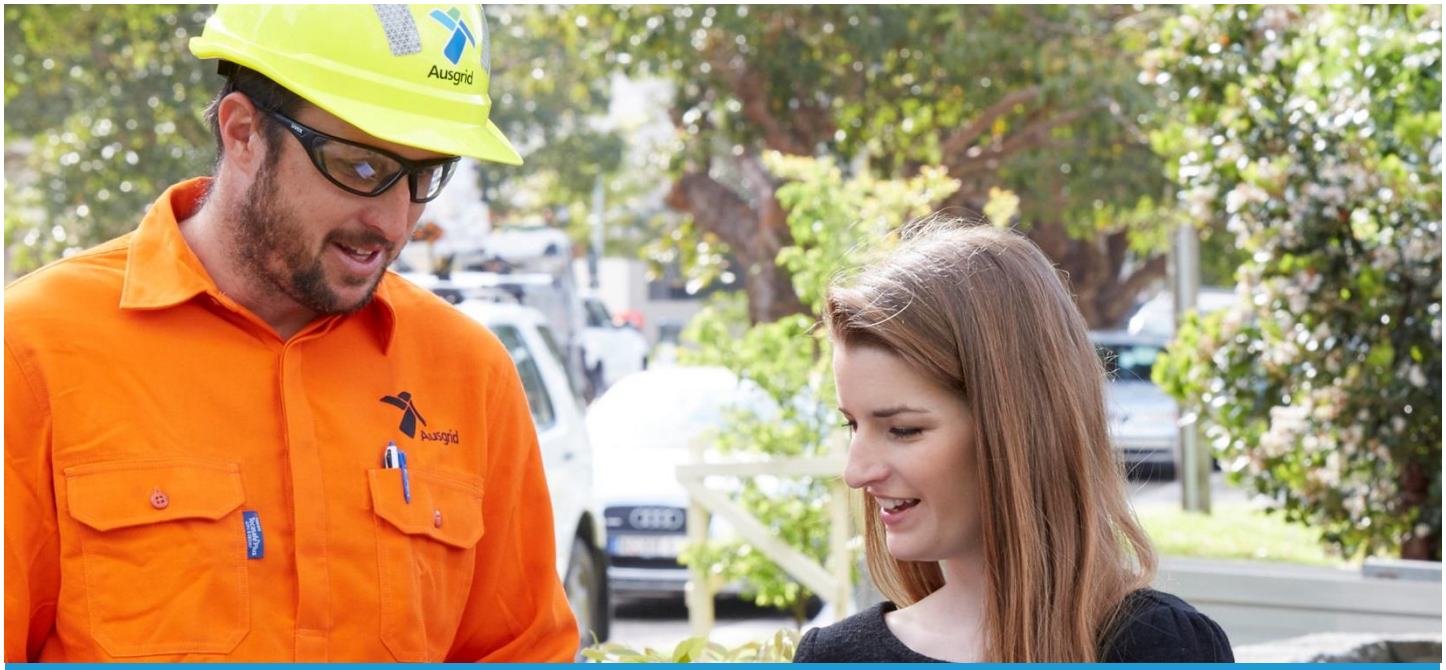


OVERVIEW

Revised Tariff Structure Statement

October 2016

Ausgrid

Contents

A note to our customers

Our Revised Tariff Structure Statement (TSS) outlines reforms that will improve the efficiency of our electricity network tariffs, and the safeguards we are putting in place for our customers.

The TSS is a new requirement under the National Electricity Rules (the Rules) to promote more efficient network tariffs. Efficient network tariffs reflect the underlying cost of delivering a safe and reliable supply of electricity to our different customers and the fair price customers should pay for using the electricity network.

Tariffs that better reflect underlying cost drivers promote economic efficiency by encouraging electricity consumers to make efficient consumption decisions that can reduce both their energy bill and the cost of providing the electricity network service they require. Importantly, the regulatory framework governing the services we provide ensures that improvements in efficiency or cost savings are ultimately passed on to our customers through lower prices. It therefore follows that tariff reform has the potential to provide significant and long-lasting benefits to our customers.

The new Rules require us to start transitioning to more efficient tariffs from 1 July 2017. However, we must also consider the impact on our customers from any changes to our tariff structures. This revised TSS acknowledges feedback from our stakeholders and the AER about a number of issues, including our previously proposed declining block tariff. The reforms presented in our TSS are summarised in section 4 of this Overview.

A key issue raised by our stakeholders and the AER was the need to safeguard customers from potential and sudden bill increases, therefore, our TSS includes a number of additional measures directed at protecting customers, including:

- new transitional tariffs that ensure customers do not incur an unacceptable change in their bill as a result of particular reforms; and
- a constraint on the extent to which fixed charges will change.

With these safeguards in place, we are confident that the proposed changes to our tariffs and policies will not have disproportionate impacts on our customers, particularly vulnerable consumers. Because we are required to operate under a revenue cap, any tariff changes that we are proposing will also not increase the total amount of revenue we collect.

Our analysis shows that our reforms will result in customer bill changes that are either on average in line with inflation, or reducing. For example, we expect 60 per cent of residential customers on a TOU tariff to see a reduction in the network component of their electricity bill.

I would like to thank the consumer groups, industry associations, electricity retailers and the AER for the time and effort they have taken to help us develop this revised TSS. In particular, I acknowledge their comments that more time and care could be taken to engage with stakeholders earlier in the TSS process, and to do so more thoroughly, so that our TSS can better reflect their views on tariff design, customer behaviour and impacts.

We are committed to making these changes and have already started to plan for our next TSS for the 2019-24 period. This includes working with stakeholders on the design of an engagement and consumer insights program to help us better test future tariff design. This will include topics such as demand charges for residential customers and further refinement to both TOU and non-TOU tariffs

Trevor Armstrong
Acting Chief Executive Officer
Ausgrid

1 Our network costs and tariffs

Ausgrid operates the poles and wires in eastern Sydney, the Central Coast and the Hunter regions of New South Wales. We recover only the cost of providing efficient and reliable network services – as determined by the AER – through network tariffs, which account for about 40 per cent of a typical residential bill.

1.1 About our network

Ausgrid's network – often called "the poles and wires" – is a key element of the electricity supply chain that delivers electricity to customers' premises. Once power is generated, it is transported at high-voltage over long distances by TransGrid. Our network then transforms the power into lower voltage electricity at sub-transmission and zone substations. This electricity is again transformed at local distribution substations so it can be safely supplied to our customers.

We build, maintain and operate more than 200 zone substations, 30,000 distribution substations, 48,000 kilometres of power lines and 500,000 power poles. These assets, along with our depots and other properties, are known as our regulated asset base and are worth approximately $15 billion. Our network transports electricity to more than 1.7 million customers in eastern Sydney, the Central Coast and the Hunter Region regions of New South Wales.

Our objective is to deliver safe, reliable and affordable energy services. Consistent with recent industry reform in NSW, our focus has been on reducing our costs without compromising the safety and reliability of the services our customers require.

1.2 Network cost drivers

In recent years, changes in technology and customer preferences have led to customers using more energy at similar times of the day and night, which has led to peaks in electricity demand. Since we need to build our network to accommodate these peaks in demand, the use of electricity during peak times can contribute to a need for further investment in our network, thereby increasing our costs. Therefore, peak demand is a key driver of our costs.

It follows that the decisions made by our customers as to the level and timing of their energy consumption have a significant bearing on the costs of providing our services. In this context, it is important that we provide customers with price signals that reflect the true cost of delivering their electricity, particularly when further use of our network at peak times may contribute to a need for further investment in our network.

At the same time, a large part of our ongoing costs relate to past investment in our electricity network and therefore are not affected by the consumption levels of customers. These fixed costs are referred to in the Rules as residual costs.

The key challenge is to design our tariffs to signal to customers the efficient cost of their network usage and to ensure that our fixed costs are efficiently and equitable recovered.

1.3 How we recover revenue using network tariffs

Every five years the Australian Energy Regulator (AER) assesses the forecast cost of efficiently providing the services that our customers require. Based on these approved costs, the AER determines a revenue allowance for each year of the regulatory period. In our case, the AER made a determination in 2015 which set the maximum revenue we could recover for each year of the 2014-15 to 2018-19 period.

Our tariffs recover the costs of delivering electricity to our customers. We apply these charges to electricity retailers, which pass on these charges to their customers via their electricity bills.

Ausgrid operates under a revenue cap framework, which means that if our revenue exceeds or is below the annual revenue requirement – as determined by the Australian Energy Regulator (AER) – adjustments will be made to future prices to reflect

this excess or shortfall. It is therefore important to note that any tariff changes will not increase the total amount of revenue we collect.

We establish our network tariffs every 12 months in a pricing proposal that is approved by the AER. Going forward, our tariff structures must comply with the structures set out in our AER-approved TSS and must be set so as to permit the recovery of our efficient costs only, as determined by the AER.

Tariff classes

It would be time consuming and inefficient to develop an individual tariff for each of our 1.7 million customers. For this reason, we assign customers with similar characteristics to a tariff class.

Figure 1 below provides an illustration of tariff classes, where voltage level is a main distinction between tariff classes.

Tariffs and charging parameters

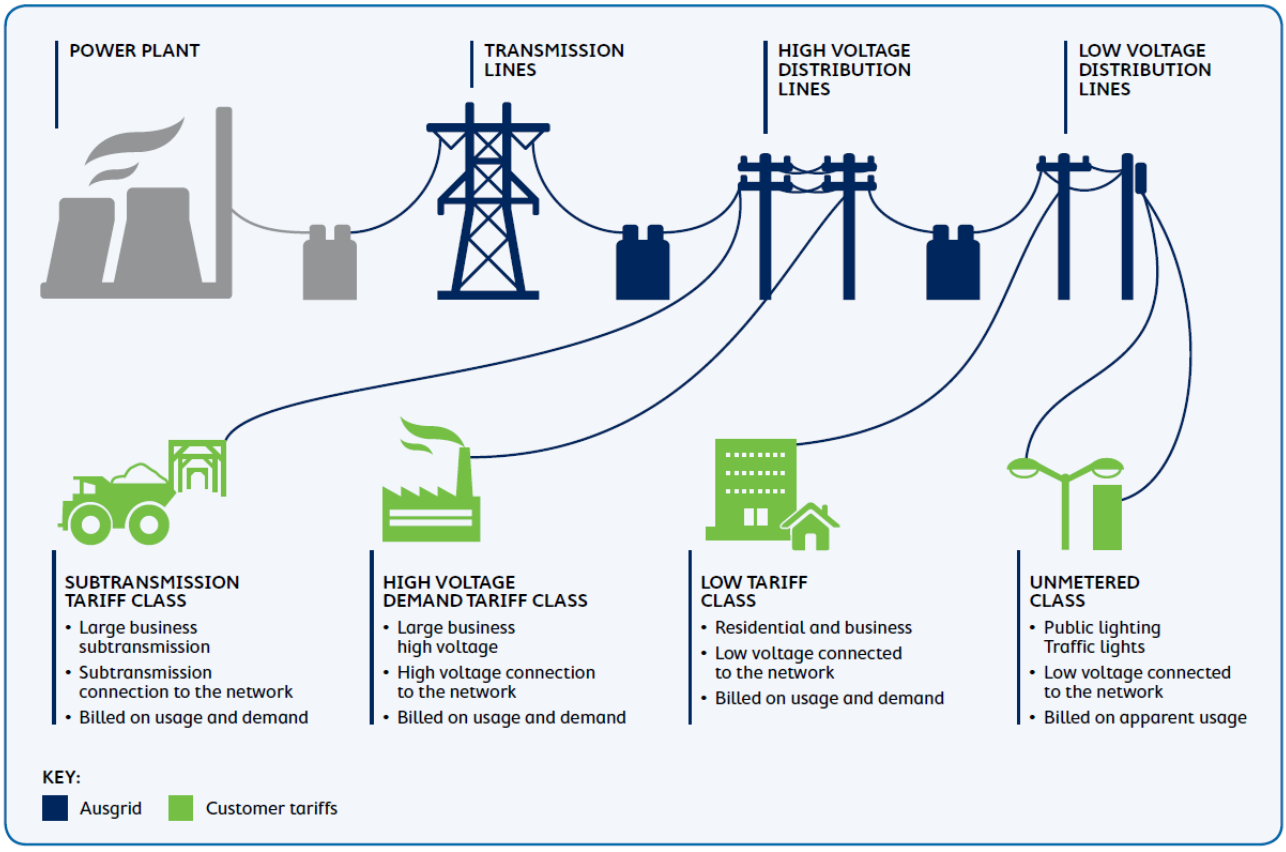
Our next step is to assign the customers in each tariff class to a particular tariff. We do this by reference to a number of factors, such as whether the customer is a residential or business customer, and the level of the customer's annual electricity consumption.

Each tariff consists of one or more charging parameters, which typically include both fixed and variable components. The actual charge is the numerical value assigned to a charging parameter, eg, 'cents per kilowatt hour' or 'cents per day'.

The type of meter a customer has plays a significant role in the types of tariffs that we can offer to particular customers. There are many different types of electricity meters, which can be broadly classed into three groups. A traditional (or basic) accumulation meter tracks total power use over time, while an interval meter records both power use and the time at which that use occurred, and so is compatible with time-based tariffs. Similarly, a smart-meter records power use every 30 minutes, but can also communicate remotely.

Across Ausgrid's network, around 1.3 million customers have a basic accumulation meter installed in their property and more than 440,000 customers have an interval meter, while a small number have a smart-meter.

Figure 1: Tariff classes and customers



Within a customer's tariff there will be a mix of charging parameters, the nature of which is generally dictated by the customer's meter type. For example, a customer with a basic accumulation meter installed in their property will generally pay a fixed charge and an energy charge:

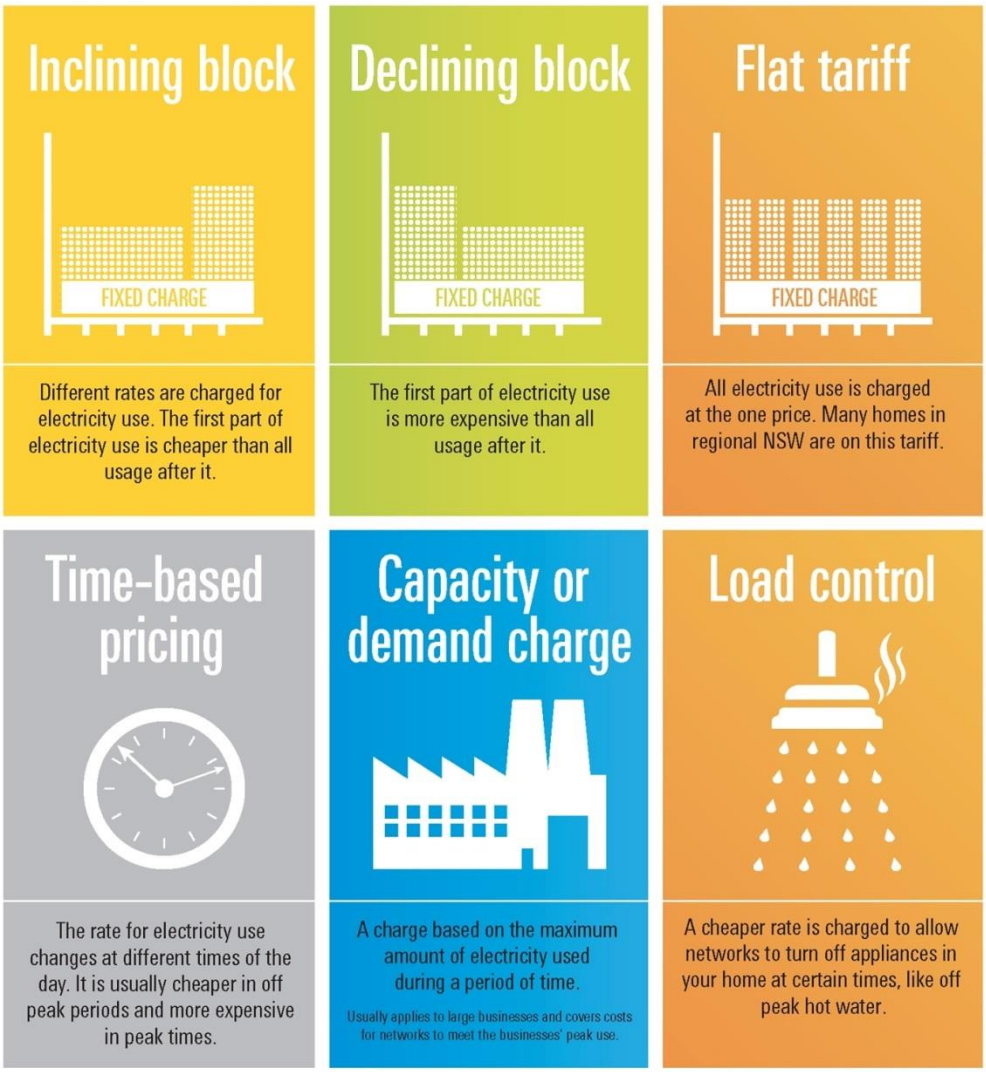
- a fixed charge is generally an annual supply charge (often cents per day) that applies to each connected premises – the amount does not vary with the amount of energy that is used; and
- an energy charge applies to each unit of electricity consumed (generally in cents per kilowatt hour) – depending on the particular tariff, the consumption charge may involve a rate for blocks of consumption (for example flat or inclining or declining blocks).

A customer with an interval meter installed in their property could potentially face a fixed, energy and/or demand charge:

- a fixed charge is generally an annual supply charge (often cents per day) that applies to each connected premises – the amount does not vary with the amount of energy that is used;
- an energy charge applies to each unit of electricity consumed (generally in cents per kilowatt hour), and the level of the energy charge may vary across pre-defined times of the day, eg, peak, shoulder and off-peak periods; and
- a demand charge may be applied to a customer's capacity requirement - it is generally measured in dollars per kilowatt or kilovolt-ampere.

Figure 2 provides further information on some of the key concepts in tariff design.

Figure 2: Types of tariffs



2 Tariff reform background

The TSS is part of a new Rule that seeks to promote more efficient price structures, which can lower the cost of providing network services for our customers, and therefore network charges. Our TSS comes into effect on 1 July 2017.

2.1 Changes to the Rules

In late 2014, the National Electricity Rules were changed to require distribution networks to set more efficient or cost-reflective tariffs.

Tariffs that better reflect underlying cost drivers promote economic efficiency by encouraging electricity consumers to make efficient decisions about their electricity use that can reduce both their energy bill and the cost of providing the electricity network service they require. The regulatory framework governing the services we provide ensures that improvements in efficiency or cost savings are ultimately passed on to customers through lower prices. In other words, more efficient tariffs can encourage customers to use our electricity network more efficiently, which ultimately leads to lower electricity network prices than would otherwise have been the case.

For these reasons, tariff reform has the potential to provide significant and long-lasting benefits to our customers.

As part of the Rule change we are required to publish a TSS that provides clarity on our approach to setting tariffs for the next regulatory period. Electricity distribution network businesses are required to submit a TSS as part of their regulatory proposal so that the document can apply for the next regulatory period.

In the case of the NSW distributors, the Rule change came into effect after we had submitted our regulatory proposal for the 2014-2019 period, and so we are required to submit a TSS that applies from 1 July 2017 until the end of the current regulatory period (30 June 2019).

We submitted our draft TSS in November 2015 and, in August 2016, the AER published its draft decision, encouraging Ausgrid to consider further various elements of its approach to tariff reform. Taking into account feedback from our stakeholders and the AER, we submitted this revised TSS on 4 October 2016, which addresses the feedback we received and sets out the justification for our approach. The AER will publish its final decision on our revised TSS in February 2017.

2.2 Contents of Ausgrid's revised TSS

Ausgrid has listened to feedback from stakeholders and the AER in developing our revised TSS, helping us to develop measures that protect customers from unacceptable bill changes.

Our TSS contains detailed information on reforms to our tariffs for direct control services[1] to be introduced progressively from 1 July 2017. It addresses the specific Rule requirements by including:

- the proposed tariff classes into which retail customers will be divided;
- the proposed procedure for assigning or re-assigning retail customers to tariffs;
- how the TSS complies with the pricing principles in the Rules;
- the structures and components for each proposed tariff; and
- an indicative pricing schedule for each tariff for the remainder of the current regulatory control period.

Our revised TSS also spells out the underlying rationale for our reforms and our methodology for determining cost-reflective prices. We also identify the specific considerations that influenced our decision to depart from efficient tariffs, namely our desire to avoid customer bill impacts.

[1] The TSS only applies to services classified as direct control services including network services, ancillary network services, metering services and public lighting services. For the latter 3 services, the AER has already established a price that Ausgrid can charge its customers, such that we simply re-state these prices in the TSS and focus our document on network services.

3 Engaging our stakeholders

We have engaged with stakeholders and sought to address their views throughout the development of our TSS.

The focus of our TSS engagement has been to meaningfully explore insights and options for tariff reform with our customers, retailers, the AER and other stakeholders. Some views have been taken into account in changes we have made as part of this TSS. Other comments or suggestions we have deferred pending more detailed analysis or engagement to ensure they give rise to no unacceptable adverse impacts on our customers or our required revenue.

Ausgrid engaged with stakeholders in the lead up to the submission of its initial proposed TSS in November 2015, although we acknowledge that there was limited scope for stakeholders to express their views on this initial TSS, and for their views to be genuinely considered in the compressed timeframe. This view was shared by many stakeholders, who would have preferred more time to consider alternative tariff options and their implications. We acknowledged those concerns and noted that the development of our revised TSS provided our stakeholders with additional opportunities to provide feedback.

Ausgrid took advantage of the period between the release of the AER's Draft decision on our TSS and the deadline to submit our revised TSS as an opportunity to listen to the views from stakeholders and asses which elements can be included and which ones should be considered more thoroughly for our next TSS, which is due to be submitted to the AER in less than 15 months' time.

We held briefing sessions, produced a succinct options paper and reported back to stakeholders on the changes we proposed to make in the revised TSS, and on which issues require more extensive analysis.

There was uniform support amongst stakeholders for our decision to replace the declining block tariff structure. Most stakeholders accepted the flat tariff structure as an acceptable substitute; however, some stakeholders requested further consideration of an inclining block tariff, while generally recognising that this matter should be considered as part of the next TSS.

A key issue for some stakeholders was the time periods for the residential TOU tariff, namely the summer peak period and the weekend shoulder period. In the days after the mid-September stakeholder workshop, Ausgrid sent stakeholders a follow-up communication reflecting on the views provided by stakeholders in the workshop and how Ausgrid proposed to take those views into consideration, bearing in mind the short timeframe for submission of the revised TSS. Specifically, we explained that our preferred approach was to:

- retain the 2pm to 8pm peak period in the summer months;
- reduce and shift the winter peak period to 5pm to 9pm for residential customers; and
- retain the weekend shoulder period for residential customers.

Our decision to retain the existing summer peak period reflects significant diversity in the timing of peak demand across our network, the network-cost implications of an inappropriate peak period and the tight time frame for submission of the revised TSS. Nevertheless, Ausgrid is committed to making this a key area of focus in the next TSS, which will enable us to undertake the research, detailed analysis and consultation necessitated by a reform of this magnitude.

We outlined to stakeholders that our preferred position was to retain the weekend shoulder period in the current regulatory control period due to the price and customer impacts of removing the weekend shoulder. Removing the weekend shoulder would necessitate a substantial increase in the shoulder price, with corresponding adverse bill impacts on customers with usage in the shoulder period on weekdays. Ausgrid proposed to consider reforming

the weekend shoulder period for residential customers once it has mitigated the customer impacts of the substantial reforms proposed in this TSS, ie, as part the next TSS.

Further, we are mindful of the potential confusion and inconvenience of adopting a changed position on the charging windows for the 2017-19 period, where further analysis as part of the next TSS may indicate that further changes are again required.

With this mind, we proposed to work closely with stakeholders to help build an overall research and engagement program on future tariff structures that would include a review of existing knowledge and research on electricity tariffs to help inform this overall approach. This will include discussion on the merits of future trials or pilots on tariffs, including changes to charging windows and the impacts on customers or likely customer response. This work has already begun.

Ausgrid considers that it is in everyone's interest to build a considered engagement program with our stakeholders before making changes to tariff designs. Our engagement with stakeholders identified key areas of focus for consideration as part of the consultation for the next TSS, including:

- the future of the non-TOU tariff for residential and small business customers;
- the potential to implement a demand charge for residential customers;
- the scope to reform the peak periods and the weekend shoulder period; and
- how best to mitigate customer bill impacts for low-income and vulnerable householders.

Ausgrid looks forward to further consultation with stakeholders on these matters and continuing to work together in developing and implementing Ausgrid's transition to efficient tariffs.

4 Our approach to tariff reform

Our tariff structure reforms represent a significant step towards efficient price structures, while containing appropriate safeguards for our customers.

4.1 Balancing efficiency and customer impacts

When developing our TSS we have sought to move towards an efficient tariff structure while minimising adverse impacts on our customers. Therefore, consistent with the framework established by the Rules, our approach to developing our proposed tariffs broadly involved:

- developing an 'efficient tariff' directed purely at the promotion of economic efficiency;
- evaluating the customer impacts arising from this 'efficient tariff', which we deemed unacceptable;
- developing proposed reforms that strike a better balance between the promotion of economic efficiency for the long term interest of consumers and the mitigation of adverse customer bill impacts from year-to-year; and
- improvements to the way we engaged and listened to stakeholders throughout this process.

On the basis of our assessment of the customer impacts arising from purely efficient tariffs (which included marked increases in fixed charges), Ausgrid concluded that these impacts on retail customers are contrary to the customer impact principle embodied in chapter 6 of the NER. As such, Ausgrid will transition to more efficient tariff structures over a period of time that is sufficient to avoid unacceptable retail customer impacts.

This approach reflects a key concern of our stakeholders - the possibility of unacceptable bill impacts arising from improvements to the efficiency of our tariffs. In particular, the majority of stakeholders considered that there should be strong transitional pricing arrangements in place to ensure that existing customers do not face unacceptable bill changes.

4.2 Key changes to our tariffs

Our TSS, and the accompanying appendices, provide further information on our approach to developing tariff structures and price levels, our proposed reforms and indicative prices for the 1 July 2017 to 30 June 2019 period.

Bearing in mind the concerns of our stakeholders and the customer impact principle in the Rules, Ausgrid will adopt a gradual approach to reform, while avoiding unacceptable customer bill impacts. Therefore, Ausgrid will reform tariff structures in the following key areas in the 2017 to 2019 period:

- replace the existing declining block tariffs with flat-rate tariffs;
- place a constraint on any changes in fixed charges;
- introduce seasonal peak periods for our TOU tariffs;
- refine the peak period in the winter months for residential customers;
- improve our process for assigning and reassigning customers to efficient tariffs;
- introduce new transitional tariffs to prevent unacceptable customer impacts;
- remove the shoulder period on weekends for small business customers; and
- introduce a new tariff for transmission-connected customers.

We briefly explain these reforms below. A detailed discussion on these reforms can be found in our TSS.

Replacement of the declining block tariffs with a flat tariff

While a flat tariff reduces the flexibility for Ausgrid to manage the bill impact of transitioning to a usage

charge that reflects long run marginal cost (LRMC), in the AER's opinion, a flat tariff strikes a better balance between customer impact and more quickly reducing usage charges to reflect estimated long run marginal cost. Ausgrid supports the AER's view on this matter and stakeholders' preference for moving away from declining block structures. Therefore, Ausgrid is comfortable with reflecting the AER's preference for a flat tariff structure in this TSS.

Placing a constraint to limit any increases in fixed charges

Bearing in mind that more efficient tariffs generally involve higher fixed charges, Ausgrid has elected to voluntarily impose a rebalancing constraint that limits any increases in fixed charges so as to provide certainty to customers and mitigate the risk of adverse customer bill impacts.

Introducing seasonal peak periods

In developing the revised TSS, Ausgrid undertook further analysis of network congestion times, with a greater focus on localised demand patterns at the zone-substation level. The existing definition of the 'peak period' is 2pm to 8pm on all working weekdays throughout the year. However, our analyses indicated that there are efficiency gains to be achieved from the introduction of seasonal peak periods. Therefore, the peak period will apply only:

- in the summer months, from 1 November to 31 March (inclusive); and
- in the winter months, from 1 June to 31 August (inclusive).

This will mean that any consumption during the former peak periods in the autumn and spring months will be charged at much lower shoulder rates. This reform will come into effect from 1 July 2018.

Refining the winter peak period for residential customers

Our analysis indicated that a 5pm to 9pm peak period for residential customers in the winter months will better target the timing of residential peak demand in the winter months. This reform will come into effect from 1 July 2018.

Improving the assignment and reassignment of customers to tariffs

We have refined our assignment and reassignment process to ensure that a greater proportion of customers are assigned to more cost reflective tariffs, while avoiding adverse customer bill impacts.

Introducing transitional tariffs

We will introduce a number of new transitional tariffs to protect certain customers from potential bill impacts that may arise from particular reforms. These transitional tariffs will have a TOU structure, but with the same usage rate applied across the peak, shoulder and off-peak periods. This will allow customers time to understand their usage patterns, while mitigating the customer bill impact that would arise from being assigned to a more cost reflective TOU tariff.

Removing the weekend shoulder period for small business customers

At present, small business customers are charged at the shoulder rate for consumption between 7am and 10pm on weekends and public holidays. However, from 1 July 2018 Ausgrid will remove the shoulder period on weekends for small business customers and replace it with an off-peak period, consistent with the treatment of medium and larger business customers.

Tariffs for new transmission customers

Our analyses indicated that economic and equity outcomes will be improved for all customers if we introduce a default tariff for new customers connected directly to our electricity transmission network. This new tariff ensures that new transmission-connected customers do not pay for the cost of the distribution network, which they will not use. The new tariff applies only to new connections.

4.3 Impacts for our customers

Due to the safeguards we will put in place, we expect that our customers will not face adverse bill shocks while slowly transitioning to more efficient tariffs.

Indeed, the vast majority of residential customers on our non-TOU tariff will experience a bill change broadly in line with the Reserve Bank of Australia's inflation target. Further, approximately 6 out of 10 residential customers on a TOU tariff are expected to receive a bill reduction and, for the remaining residential TOU customers, their bill changes will on average be in line with inflation. Similarly, business customers are expected to realise bill changes that are on average in line with inflation.

Have your say

Provide feedback

We want to hear your views on the TSS and would like to work with you on our plans for tariff reform. You can tell us your views by:

- sending an email to pricing@ausgrid.com.au
- visiting us on Facebook: www.facebook.com/Ausgrid
- talking to us on Twitter: www.twitter.com/Ausgrid

What happens next?

- The AER will make a final decision on our revised TSS in early 2017.
- The changes we make under the final TSS will be introduced from 1 July 2017.