 42-43

[3] The AA/AAI reference column from June 2015 has been removed, to avoid confusion with references to this January revised proposal.

| Elements of the proposal | Interrelationships | Implications of the draft decision |
|---|---|---|
| Forecast opex | Efficient management of the network involves trade-offs between capex and opex, and these must be taken into account when the capex and opex allowances are set. For example, if the AER rejects AAD's proposed maintenance expenditure, this will have implications for the required asset replacement expenditure in the 2016-21 access arrangement period and future periods. | The draft decision opex allowance is 8.3% below our proposal.<br><br>While the AER has noted some opex interdependencies in the draft decision, it has not correctly addressed the interrelationships between the setting of the opex allowance and the operation of the efficiency carryover mechanism (ECM). |
| Incentive mechanism | The ECM is intrinsically linked to the forecasting approach to opex. It is by applying an ECM in combination with a revealed cost base-step-trend forecasting approach that a service provider is provided with a continuous and time invariant incentive to achieve efficiency gains, which are shared between network service providers and consumers in the proportions 30:70. | In the draft decision the AER has failed to correctly apply the ECM in combination with a revealed cost base-step-trend opex forecasting approach. This jeopardises the incentives to achieve efficiency gains and fair sharing of such gains between AAD and consumers that the ECM is designed to deliver. |
| Forecast demand and connections | Forecast throughput and connections influence the price path under the WAPC. If the AER rejects AAD's forecasts, AAD will be forced to bear additional revenue risk.<br><br>Forecast connections and maximum demand are drivers of the capex program. If the AER rejects the forecasts and the associated capex, AAD may not be able to deliver the services consumers demand. | The AER has rejected our residential connections forecast and adopted a significantly lower forecast.<br><br>The AER has not addressed the impact of its lower residential connection forecast (and associated lower capex) on AAD's ability to connect new customers and deliver the services that consumers demand. |
| Forecast capex | As noted above, forecast capex and opex are closely linked. A decision by the AER to reject the proposed capex allowance will also have implications for the ability of AAD to expand its market and achieve the connections forecast. Deferring capex in the 2016-21 period will also result in higher costs and higher prices in future periods. | The draft decision capex allowance is 38.9% below our proposal.<br><br>In the draft decision the AER notes that it has considered trade-offs between potential capex and opex solutions. |
| Revenue requirement and price path | Changes to any of the proposed building block elements or the throughput and connections forecasts will have implications for the price path (X factors), which AAD has developed in consultation with its customers. | The AER's draft decision revenue allowance is 21 per cent below our proposal.<br><br>The AER has not addressed the impact of this lower overall revenue allowance on AAD's ability to recover its efficient costs of delivering its services and complying with its regulatory obligations.<br><br>The AER has also retrospectively set a revenue allowance for 2015/16, which influences the |

| Elements of the proposal | Interrelationships | Implications of the draft decision |
|---|---|---|
| | | value of the true-up (or revenue reconciliation). As explained in our *Response to the draft decision (Overview)*, we have estimated a revised value of the true-up which takes account of our revised values for the building blocks for 2015/16. We maintain our position that if the AER applies a true-up, our approach and revised parameters should be used to calculate the value. |
| Reference tariff variation mechanism | A decision by the AER not to accept the proposed reference tariff variation mechanism, or any element of it, will mean that AAD may not be able to recover its efficient costs, and/or not tailor tariffs to the needs of particular customers or market segments. | While the AER has accepted some elements of our reference tariff variation mechanism it has not accepted all elements of our proposed cost pass through arrangements. In doing so it has not addressed the implications for the ability of AAD to recover its efficient costs. |