**Consumer Challenge Panel (Panel 5)**

**Transmission for the Generations III**

Response to:

**Revised revenue proposal by** **AusNet Services**

For:

**Transmission Revenue Review 2017-22**

**October 2016**

**VALE Dr GILL OWEN**

In September 2016, we were saddened to learn of the passing of Dr Gill Owen, who in 2013 was appointed an inaugural member of the Australian Consumer Challenge Panel, along with both of us. We worked with Gill on the very first reviews in which the Consumer Challenge Panel participated.

We take this opportunity to reflect on and acknowledge Gill’s contribution.

Gill was a quiet but determined woman of great integrity and professionalism. She generously shared with all of the Consumer Challenge Panel her experience of consumer challenge in the UK and her views on how best to do this in Australia. She was sensible, thoughtful, thorough, and unfailingly ‘spot on’ in her input to our advice to the AER. Gill’s contribution to the Consumer Challenge Panel and to the AER was immense. Gill’s unflinching commitment to better energy outcomes for end consumers cannot be questioned and in championing these outcomes there is no doubt that many people in Australia and the UK have enjoyed some savings to their energy bills.

Gill gave CCP1 the title of the first CCP report to the AER: “Jam Tomorrow” reflecting the consumer frustration that they always seem to be paying more now with the promise of lower prices one day in the future. Gill has helped bring the “Jam” closer to today.

As a person, she was a calm and courteous delight to spend time with. We enjoyed working with Gill and are very grateful that we had the opportunity to do so. She has left us too soon, but her legacy remains.

With fondest memories

Ruth Lavery and Mark Henley

[1 The Consumer Challenge Panel 1](#_Toc464664235)

[2 Overarching issues 2](#_Toc464664236)

[2.1 Process 2](#_Toc464664237)

[2.2 Context 2](#_Toc464664238)

[2.3 Application of the National Electricity Objective 4](#_Toc464664239)

[2.4 Excess precision 6](#_Toc464664240)

[2.5 Fallacy of composition 6](#_Toc464664241)

[2.6 Cherry picking 7](#_Toc464664242)

[2.7 Flat prices 8](#_Toc464664243)

[3 Rate of return, value of imputation credits, and forecast inflation 9](#_Toc464664244)

[3.1 Market risk premium 9](#_Toc464664245)

[3.2 Equity beta 10](#_Toc464664246)

[3.3 Cost of debt 11](#_Toc464664247)

[3.4 Value of imputation credits 12](#_Toc464664248)

[3.5 Inflation 13](#_Toc464664249)

[3.5.1 Reserve Bank of Australia estimates 14](#_Toc464664250)

[3.5.2 Liquidity of indexed bonds 15](#_Toc464664251)

[3.5.3 Low and negative interest rates 17](#_Toc464664252)

[3.5.4 Not the time to change the way of forecasting inflation 18](#_Toc464664253)

[3.6 Summary 18](#_Toc464664254)

[4 Operating expenditure 19](#_Toc464664255)

[4.1 Step changes 19](#_Toc464664256)

[4.1.1 Decommissioning step change 19](#_Toc464664257)

[4.1.2 Is a step change necessary? 20](#_Toc464664258)

[4.1.3 Is this a step change, or something else? 20](#_Toc464664259)

[4.2 Other opex considerations 22](#_Toc464664260)

[4.2.1 Base year 23](#_Toc464664261)

[4.2.2 SAIP roll out 23](#_Toc464664262)

[4.2.3 Labour and non-labour weights 23](#_Toc464664263)

[4.2.4 Productivity change 24](#_Toc464664264)

[AusNet Services said in their original proposal: 24](#_Toc464664265)

[5 Capital expenditure 25](#_Toc464664266)

[5.1 Safety risk 25](#_Toc464664267)

[5.1.1 Safety impacts for consumers of higher than necessary prices 26](#_Toc464664268)

[5.1.2 Safety is not the primary objective of the NEO 26](#_Toc464664269)

[5.1.3 Elimination and minimisation of risk. 27](#_Toc464664270)

[5.1.4 Hazard Zone Occupancy rates 28](#_Toc464664271)

[5.1.5 Explosive failure examples 28](#_Toc464664272)

[5.1.6 Interpretation of ARORO and BEE 29](#_Toc464664273)

[5.1.7 Diminishing time between explosive failures 30](#_Toc464664274)

[5.2 Major station replacement 32](#_Toc464664275)

[5.2 Demand forecast 32](#_Toc464664276)

[5.3 Additional capital expenditure 33](#_Toc464664277)

[6 Depreciation 34](#_Toc464664278)

[7 Incentive schemes 36](#_Toc464664279)

[8 Consumer engagement 37](#_Toc464664280)

[9 Concluding comments 39](#_Toc464664281)

# The Consumer Challenge Panel

The Consumer Challenge Panel (CCP) was established on 1 July 2013 to be a ‘critical friend’ for the Australian Energy Regulator (AER), by considering regulatory issues from an end consumer perspective. The AER implemented this process as a part response to the information asymmetry that exists in regulatory processes, to the detriment of consumers.

The primary duty of the CCP is to provide advice to the AER on whether proposals by network operators meet the National Electricity Objective (NEO), in particular whether proposals are in the long-term interests of consumers. This means taking into account costs to consumers and other interests of consumers such as safety, price and reliability. To meet this duty the CCP is required to challenge the AER on decisions that go into its regulatory decisions by providing input on issues of importance to consumers and to provide advice on consumer engagement that has been undertaken.

The CCP’s role is therefore to:

• advise the AER on whether a network business's proposal is justified in terms of the services to be delivered to customers; whether those services are acceptable to, and valued by, customers; and whether the proposal is in the long term interests of consumers; and

• advise the AER on the effectiveness of network businesses’ engagement with their customers and how this engagement has informed, and been reflected in, the development of their proposals.

The CCP provides consumer perspectives to the AER to better balance the range of views considered as part of its decisions. However, its role is limited. There remains significant asymmetry between powers of demand and supply players in this market and the AER must still provide a surrogate for competition. The CCP is not designed to be **the** representative of the consumer or ‘demand’ side of the electricity market, but to carefully consider the National Electricity/Gas objectives with regard to the long term benefit of consumers.

The CCP is resource-constrained and cannot be expected to provide advice to counter all experts retained by network operators; such expert input must be reviewed and explained by the AER. The CCP can, however, provide advice to the AER on key areas where it is of the view that the long term interests of consumers are unlikely to be met under proposed arrangements, and where there is scope for the AER to exercise its judgment or to obtain expert advice that might assist it in reaching an independent view.

The CCP is organised into subpanels in order to deal with the large number of regulatory decisions made by the AER. The subpanel considering the AusNet Services Victorian Transmission Revenue Review (TRR) 2017-22 comprises Ruth Lavery and Mark Henley.

# Overarching issues

## Process

This is the third submission that the CCP has made with regard to the AusNet Services Victorian transmission regulatory process for 2017-22.

This particular submission responds to the Revised revenue proposal lodged by AusNet Services on 21September 2016. This release date effectively coincided with the timing of lodging our (second) submission responding to the AER’s Draft Decision dealing with the initial AusNet Services regulatory proposal. The disconnect provided for by the timing in the rules means that AusNet Services has not responded to concerns and observations that were expressed as part of the AER Draft Decision submissions. It also means that we have had limited time to respond to the more significant changes that have been made in the Revised revenue proposal.

Consequently, this CCP subpanel submission needs to be considered in conjunction with our response to the Draft Decision. On issues dealt with by both submissions, the views expressed in this submission should be regarded as taking precedence.

We recognise that there are a number of aspects of the AER’s Draft Decision that have been accepted by AusNet Services , while there are other aspects of the Draft Decision which are disputed and formed the focus of the revised revenue proposal.

Due to resource constraints, we have not addressed every area of AusNet Services’ revised revenue proposal (and there are a great many areas where it does not accept and is inconsistent with the AER’s Draft Decision), but are satisfied that we have addressed the most important issues.

## Context

In our response to the Draft Decision, we commenced by identifying some broader ‘context’ issues, pertinent to the many aspects of detail provided within the AusNet Services initial revenue proposal, specifically:

2.1 Form of regulation

*“The first contextual theme is that Australian energy regulation is ‘incentive regulation’ based on the notion that the revenue in any year is built on revenue in the previous year plus CPI (so that costs are constant in real terms), adjusted by a discount factor ‘X’ applied to set the expectation for consumers that the real costs of network services diminish over time. Thus, the regulatory framework should result in consumers receiving an ‘efficiency dividend’ and businesses being incentivised for continual improvement in their efficiency. Real costs to consumers should fall due to efficiencies achieved, and consumers should expect to see in their bills the benefit of efficiencies.”*

2.2 Trust

*“Low levels of trust across the energy market are a significant concern since efficient market operation and fair prices for consumers are a ‘bargain’ that should be reached based on a high degree of trust between parties. Low levels of trust can mean that some elements of the energy market will seek higher prices from customers than are efficient, and that customers will respond by seeking to block energy company developments, as a matter of course, rather than providing a ‘social licence to operate’ for efficient development.*

*Because of this low trust, it is incumbent on networks to explain the rationale for their funding proposals in a way that justifies to consumers why these revenues are required in order that the network operates efficiently to meet the needs of consumers.”*

2.3 Changing energy markets

*“Consumers have responded to rising energy bills by being more creative about their use of (new and emerging) technologies, by using energy efficient appliances, by shifting demand and by simply reducing per capita demand to some extent.*

*The Australian economy is in the process of shifting away from manufacturing and mining towards service, which means that energy consumption of the volume and load profile typically that of industry is reducing. The demand environment in which network businesses now operate in Australia is very different from 20 years, or even 10 years ago.*

*Electricity network businesses must confront and respond to the structural changes described above. That may be by focussing on the structure of remaining and new demand and considering the price sensitivity and likely growth of remaining and new demand, then investing and pricing in a way that meets the requirements and needs of that market.”*

2.4 The future of the grid

*“The future of the Australian electricity grid has been heavily debated recently with competing views about the long-term future viability of a nationally interconnected electricity grid. Some claim that the rise of renewable generation particularly solar PV at domestic and small business level, coupled with increasingly affordable battery storage and home energy management services will mean that growing numbers of households and even small businesses will leave the grid.*

*This conjecture and many other views about the future of Australia’s electricity grid has been the focus of an extensive project undertaken between Energy Networks Australia (ENA) and the CSIRO, first looking at Australia’s future grid and currently developing a roadmap for the future network. They conclude:*

*“F 2.5; the updated scenarios continue to reflect electricity networks performing an evolving range of critical roles to 2050, supporting diverse energy use and services for customers.”[[1]](#footnote-1)”*

2.4.1 Planning for the Victorian Grid

*“AEMO said “From the Victorian annual planning report the key driver for network augmentation is a shift away from the need to manage peak demand growth to integrating renewable generation.” “*

These issues of context remain significant for the revised revenue proposal. We also re-state the following observation from our earlier submission:

“… we are surprised that the AusNet Services regulatory proposal does not give much attention to its ‘story’ about how it perceives the future. Indeed we opine that the tenor of the regulatory proposal is one of muted pessimism about the future for, in this instance, a major transmission business.”

This perspective is reiterated with regard to their revised revenue proposal.

There are five other observations that we wish to make regarding the way we see the context of this revised revenue proposal, specifically:

1. understanding of the National Electricity Objective (NEO)
2. excess precision, where new formulae seem to override the regulator’s right to exercise discretion
3. an assumption that the properties of parts apply to the whole - which may not be true (the fallacy of composition)
4. a preponderance to cherry pick approaches that would appear to benefit network shareholders over and above consumers, in the short-term and
5. an apparent assumption that keeping prices flat is a goal.

## Application of the National Electricity Objective

The NEO, as stated in the National Electricity Law, is:

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. [[2]](#footnote-2)

In its revised revenue proposal, AusNet Services regularly states that aspects of the AER’s Draft Decision failed to meet the NEO. For example, the following extract is from the revised revenue proposal overview:

“However, there are several areas where AusNet Services considers the Draft Decision is not consistent with the NEO and the long term interests of consumers, including:

* Capital Expenditure – The AER’s approach to valuing safety risk does not reflect the rigorous obligations in place to protect the safety of both employees and the general public. If implemented, the AER’s approach would result in a substantial deterioration in the safety of transmission assets. The resulting change to work practices and feasible capex solutions would increase long term costs to consumers.
* Rate of Return and the Value of Imputation Credits – The allowed rate of return is not commensurate with benchmark efficient financing costs. In addition, the value of imputation credits is over-estimated. The Revised revenue proposal updates AusNet Services s’ proposed rate of return for the latest interest rate information and to reflect the Australian Competition Tribunal’s February 2016 decision which sets out that efficient financing costs should reflect those that would be incurred by an unregulated entity.
* Operating Expenditure – The AER’s rejection of additional costs for decommissioning assets reflect a misunderstanding about the treatment of historical decommissioning costs. AusNet Services can confirm that similar asset decommissioning costs are not embedded in its historic operating expenditure, and therefore the proposed step change is justified. Asset decommissioning is likely to become more frequent in future – it is important that efficient decommissioning costs can be recovered to maintain appropriate incentives to minimize long term costs. AusNet Services also considers the AER’s approach to forecasting self-insurance costs is incorrect.
* Expected Inflation – The AER’s inflation forecasting methodology does not produce realistic inflation forecasts. To allow AusNet Services to recover its efficient costs, it is imperative that the AER’s approach is revised before AusNet Services s’ Final Decision. If the AER does not do so, its Final Decision is likely to apply de facto negative real interest rates over the coming period, contrary to observed Australian market outcomes. This clear perverse outcome will impact the level of investment AusNet Services is able to attract to efficiently invest in the network.” [[3]](#footnote-3)

We suggest that there has been some conflation of the long term interest of consumers (of electricity) with the interests of AusNet Services’ shareholders.

While there are many situations where the long-term interests of consumers and the best interests of stakeholders of an efficient energy network business are the same, this is not always the case. We do not consider that AusNet Services has presented a case to show that any of the following aspects of their revised revenue proposal are in the best interests of consumers:

* increasing capital expenditure above the level sought in the original proposal
* increasing rate of return levels beyond prevailing returns, including basing return to debt on trailing average
* decreasing the value of imputation credits (gamma)
* increasing operating expenditure, particularly through seeking additional revenue for decommissioning fully depreciated assets that have no future use, or
* decreasing the inflation forecast to increase revenue.

We encourage the AER to ask how all these proposals within the revised revenue proposal are in the better interests of consumers when compared with the positions presented in its Draft Decision.

## Excess precision

The notion of excess precision may seem to be an oxymoron, however, in regulation there are matters for which there is no single correct answer (beta, gamma, theta, WACC, rate of inflation, and safety risk are some examples). These are matters where the regulator must exercise judgement amongst a myriad of considerations and competing interests.

It is our opinion that some aspects of the revised proposal have been presented in a manner that is overly formulaic. For example, calculations of “hazard zone occupancy rate” of greater than 100% are constructed using a formula that may be argued to give greater precision, but in practice an occupancy rate above 100% makes no practical sense.

Not all of these ‘new’ formulae are nonsensical, but in trying to put a structure around events or observations that move and vary, they must constantly be tinkered with in order to make sense, or to fit circumstances better. That means that they do not necessarily create greater certainty, particularly for consumers. It seems to us that the ‘tinkering’ is done by or encouraged by the networks (and their consultants), usually to the detriment of consumers. The various formulae used in the safety explanation for capex are a prime example of where consumers have little ability to push back on the assumptions going into the formulae.

Condensing complex and multifaceted issues to mathematical formulae can be useful for analysis, but we believe any attempt to appear to be providing a definitive answer where none exists is unhelpful. The NER now gives the AER greater ability to exercise its discretion, and we continue to urge the AER to recognise that there are areas where it is its responsibility to make a judgement call, even where there is pressure to imply that consultants and formulae can give a more ‘correct’ and specific answer than is possible.

## Fallacy of composition

A definition from economics states the fallacy of composition is “the false assumption that something which is true for one segment of the economy is true for the economy as a whole.”[[4]](#footnote-4)

(For example, in a theatre full of patrons, if one person stands they get a better view, however if everybody stands the reality is that not everybody gets a better view of the stage.)

We suggest that the fallacy of composition applies particularly to the component of the revised proposal relating to safety risks in capital expenditure (capex) considerations, including explosive risk. We suggest that considerable work has been put into emphasising some specific examples of explosive risk, for example the Richmond 220kv current transformer. It is unreasonable to infer or imply that the safety risk in one element of capex, like the current transformer, can be escalated to apply to most capex items. The attempt to compose a substantial safety risk in most items of proposed capital expenditure, linked to an explosive risk with a handful of items, we suggest is an example of the fallacy of composition of safety risk across the full capex bid.

The sum of all the safety risk elements equals more than the safety risk of the whole if the risk from the most risky element is embedded in all capex elements and then added together. This would then lead to a ‘risk cost’ for consumers that is excessive.”

## Cherry picking

A core theme of the 2012 rule changes with regard to network regulation processes were attempts to provide greater fairness through improved longer-term certainty for both network businesses and consumers. This meant that over time there would be some ‘swings and roundabouts’ where fluctuations in financial markets, cost structures etc would see some movement of fluctuating benefits between network businesses and consumers with the realisation that over time the net impact for shareholders and consumers would be the same and consequently fair to both parties of the regulatory bargain.

We suggest that there are aspects of the revised revenue proposal which effectively cherry pick positions or analysis that suits AusNet Services shareholders in the short-term, at some cost to consumer interests. Examples include:

* proposing a transition process for rate of return that differs from the rate of return Guideline.[[5]](#footnote-5) Specifically, AusNet Services is proposing an immediate transition to the trailing cost methodology rather than the staged transition from ‘on the day’ to trailing average approaches. In recent history, the application of ‘on the day’ approaches worked against consumers in the short term, in particular around the time of the GFC. Now with a much lower interest rate environment, a pure trailing average approach will also give better outcomes for network shareholders compared to consumers. Hence the transition process under the Guideline that provides a mix of on the day and trailing average approaches. This approach needs to be maintained for longer term stability and fairness.
* Arguing for CAPM models, utilised in determining return on equity, that are likely to favour of network shareholders in the short-term. We strongly support the consistent application of the Sharpe-Lintner CAPM.
* Use of cost of debt as suggested by the Australian Competition Tribunal, when this is being challenged in the Federal Court (along with other Tribunal decisions)
* Selection of inflation forecasts
* Degrees of acceptance of AEMO authority and independence. AusNet Services “does not accept the automatic application of AEMO’s forecasts”[[6]](#footnote-6) Then AEMO is cited as having the same safety obligations as AusNet Services, they argue, due to AEMO’s “obligations and responsibilities in relation to the Victorian transmission network”.[[7]](#footnote-7) We suggest the role of AEMO is construed differently in different sections of the revised proposal, depending on how convenient it is for AusNet Services.
* Considering ‘safety’ from a network only perspective while failing to consider safety issues for end consumers

In the same vein, we suggest that there is a theme of selectively ignoring the process by which the Better Regulation Guidelines were established, namely with extensive consultation with network businesses as well as consumers over an extended period of time and in which general acceptance of the Guidelines occurred, for example, AusNet Services’ approach to whether the AER’s Draft Decision meets the Allowed Rate of Return Objective (ARORO). It seems to us that there is selective – ‘when it suits’ - acceptance of the Better Regulation process. We query the prudency and efficiency of amounts spent by networks on consultants who are re-examining the same issues, with perhaps little new evidence, that were addressed by the AER during the Better Regulation process.

## Flat prices

The Revised revenue proposal states, “AusNet Services has not adopted the AER’s approach to valuing safety risk. It considers that its current approach leads to targeted replacement of the most risky assets to the degree required by safety obligations, while allowing low and flat transmission prices to be maintained”[[8]](#footnote-8) It later says, “AusNet Services’ proposed rate of return maintains flat transmission prices”[[9]](#footnote-9)

It is our view that ‘**low and flat** transmission prices’ are not the goal, and that the NER contemplates that prudent and efficient expenditures will lead in some cases to reductions in transmission prices.

This would meet the NEO by being in the long term interests of consumers.

A presumption that expenditures and costs should be allowed so long as prices do not increase is incompatible with the NER.

# Rate of return, value of imputation credits, and forecast inflation

AusNet Services has adopted the AER’s preferred formula to compute the rate of return, being the Sharpe-Lintner CAPM formula (SL-CAPM). In populating the SL-CAPM, AusNet Services has not adopted some of the AER’s parameter approaches. AusNet Services’ revised proposed risk free rate and gearing are consistent with the AER’s approach, and will not be discussed further in this submission. AusNet Services has not used the AER’s Draft Decision Market Risk Premium (MRP) or return on debt in calculating the rate of return, or the AER’s forecast inflation or value of imputation credits.

The following table compares AusNet Services’ parameters with those used by the AER.

##### Table 1. Weighted average cost of capital

|  |  |  |
| --- | --- | --- |
|  | **AER Draft Decision** **August 2016** | **AusNet Services’ Revised revenue proposal****September 2016** |
| Risk free rate | 2.57% | 1.97%  |
| MRP | 6.50% | 7.50%  |
| Equity beta | 0.7 | 0.7  |
| Equity risk premium | 4.55% | 5.25%  |
| Return on equity (nominal post tax) | 7.10% | 7.2%  |
| Return on debt (nominal post tax) | 5.54% | 7.56% |
| Gearing | 60% | 60% |
| Weighted average cost of capital (nominal vanilla) | 6.16% | 7.41% |
| Forecast inflation | 2.44% | 1.65% |
| Value of imputation credits | 0.4 | 0.25 |

Source: AusNet Services’ Revised revenue proposal and AER Draft Decision

## Market risk premium

AusNet Services has proposed a MRP of 7.5%.

The AER’s MRP range is 5.0 to 7.5[[10]](#footnote-10) and the AER is clear in its rate of return Guideline[[11]](#footnote-11) that it will use its judgement to set the point estimate within this range. The AER has never used a MRP higher than 6.5%. Until 2013, the AER had consistently used a MRP of 6.0% for some years.

AusNet Services says that its 7.5% MRP is consistent with the AER’s Guideline on rate of return but is inconsistent with decisions made by the AER under its Guideline.[[12]](#footnote-12) We agree that 7.5% is within the AER’s range but it is at the extreme end of the range, that will benefit AusNet Services’ shareholders to the greatest degree. AusNet Services’ primary argument is that the risk free rate has fallen from 4.1% to 1.9% over the last three years and that this results in an “implausible” estimate of market return if the MRP is kept constant at 6.5%.[[13]](#footnote-13) AusNet Services claims that estimates of the MRP using the Dividend Growth Model indicate that the MRP has increased following this recent decline in the risk free rate.

The basis of the CAPM is the relationship between risk and return. Although there is some debate over the strength of the risk return relationship, evidence indicates that over the very long term there is a linear and positive relationship. Estimating the risk premium for the market as a whole is the function of the MRP, which represents the return that investors require to invest in the equities market as a whole in addition to the risk free return. There are significant fluctuations in the measure of the market premium, and it may be measured as negative in some years.

The AER knows that it needs to use judgement in setting the point estimate for this parameter. Other CCP submissions to the AER, including our submission in February 2016, have suggested that the 6.5% that has been used for the last three years is too high,[[14]](#footnote-14) that a lower MRP would also be consistent with the AER’s Guidelines, and that the AER should use its discretion to do this.

We suggest an increase to the MRP in this TRR would be a knee jerk response to what may well be a short term fluctuation in the risk return relationship. The assumption the AER should be making in this instance is that if there is in fact an aberration in the “measured “ MRP right now, then that aberration should only be reflected in the regulatory MRP if it is a long term structural change in the way investors measure returns.

It provides no certainty to consumers or networks to have a MRP that floats up and down depending on relatively short term measurements. It would be inconsistent with the AER’s Better Regulation program, which was put in place to increase longer term certainty for consumers and regulated businesses.

Moving the MRP to 7.5% would be in the better interests of networks and the worse interests of consumers. We believe 6.5% has been too high, in any event. We are not confident that there will be a symmetrical reduction in the regulatory MRP to, say 5.0% (at the bottom of the AER’s range), when the risk free rate rises again. To increase the MRP in this review may well embed a long term benefit for all regulated networks, which is clearly not consistent with the NEO.

Unless the AER can satisfy itself beyond doubt that any current ‘aberration’ in the risk free rate is in fact a long term structural change and that overall market returns have stayed constant over the last three years (because of a rise in the MRP), then it cannot burden consumers with a higher MRP than 6.5%. This is a time for the AER to at least hold firm to its previous decision on the MRP, if not reduce its MRP, in the better interests of consumers.

## Equity beta

AusNet Services has accepted the AER’s equity beta of 0.7, because “the Australian Competition Tribunal has found that the AER’s approach to estimating beta is not subject to error”[[15]](#footnote-15) but maintains that an equity beta higher than this would be best. Its initial revenue proposal included an equity beta of 0.882.

Despite accepting 0.7 for this TRR, AusNet Services has commissioned a consultant (CEG) to update the AER’s consultant’s (Olin Henry) 2014 analysis on equity beta. It is unclear to us why this analysis - and three pages of AusNet Services’ submission - is necessary, given the network has accepted the AER’s Draft Decision equity beta of 0.70. If it is provided so that the AER feels compelled to leave equity beta at 0.7 rather than move it lower within its range (given that 0.7 is the absolute top of the AER’s range), or if it is provided to plant a seed that the AER should alter its range, that is not explicitly stated. If it is provided as a placeholder’ position by the network, in case the results of the judicial review are not in the AER’s favour, then it is irrelevant to the decisions being made by the AER in response to the revised revenue proposal. Is AusNet Service’s expenditure on the CEG report efficient and prudent? We suggest it is neither prudent nor efficient, and is not in consumer’s long term interests, for a network to spend time and funds in preparing analysis that is not linked to its proposal and that maybe is prepared to support a future claim for a higher equity beta.

We do wonder whether CEG’s results would have been provided to the AER in the event they resulted in a beta range lower than those previously calculated by Olin Henry. We don’t know how consistent CEG’s analysis is with Olin Henry’s analysis and whether Olin Henry’s own analysis would arrive at the same results, and therefore how worthwhile the analysis is.

Our view remains that, even within the Guidelines, the AER could still set a lower return on equity by specifying an equity beta closer to 0.4 than 0.7, which would be within the AER’s range but lower than that set by the AER to date. This would be more in the long term interests of consumers while still meeting investors’ rights to an adequate return on capital invested.

## Cost of debt

AusNet Services now proposes a cost of debt of 7.56%. In October 2015, AusNet Services proposed a cost of debt of 5.37%. The AER’s July 2016 Draft Decision set cost of debt at 5.22%.[[16]](#footnote-16)

AusNet Services has changed its approach to cost of debt, adopting an approach which it says reflects a recent Australian Competition Tribunal (ACT) decision. It has the result of increasing the cost of debt by over 200 basis points from its previous proposal and the AER’s Draft Decision.

In March 2016, the AER applied to the Federal Court for judicial review of the ACT decisions on which AusNet Services bases its revised proposal. It is unlikely that the result of that judicial review will be known before the AER releases it’s Final Decision on AusNet Services’ TRR 2017-22. By setting in train this judicial review, a time-consuming and costly exercise, the AER is clearly of the view that its approach meets the requirements of the NER, and consequently we see no reason for the AER to change its approach for this revised regulatory proposal.

The NER requires that the AER allow a cost of debt that is the average return that would have been required by debt investors in a benchmark efficient entity (BEE). The 2016 annual report of AusNet Services Limited, the ASX-listed owner of the Victorian transmission business that is the subject of this TRR, discloses that its average interest rate at 31 March 2016 was 5.1% and a year earlier was 5.8%.[[17]](#footnote-17) AusNet Services Limited is primarily a regulated network business - *“We derive most of our earnings from three regulated energy network businesses, which include Victoria’s high voltage electricity transmission network, an electricity distribution network in eastern Victoria and a gas distribution network in western Victoria.”*[[18]](#footnote-18) AusNet Services Limited itself is not the BEE envisaged by the NER, is primarily a regulated energy network owner and operator, so its disclosed rates provide a very relevant cross-check on whether a regulatory cost of debt of 7.56% is appropriate.

We view AusNet Services’ Revised revenue proposal on cost of debt as an opportunistic grab, given its original proposal was so much lower and the rates disclosed in its parents consolidated accounts are so much lower. It is exploiting the ACT decision, which the AER contends is incorrect enough to merit a judicial review. Its genuine cost of debt is without doubt closer to 5.22% than 7.56%.

Regulated networks must face an incentive to keep all costs as low as possible, including cost of debt, and it is incomprehensible to us that between AusNet Services’ original proposal in October 2015 and this proposal in September 2016, their efficient cost of debt has risen by 200 basis points. It is in consumers’ long term interests that the cost of debt included in the rate of return reflects current market conditions and motivates businesses to borrow in the most efficient and prudent way.

## Value of imputation credits

AusNet Services maintains its claim for a gamma of 0.25% based on its view that the methodology in the AER’s rate of return Guideline is flawed, and that a recent decision by the ACT did not accept the AER’s reasoning.

In March 2016, the AER applied to the Federal Court for judicial review of the ACT decisions on which AusNet Services bases its revised proposal. It is unlikely that the result of that judicial review will be known before the AER releases it’s Final Decision on AusNet Services’ TRR 2017-22. By setting in train this judicial review, a time-consuming and costly exercise, the AER is clearly of the view that its approach meets the requirements of the NER, and consequently we see no reason for the AER to change its approach for this TRR.

Further, given that the ‘flaws’ were set out in AusNet Services’ initial revenue proposal, the AER applied a 0.4 gamma in its Draft Decision, and AusNet Services has provided no new evidence or argument in its Revised Proposal, we are of the view that no case has been made by AusNet Services for the AER to change its decision.

As set out in both our previous submissions[[19]](#footnote-19) to this TRR, our view is that there is considerable imprecision around estimating this parameter, and that academics and consultants will be finding areas on which to disagree, forever. It is an issue quite unique to the Australian regulatory system, is disregarded by private sector investors in Australian assets, and there are a great many assumptions that must be made in finding benchmarks or comparators.

The AER’s Guideline calculates a range for gamma of 0.3-0.5, and specifies a point estimate of 0.5 from this range.[[20]](#footnote-20) The AER has used a value of 0.4 in its more recent decisions, moving down (and in the better interests of the regulated networks) from the 0.5 point estimate in its rate of return Guideline. We do not believe the AER should buy into technical arguments that contain so many debateable assumptions, but should use its judgement in the long term interests of consumers and revert to a value for imputation credits of 0.5 as originally suggested in its Guideline.[[21]](#footnote-21)

## Inflation

The AER’s approach uses an average of the RBA's short term inflation forecasts and the mid-point of the Reserve Bank of Australia’s (RBA) inflation targeting band, an approach it has applied since 2008. The AER forecasts inflation at 2.46% in its July 2016 Draft Decision.

In its initial revenue proposal, AusNet Services estimated inflation at 2.35%, using the implied rate from comparing inflation-indexed and nominal Government bonds. AusNet Services stated that “*there is no longer a presumption in favour of the use of third party forecasts of inflation in place of the implied inflation measure that is provided by financial markets.”*[[22]](#footnote-22) This bond-based methodology had been used by the AER until 2008, and is a widely accepted corporate finance methodology for forecasting inflation. The AER ceased using it because the Commonwealth Government had stopped issuing indexed bonds in 2003 and the market was considered to be illiquid.

Liquidity describes the degree to which a [security](http://www.investopedia.com/terms/s/security.asp) can be quickly bought or sold in the market without affecting the asset's price. It is not absolute, it is on a scale, and there is no point at which one can say that a security is or is not liquid. Higher yields are required for investors to hold illiquid securities, to compensate for the prospect of adverse yield movements on the sale of that security, which means that the signals sent by yields on illiquid securities are distorted.

In its September 2016 Revised Proposal, AusNet Services still proposes forecast inflation at 1.65%, using the approach formerly used by the AER pre-2008, because of the current low inflation environment. AusNet Services is concerned that the AER’s current approach would “embed a negative real risk free rate in its regulatory decision.”[[23]](#footnote-23)

The reduction from 2.35% to 1.65% in the forecast inflation rate is approximately 30%. The impact on proposed revenues is through depreciation and the Regulatory Asset Base (RAB), and increases revenue by around $120 million (nominal) over the regulatory period, based on AusNet Services’ Revised revenue proposal compared to its initial revenue proposal (ie not allowing for any other changes, for example reductions in capex or opening value of the RAB.)[[24]](#footnote-24)

### Reserve Bank of Australia estimates

Inflation recorded by the Australian Bureau of Statistics (ABS) has dropped markedly over the past 18 months, as shown in table 2.

##### Table 2. Actual inflation (percentage change from corresponding quarter of previous year, weighted average of 8 capital cities)

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Sep 12** | **Dec 12** | **Mar 13** | **Jun13** | **Sep 13** | **Dec13** | **Mar14** | **Jun14** | **Sep14** | **Dec14** | **Mar 15** | **Jun15** | **Sep15** | **Dec15** | **Mar 16** | **Jun16** |
| 2.0 | 2.2 | 2.5 | 2.4 | 2.2 | 2.7 | 2.9 | 3.0 | 2.3 | 1.7 | 1.3 | 1.5 | 1.5 | 1.7 | 1.3 | 1.0 |

Source: ABS, 6401.0 - Consumer Price Index, Australia, Jun 2016 [[25]](#footnote-25)

The RBA’s forecasts of short term inflation over the last two years are set out in Table 3. They are reducing, reflecting the actual rates recorded by the ABS, but still higher than actual inflation.

##### Table 3. RBA’s forecast short-term inflation

|  |  |  |
| --- | --- | --- |
|  |  | **year ended** |
|  |  | **Dec-14** | **Jun-15** | **Dec-15** | **Jun-16** | **Dec-16** | **Jun-17** | **Dec-17** | **Jun-18** | **Dec-18** |
| SMP | Aug-16 |  |  |  | 1 | 1½ | 1½–2½ | 1½–2½ | 1½–2½ | 1½–2½ |
| May-16 |  |  | 1.7 | 1 | 1–2 | 1½–2½ | 1½–2½ | 1½–2½ |  |
| Feb-16 |  |  | 1.7 | 1½ | 2–3 | 2–3 | 2–3 | 2–3 |  |
| Nov-15 |  | 1.5 | 1¾ | 1½–2½ | 2–3 | 2–3 | 2–3 |  |  |
| Aug-15 |  | 1.5 | 2½ | 2–3 | 2–3 | 2–3 | 2–3 |  |  |
| May-15 | 1.7 | 1½ | 2½ | 2−3 | 2−3 | 2−3 |  |  |  |
| Mar-15 | 1.7 | 1¼ | 2–3 | 2¼–3¼ | 2¼–3¼ | 2¼–3¼ |  |  |  |

Source: RBA Statements of Monetary Policy, table 6.1

The RBA’s August 2016 quarterly Statement of Monetary Policy (SMP) did not lower its short term inflation forecast; that was done in the May 2016 SMP[[26]](#footnote-26) and is reflected in the AER’s Draft Decision inflation forecast. The next SMP is due to be published on 4 November 2016, possibly not in time for any further change to forecast inflation (should the RBA decide to do so) to be incorporated into the AER’s calculation of forecast inflation for its Final Decision.

The RBA’s inflation target band has been constant at 2%-3% for over two decades. It seems unlikely that the inflation target will be changed in response to current economic circumstances, with former RBA Governor Glenn Stevens saying recently that “*If it were the case that undershooting the target for a period while achieving reasonable growth was the 'least bad' option available, the inflation targeting framework has the requisite degree of flexibility to allow such a course*” and that he "*would counsel caution in fiddling too easily*" when asked if he would loosen or abandon the target.[[27]](#footnote-27)  New RBA Governor Philip Lowe has also defended the inflation target, which he recently confirmed with the Australian Treasurer, saying the Australian *“framework allows for temporary deviations of inflation from the medium-term target. In this regard, we have a degree of flexibility not available to some other central banks that have a singular focus on inflation. Some of these central banks have felt that given their mandates they had little choice but to take whatever measures were available to them to push inflation higher. We have never thought of our job as keeping the year-ended rate of inflation between 2 and 3 per cent at all times. Indeed, since June 1993, CPI inflation has been below 2 per cent for 24 per cent of the time, and coincidentally above 3 per cent for 23 per cent of the time. What is important is that we deliver an average rate of inflation consistent with the medium-term target.”[[28]](#footnote-28)*

We note that the AER contemplated the current situation (where actual inflation is outside the target band) when it first put in place the current method of forecasting inflation, stating that “whilst 2-3 %, on average, is the RBA’s target range, this does not imply that inflation would not be outside the boundaries of this range at any particular time, or that the average should be expected to fall in the middle of this range.”[[29]](#footnote-29)

This long term view taken by the RBA Governor is consistent with the AER’s requirements of an inflation forecast, as it is unlikely to respond to short term or unusual market and economic movements.

The inflation target band is so dominant an influence on the AER’s forecast methodology that even if the RBA’s forecast of short term inflation is reduced to 0%, the AER’s methodology would produce an inflation forecast of 2.25%, which is only 0.21% lower than the current forecast. It is unlikely that the AER’s current methodology will produce a significantly different forecast from that currently used, while the target band remains 2-3%.

### Liquidity of indexed bonds

The AER’s Draft Decision states that *“despite having improved since 2007, the size and liquidity of the indexed CGS market is still limited*”, a conclusion it appears to have reached from a 2012 article.[[30]](#footnote-30)

When the AER first put the current approach to forecasting inflation in place in 2007, the RBA had advised it that *“there have been no indexed bonds issued since February 2003, outstandings are limited to just three issues, and demand for these bonds has increased as supply has fallen.”[[31]](#footnote-31)* The Australian Office of Financial Management (AOFM) records that *“throughout the late 1990s the stock of Treasury Bonds declined and tender activity fell to levels below the volume of maturing bonds. Tender activity focused on new long-term bond lines in order to maintain a Treasury Bond curve with a tenor of 12-13 years . . . Other Commonwealth securities were discontinued in order to maintain liquidity in Treasury Bonds . . . Tender activity increased substantially in February 2009 as the impacts of the global financial crisis began to hit Australia. . . In October 2009 the Treasury Indexed Bond market was re-opened to diversify the investor base.”[[32]](#footnote-32)*

Issues have been made every year since then, so that the current face value of bonds on issue is almost $40 billion, up from $6 billion in 2007.[[33]](#footnote-33)

However, liquidity is not simply a function of the amount of stock available. For bona fide depth, there must also be an active secondary market, along with derivative offerings, and adequate turnover in the ‘useful-dated’ bonds, ie around ten years. Some turnover information is available from the Australian Financial Markets Association (and has been used by AusNet Services’ consultant, CEG). [[34]](#footnote-34) We suggest this information, and the analysis provided by CEG, is insufficient to establish whether the market is liquid for the purposes of the AER’s requirements. The turnover information on the AFMA website is not disaggregated into maturities. A simple ratio of turnover divided by average outstanding bonds provides a number, but whether that means the market is liquid is not explained by the number.

With regard to the consultant report by CEG provided by AusNet Services to support the change in inflation forecast methodology, we agree that the breakeven approach using nominal and inflation-indexed bonds is a widely used method of forecasting inflation. However, at this point we are not persuaded by the information provided in it that the market is now liquid, and that the breakeven approach would better forecast ten-year inflation for the purposes of AER’s regulatory decision-making.

Expert advice from those who administer the market and are most closely involved with it is the most useful input into whether it is a liquid and well-functioning market, so we suggest the AER should consult with the RBA and Australian Treasury, as it did in 2007, about this, before it makes any changes to the methodology it uses. Reverting to an approach that uses scarce bonds or too-long or too-short dated bonds, or relies on a dysfunctional market will not make this a better approach.

In any event, even if the market is currently liquid, there are wider regulatory issues to consider than simply an economic argument. There has been little stakeholder consultation about changing from a methodology that has been in place for eight years, and changing methodologies at the request of a network when it is so significantly advantaged by the change that it looks like cherry-picking. In the interests of good administrative practice, our view is that more stakeholder consultation and a far wider analysis by the AER is required before any change in methodology.

### Low and negative interest rates

AusNet Services complains of a negative real return on the risk free rate, saying “this is contrary to investors being able to earn a positive guaranteed real return on inflation indexed Commonwealth Government Securities.”[[35]](#footnote-35)

 In our previous submission to this TRR, we set out some data on how low interest rates are. They could go lower. Negative interest rates, while unusual, are not non-existent. In July 2016, the German Bundesbank issued more than 4 billion euros of a new 10-year bond with a yield of minus 0.05%. Germany’s status as a safe haven for investors, the German ten year bond’s status as a benchmark, and fears about worldwide economic issues combined to make this apparently irrational thing a reality. Investors will pay to have money in a safe place.[[36]](#footnote-36) (The apparently irrational happens even when there is not economic uncertainty incentivising investors to find a safe haven; it has happened even in Australia where accounting and tax considerations will drive an investment decision more than the returns.[[37]](#footnote-37))

It is not irrational to think the German scenario could occur in Australia – very low rates are a fact, and negative rates are not outside the realms of possibility. This is the economic environment we exist in at present, and are not likely to emerge from in the short term. It is likely that interest rates will remain low for some time. The US Federal Reserve Bank of Chicago president Dr Charles Evans was recently reported as warning *“that any sudden acceleration could weigh too heavily on inflation expectations that are still too low. We’re in for low interest rates for quite some time, even if we begin to increase the short end”* [[38]](#footnote-38)

In June 2016, it was reported that the “average yield on German government bonds has fallen below zero for the first time as the phenomenon of negative interest rates intensifies across global financial markets.

So-called “umlaufrendite”, the average rate across outstanding bonds published once a day by Germany’s Bundesbank, hit a new low of minus 0.02 per cent on Monday, surpassing its [previous low of zero](https://www.ft.com/content/40de8ba2-0002-11e6-99cb-83242733f755) reached in April.”[[39]](#footnote-39) The European Central Bank has at the same time been purchasing bonds that have been issued by the Bundesbank and other member central banks, to manage economic issues within the European Union.

AusNet Services’ argument in support of shifting back to a market-based methodology using Government bond yields is that short term monetary policy is losing its effectiveness to influence economic activity and therefore the inflation target will become less accurate.[[40]](#footnote-40)

However, it is likely that issuance and repurchase by central banks of Government bonds will become a more widely used tool to manage the economy, as is occurring in Europe. That would make the use of bond yields to forecast inflation somewhat circular – bonds would be the measure as well as the tool wielded by Government to affect the measure. In our view, this would make reverting to a forecasting approach based on bond yields, at this point in time, unnecessarily complicated.

### Not the time to change the way of forecasting inflation

The AER has in its Draft Decision accepted that there are benefits and limitations to both the methodology it uses and that proposed by AusNet Services, concluding that on

It is our view that it would be premature to change methodologies without more stakeholder consultation. More information about the liquidity of the indexed bond market is required (and we suggest the AER consults the RBA and Australian Treasury on this.) More investigation of alternative methodologies is required. Our overriding comment on forecast inflation is that if the AER cannot be sure that any alternative methodology to the one it is currently using better meets the NER’s requirements, then it should not change methodologies.

Any effect on the networks should be considered a matter of symmetry. It may be a flawed methodology, but picking and choosing between methodologies from time to time, based on the perceived impact on networks, is not in the long term interests of consumers.

## Summary

The theme of AusNet Services’ Revised Proposal for rate of return, value of imputation credits and forecast inflation is to pick what suits the network best. It is not in the best interests of consumers that a high rate of return, low gamma, or low inflation is applied. Neither is it in the long term interests of consumers that networks can pick and choose methodologies and inputs that achieve the aforementioned rates, from time to time.

We suggest the following principles are fair:

* Consumers are entitled to a certainty in the approach from the regulator.
* Consumers should not be facing changes in approach from review to review without significant change being firmly identified in the operating environment.
* Consumers are entitled to bear risks symmetrically with the regulated businesses.

We urge the AER to use these principles in exercising its discretion in the best long term interests of consumers.

# Operating expenditure

In their original regulatory proposal, AusNet Services sought $1,101.7m (real, 2016-17 prices), revised to $1,057.6 which is a decrease of 4% from original to revised regulatory proposal. The revised proposal is still 2.5% higher than the Draft Decision of $1,031.9m for operating expenditure (opex) over the 5 years of the regulatory period.

## Step changes

The AER’s Draft Decision did not allow any of AusNet Services’ initially proposed $13.5m (real $2016-17) in step changes. The revised proposal still seeks $11.0 million in ‘step changes.’

The Guideline on expenditure forecasts states that “Step changes may be added (or subtracted) for any other costs not captured in base opex or the rate of change that are required for forecast opex to meet the opex criteria.”

We retain the view expressed in response to the draft determination and now for this revised revenue proposal that there are no step changes, rather there are some variations in selected areas of base operating costs.

### Decommissioning step change

We suggest that the most significant issue raised in the opex sections of both the original and revised proposals relate to decommissioning of the Morwell power station, without replacement. We’ve given considerable attention to this issue over the course of this regulatory proposal and have not changed our views from those expressed in our response to the draft decision. We therefore reproduce this section of our previous submission because there remain two important questions first to the question of what constitutes a step change and then the treatment of the decommissioning of the Morwell power station.

Included in the bid for ‘step change’ allowances was $4.3m in 2017-18 related to decommissioning synchronous condensers and Morwell Power Station assets.

In our February 2016 submission to the AER on AusNet Services’ December 2015 proposal, we expressed the view that this proposed expenditure was not a step change because it was not unexpected and was part of normal operations, albeit a larger expenditure.[[41]](#footnote-41)

At the AER’s public hearing held on 9 August 2016, AusNet Services gave a more comprehensive explanation as to the nature of these costs than was included in its 2015 proposal, saying that in the past, decommissioning expenses were included in capital expenditure as part of the cost base of its replacement assets; however, the synchronous condensers and Morwell assets will not be replaced (as part of AusNet Services’ response to declining utilization of the network) and consequently the cost of decommissioning will constitute operating expenditure. AusNet Services suggested there will be more such decommissioning without replacement, and that the expenditure should form an operating expenditure (opex) step change as the business transitions to a lower level of replacement capex. AusNet Services said that as this is a new type of decommissioning where there are no ‘revealed costs’ and that is why they claim it as a ‘step change’ rather than a more standard cost.

AusNet Services’ treatment of decommissioning costs by capitalizing them within the cost base of replacement assets is in accordance with accounting standard AASB 116 Property, Plant & Equipment: [[42]](#footnote-42)  Paragraph 16(c) of that standard outlines the elements of cost, which includes dismantling and restoration costs. The effect of this standard accounting treatment on the building block regulatory methodology is that decommissioning costs where the asset is replaced, are rolled into the RAB, and AusNet Services earns revenue through Return On and Of Investment, whereas revenue is derived through the opex component of the methodology when there is no replacement. Given that what AusNet Services does is in accordance with accounting standards, there is no question that these decommissioning costs should be expensed and should be part of opex; there is no reason for the regulatory framework to differ from the accounting standard’s requirements.

 The two issues we suggest are pertinent are a) whether a step change is necessary (and if so, what the amount should be) and b) whether this proposed 2017/18 step up followed by a step down in 2018/19 is in fact a step change or whether it is a new way to forecast expenditure.

### Is a step change necessary?

We expect that AusNet Services has, in the past, incurred (smaller) decommissioning expenditure irrespective of whether there was replacement, and consequently we believe there is likely to be a level of decommissioning costs within base opex, which should, under the methodology set out in the AER’s Guideline on expenditure forecasts, form the revealed cost. If there are decommissioning costs in previous years’ opex, then the claimed $4.3 million is not a new cost, but a larger variation on an existing cost and is unusual by size rather than by rarity.

We take this opportunity to ask AusNet Services to provide details of past expensing of decommissioned assets that are not replaced, regardless of the size of the expenditure. This will assist in assessing whether there is a revealed cost and a justifiable step change in accordance with the AER’s Guideline before the AER makes its Final Decision.

### Is this a step change, or something else?

We observe that the AER’s Guidelines do not contemplate an approach where there is a step up for a particular opex item in one year followed by a step down for the same item in the following year. [[43]](#footnote-43)

The Guideline on expenditure forecasts does not anticipate a step change for costs of decommissioning, but does state that “If it is efficient to substitute capex with opex, a step change may be included for these costs (capex/opex trade-offs).”

In its explanatory document regarding forecast expenditure, the AER said:

*We then adjusted base year opex to account for changes in circumstances that will drive changes in opex in the forecast regulatory control period. These adjustments included:*

* *escalating forecast increases in the size of the network ('scale escalation')*
* *escalating forecast real cost changes for labour and materials ('real cost escalation')*
* *adjusting for efficient costs not reflected in the base opex, such as costs due to changes in regulatory obligations and the external operating environment beyond the NSP's control (step changes) . . .*

*. . . Under the base-step-trend approach to setting opex, step changes caused by incremental changes in obligations are likely to be compensated through a lower productivity estimate that accounts for high costs resulting from changed obligations. Under this approach, only changes in costs that demonstrably do not reflect historic 'average' changes will be compensated as separate step changes in forecast opex . . .*

*. . . NSPs will be expected to justify the cost of all step changes with clear economic analysis, including quantitative estimates of expected expenditure associated with viable options. We will also look for the NSPs to justify the step change by reference to known cost drivers (for example, volumes of different types of works) if cost drivers are identifiable. If the obligation is not new, we would expect the costs of meeting that obligation to be included in revealed costs. We also consider it is efficient for NSPs to take a prudent approach to managing risk against their level of compliance when they consider it appropriate (noting we will consider expected levels of compliance in determining efficient and prudent forecast expenditure). [[44]](#footnote-44)*

We are not aware of this last-mentioned justification of the step change having been undertaken by AusNet Services.

Of course, these quotes are taken from explanatory notes to the AER’s Guidelines, which themselves are not enforceable. And the quoted passage does not specifically address the type of step change proposed by AusNet Services in this instance. What we wish to draw out is that the AER has not to date contemplated the type of step change proposed. Because it is added in then taken out, it is a new type of adjustment to revealed costs.

The fact that it might be a new type of adjustment does not in itself indicate it should not be allowed by the AER. The bigger issue for the CCP is that the network is driving the expenditure forecast methodology, and that is not in consumers’ best interests. Consumers are entitled to clearly defined boundaries within which changes to expenditures and methodologies between regulatory periods can be made. Consumers are as entitled to regulatory certainty as are networks.

A tighter definition, and more comprehensive explanation of what constitutes ‘revealed cost’, would assist in ascertaining what genuine step changes are, and what other adjustments to revealed costs might be anticipated and permissible under the NER and in accordance with the NEO. It would be in the better interests of consumers to have more certainty about how the base-step-trend approach to the opex component of the building block methodology will be applied by the AER, and will provide clearer guidance to networks in the future. We urge the AER to include a revision of its Expenditure Forecast Assessment Guidelines in its future work program, to protect consumers from the flexibility currently accorded networks by this Guideline.

On the basis that consumers benefit financially from allowing a step change in opex as opposed to paying tariffs based on revenue that includes Return On and Return Of Investment over a long period, then we are inclined to support AusNet Services’ proposal to include this relatively modest one-year non-recurrent opex expenditure, but not regard it as a ‘step change’. We are reluctant to allow it as a precedent. However, if investigation of AusNet Services’ historic costs indicates that there are revealed costs, then we remain of the view that this ‘step change’ should not be allowed by the AER in its Final Decision.”

## Other opex considerations

The following comments touch briefly on other aspects of the opex proposal from the revised regulatory proposal. Chart 4 below summarises the revised proposal, we have commented about the $11m step changes proposal above and comment below on some other elements. We accept that the easement land tax is exogenously set. Lack of comment does not mean tacit acceptance of the proposed bid.

##### Table 4. AusNet Services opex summary



### Base year

We accept the allocation of 2014 15 as the base year in so doing we do not accept that this is necessarily an accurate reflection of efficient costs, but we do accept it as a reasonable base year for developing regulated revenue for 2017-22.

Note that inflation forecasting considerations are considered as separate sections of this submission. (section 3.5)

### SAIP roll out

Regarding the allowance for “smart aerial image processing” (SAIP) rollout, AusNet Services states *“the draft decision appears to be contradictory in its assessment of SAIP. The AER accepted that SAIP generally is an effective technique for condition monitoring, but did not approve the opex that will allow AusNet Services to deploy this technique on the grounds that the proposed benefits were not sufficiently identified.”*

We do not agree that this is a contradiction, we agree that SAIP can be an effective tool but certainly do not agree that additional opex is needed to utilise the technique.

This is neither a step change nor an area of expenditure requiring additional expenditure. We accept that SAIP is a useful tool and one that can be utilised within the opex allowance provided for in the draft decision.

### Labour and non-labour weights

The AER draft decision is supported noting that in a very low inflation environment, we do not accept that past costs (actual and revealed) are the best indicator of future cost movements, this is better done by utilising existing inflation CPI projections, since almost all credible economic forecasting is suggesting that the next period will be one of lower growth rates (and lower costs of capital) than in recent years, and consequently, lower rates of wage growth.

### Productivity change

### AusNet Services said in their original proposal:

*“Huegin’s [Consulting] analysis of historical industry productivity shows that over the period 2006 to 2014, average annual industry productivity change was 0.28%. This is lower than the industry average of 0.86% used by the AER in its determinations for TransGrid and TasNetworks because it has been updated to include inputs and outputs from 2014.”[[45]](#footnote-45)*

We are bemused by the lack of any productivity related change in the revised revenue proposal and included in table 4.16 from the AusNet Services revised regulatory proposal. The very basis of incentive-based regulation as practised in Australia and many other jurisdictions around the world is one of (CPI – X). The minus X component is intended to be a productivity change that both gives improved efficiency for the business and more efficient (lower) prices for consumers. To reject any productivity improvements over 5 years is both contrary to the whole intent of the energy regulatory approach in Australia and a snub for end consumers.

# Capital expenditure

In its Draft Decision, the AER rejected 23% of AusNet Services' capex forecast. As can be seen in table 5, AusNet Services’ Revised Proposal asks for almost all of that capex back, and an additional $21.5m (real $2016/17) for major stations replacement.

##### Table 5 Capex forecast for the regulatory period 2017/18 to 2021/22 ($m, real 2016-17)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | initial revenue proposal | AER’s Draft Decision  | AER's Draft Decision reductions from initial revenue proposal | Revised Proposal | Revised Proposal's increase over AER Draft Decision | Revised Proposal (decrease)/increase over initial revenue proposal |
| CBD station rebuilds  | 119 | 72 | -39% | 117 | 62% | -2% |
| Major stations replacement  | 193 | 111 | -42% | 210[[46]](#footnote-46) | 89% | 9%(- 2% + 11%) |
| Asset replacement programs  | 251 | 222 | -11% | 245 | 11% | -2% |
| Safety, security and compliance  | 72 | 63 | -11% | 70 | 10% | -2% |
| Non-network | 112 | 105 | -6% | 109 | 4% | -2% |
| Total | 746 | 573 | -23% | 751 | 31% | 1% |

Source: AusNet Services Revised Proposal tables 3.1 and 3.10 on pages 24/246 and 81/246

Indeed, the revised proposal shaves about 2% from each item of the original proposal then adds in a new capital expenditure proposal (Major Stations Replacement) to the value of $21.5m, resulting in a higher total than was sought in the original revenue proposal, and 31% higher than the AER’s Draft Decision allowance.

This discrepancy between the AER’s Draft Decision capex and the revised revenue proposal is substantial. We do not consider that a transmission network that is confronting static, at best, changes in demand over the regulatory period and with modest multifactor productivity can justify such significant capital expenditure proposals over the next five years as being the best long-term interests of consumers.

AusNet Services has maintained its original approach to incorporating safety risk into replacement capital expenditure (capex).

## Safety risk

A central theme from the bid from AusNet Services in their revised revenue proposal relates to the embedding of safety considerations in their capex component of the revised revenue proposal.

We reiterate observations that we have made in previous submissions that we have no doubt about the commitment to safety that AusNet Services has nor do we doubt the sincerity of AusNet Services in their focus on safety throughout all aspects of the business.

However we do not consider that AusNet Services has fully weighed up the trade-offs between a marginal increase in safety and the ensuing higher cost to consumers. We are also unconvinced that AusNet Services has fully canvassed alternative means to increase safety within the capex proposal.

There are a number of aspects to safety and the safety arguments raised by AusNet Services that we consider below.

### Safety impacts for consumers of higher than necessary prices

AusNet Services talks about safety purely from the perspective of a transmission network service provider and consequently argue for higher allowances then the regulator provided in the Draft Decision in order to deal with safety related capital expenditure. AusNet Services then argues that increasing expenditure for safety is in line with the National Electricity Objective. However AusNet Services does not consider the demand side realities of safety and particularly the safety considerations for end consumers of rising electricity prices (recognising that there are other factors leading to disconnections as well.) However, St Vincent de Paul Society recently reported that out of 199,704 disconnections raised by one large retailer in Australia, over the three years from 1/7/2012 to 30/6/2015, 63,900 were Victorians. [[47]](#footnote-47)

We recognise that a half all of these ‘raised’ disconnections do not result in actual disconnection, however the point is that a large number of Victorian electricity customers are disconnected from energy supply each year and double the number actually disconnected face threat of disconnection. Over 20,000 Victorians face the risk of disconnection due to inability to afford electricity costs, every year.

It is our observation that there are significant safety risks for people who are disconnected from the electricity supply due to inability to pay. Safety risks include using candles for light, naked flames for heating which pose greater threat for house fires. There are also increased health risks for people unable to keep warm / cool due to disconnection as well as risk from unrefrigerated food also caused from disconnection. The key issue with safety is that it is a two-way street, there are safety issues for network businesses – supply side - but higher electricity costs create safety risks for end customers – demand side - who are disconnected or its rate of disconnection due to inability to pay higher prices which include increased network charges.

### Safety is not the primary objective of the NEO

We want to clarify the meaning of the first paragraph of section 3.2.2 of the revised revenue proposal, where AusNet Services writes:

*“while AusNet Services accepts some aspects of the Draft Decision . . . AusNet Services is concerned about the AER’s approach to adjusting its safety risk assessment. It can be demonstrated that the approach adopted by AusNet Services produces appropriate outcomes, as shown by the age and condition of the assets currently proposed to be replaced, and is consistent with the NEO and the revenue and pricing principles. In particular AusNet Services approach allows it to satisfy regulatory requirements imposed by Australia’s occupational health and safety legislation, as well as electricity industry regulations, the primary objective of which is to deliver electricity safely”*

We are uncertain whether AusNet Services may be trying to state that safety is the primary objective of the NEO, and if so, we reject the notion. The NEO specifically states that safety is one of a group of factors impacting on the long-term interests of consumers these factors being: price, quality, safety, reliability, and security of supply of electricity. Safety is an important objective of Australian electricity industry regulations, but certainly not the primary objective.

If however AusNet Services is referring to occupational health and safety legislation, then we accept that safety is a primary objective of this legislation. Occupational health and safety legislation and other safety specific legislation is one set of legislation to which any business or organisation operating in Australia needs to have close regard. AusNet Services is no different from any other business or organisation in meeting safety legislation.

We reiterate that safety is not the primary objective of the NEO, rather one important element.

### Elimination and minimisation of risk.

The Revised revenue proposal actively considers the question of the responsibility of AusNet Services, in this case, in risk mitigation. AusNet Services states:

“AusNet Services is required to eliminate [our emphasis], where practicable, the risk of an incident before it occurs - this is the effect of legislative and regulatory requirements which oblige AusNet Services to maintain a safe workplace . . . This goes beyond an obligation to mitigate the risks when the incident actually occurs. This is an important point of distinction that is not been considered in the Draft Decision*”[[48]](#footnote-48)*

The reality is that no business, including AusNet Services, can eliminate risk, so we suggest that to use this word is unhelpful. Indeed, the notion of eliminating risk is rarely mentioned in practical responses to risk prescribing legislation. The role of AusNet Services is to take all reasonable and responsible steps to minimise risk.

AusNet Services specifically lists regulatory obligations with which they must comply with regard to safety specifying:

* Electrical Safety Act 1998 (Vic)
* Victorian Electrical Safety (Management) Regulations 2013
* Australian Standard 5577 – 2013 Electricity Safety Management Systems and
* Occupational Health & Safety Act 2004 (Vic) and Regulations.

To the best of our observation, none of these pieces of legislation requires the elimination of risk; rather language is used is similar to “minimise as far as practicable.”

The role of the regulator is to provide adequate revenue to enable an efficient business to meet its safety responsibilities. The role of the business is to meet legislative and other safety obligations, and to seek continual improvement in reducing risk, within a given budget.

### Hazard Zone Occupancy rates

In the original revenue proposal, AusNet Services defined safety risk cost as being the product of: asset failure rate, probability of a safety-related failure and risk consequence.



In the Draft Decision, the AER added hazard zone occupancy rate as a fourth factor of safety risk cost. They then proposed an indicative hazard zone occupancy rate of 1%.

AusNet Services has responded in detail to this notion of hazard zone occupancy rate, accepting the concept but challenging the indicative 1% figure. They then propose a formula to determine the hazard zone occupancy rate, giving it as

the occupation rate x the number of people on site

total of number of hours per year.

Applying this formula, AusNet Services then comes up with hazard zone occupancy rates in the range 342% for Templestowe terminal station, up to 820% for West Melbourne terminal station.

These numbers when put into the AER’s adjusted version of AusNet Services safety risk cost equation, substantially increases calculated safety risk cost.

We reject the notion of a hazard zone occupancy (HZO) rate being greater than 100% and frankly regarded as an overuse of formulas to imply greater precision which does not work in practice. It is our clear view that logically no place can have an occupancy rate greater than 100%, it is occupied, it is not occupied or it is occupied for some percentage of time between zero and 100%, over the course of a year. The number of people in a hazard zone is a factor to be considered as part of safety risk cost, but is part of the risk consequence, not a multiple of hazard zone occupancy rate.

Consequently we support the draft decision’s addition of “hazard zone occupancy rate“, as being a factor of “safety risk cost”, but are adamant that must be in the range 0 – 100%. We do not have all the facts available to calculate a definitive HZO, but intuitively expect the upper bound of the range of likely values to be correlated to an eight hour per day, five day working week, ie 23.8% (8 hours x 5 days per week x 52 weeks per year, divided by the total number of hours in a year)

### Explosive failure examples

The revised revenue proposal provides a clear example of an explosive failure, specifically at Richmond terminal station on 7 June 2016. In this instance an explosive failure of a 220kV current transformer occurred at the terminal station. . We accept that there is risk of explosive failure for transformers of this nature.

It is also clear that there are very different explosive risk profiles for different components of the transmission network. We suggest that AusNet Services has given excessive focus on explosive risk in their revised revenue proposal, to the point that some readers may regard explosive risk as effective for many or most ageing components of the transmission network. What is true of the risk for a 220 kV transformer is not necessarily true for other items of capital expenditure. Consequently we regard this approach as an example of the Fallacy of Composition, a concept from economics which is a false assumption that something which is true for one segment is true for the whole. In other words, a particular level of risk through explosive risk for one component of the network does not apply to many or all components of the network.

The heightened risk of explosive failure of some items of equipment does not justify the $178m above the Draft Decision allocation that is sought by AusNet Services.

### Interpretation of ARORO and BEE

As part of its revised revenue proposal AusNet Services has commissioned CEG to provide advice on the AER’s interpretation of the allowed rate of return objective (ARORO) and by implication the relationship with BEE, a benchmark efficient entity.

CEG summarise their findings by saying *“we do not believe that the AER’s 2016 interpretation [the one used for the AusNet Services Draft Decision] is consistent with a reasonable economic interpretation of the ARORO*.”[[49]](#footnote-49)

We will leave it to the AER to respond to the CEG challenge that *“the AER has inconsistently applied its new interpretation of the ARORO. In particular, the AER sits between its new and old interpretations when discussing: how its proposed transition is NVP=0; why it is adopting a trailing average in the long run; and white adopts a 10 year term for the cost of debt”*. *[[50]](#footnote-50)*

However, we briefly comment by stating that we believe the answers to all except the first question summarised in the paragraph above are answered in the AER is better regulation guideline.

It is also our concern that CEG has largely ignored the process by which the Better Regulation guidelines were established, namely with extensive consultation with network businesses as well as consumers over an extended period of time and in which general acceptance of the guideline occurred. We also observe that the CEG analysis fails to consider the issue in the context of the NEO and in particular the long-term benefits to consumers. Rather we suggest the approach taken in this analysis is effectively a form of “cherry picking” where the approach in the best short term interests of NSP shareholders is given precedence over the best long-term interests of consumers.

We highlight that the transition to trailing average adopted by the rate of return Guideline was very clearly predicated on striking a reasonable balance between the short-term interests of NSP shareholders and the long-term interests of consumers and recognising that fluctuations of debt markets over time meant that there would be periods where the NSP is a slightly better off and other periods when consumers were slightly better off but that over time, and particularly the longer term, a fair bargain was reached between consumer and shareholder interests. The attempt to regularly change the basis for considering rate of return (debt) by network service providers, including AusNet Services in this instance, is both disappointing and contrary to the approach of a business efficient entity and certainly contradict the long-term interests of consumers.

### Diminishing time between explosive failures

The revised regulatory proposal includes the following figure which we have labelled figure 1A which presents the estimated mean time between explosive failures at the West Melbourne terminal station, which AusNet Services claims would result from applying the draft decision approach.

##### Figure 1A, Mean time between Explosive Failures (years)



Source: AusNet Services, revised regulatory Proposal, Fig 3.14, pg 67/246

##### Figure 1B Mean time between Explosive Failures (years), with trend lines

Source: Estimates of AusNet data, redrawn for CCP

We note that using this graph, there is minimal decline in estimated time between explosive failures during the forthcoming revenue period, the trend line for diminishing time between explosive failures increases into the regulatory period beyond 2022. This is shown in figure 1B, derived from the AusNet data given in 1A. Figure 1B takes the AusNet services estimates and separates them into 2017-22 and subsequent revenue periods, then we added in linear trend lines.

Whilst clearly aware of lead time with capital projects, the AER needs to consider the extent to which safety related capex is being sought in the 2017 to 22 period that could more readily be applied for the period beyond 2022, as needed.

We recognise that AusNet Services has an excellent record in safely managing their business and that they have done so within the regulatory revenue allowances over the past couple of regulatory periods. We also think is reasonable for the Regulator and ultimately for consumers to expect that AusNet Services will continue to improve the safety performance as a consequence of a number of years of close attention being given to safety. It is consequently reasonable for consumers to expect that the allowance in the next regulatory period, for safety in this instance, is less than the allowance from previous regulatory periods, as incentive for and recognition of continuous improvement. This is the intent of the national electricity objective.

It is the role of the regulator to carefully assess the revenue proposal and to make a judgement. It is in the responsibility of the business to utilise the revenue allowed for the most effective management of the business.

This issue is discussed in our response to the Draft Decision, and we have not changed their views since considering the revised revenue proposal. In this response we drew the AER’s attention to the ACT finding from Western Australia where ATCO challenged the Western Australian Economic Regulation Authority, specifically citing safety issues as justification for additional capex.

We stated that “this case in part looked at the tension between the National Gas Rules’ requirements for expenditure to be ‘prudent’ and ‘efficient’, but also ‘necessary’ or ‘required’. The ACT found in favour of the regulator, stating the following in their judgement:

*“It is also wrong to consider “prudency” in isolation to the surrounding words. It is not prudency simpliciter. It is a prudent service provider “acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services”. These surrounding words provide context (in the regulatory scheme under the NGR) to the considerations that ought to be in the mind of a prudent service provider.”[[51]](#footnote-51)*

In applying this finding of the ACT to the AusNet Services revised revenue proposal we highlight that “prudency” was explained as occurring in the context of: efficiency being a combination of “accepted good industry practice” and at the “lowest sustainable cost of providing services.” We urge the AER to take note of this finding of the ACT in considering the AusNet Services revised revenue proposal.

In our previous submission we also talked about the ‘proportionality test’, and concluded *“that the full level of safety related capex expenditure by AusNet Services would not lead to proportional safety benefits and so is not in the best interests of consumers.”* We still believe that the claimed safety benefits from the capex bid in the revised revenue proposal are not proportional to the additional costs that would be borne by consumers.

## Major station replacement

AusNet Services has identified $21.5million in new replacement capex that was not in its original proposal, at East Rowville Terminal Station in response to a transformer fault. It is unfortunate that this capex was not included in the initial revenue proposal so that it could be assessed for prudency as a package along with all other capex. We accept that We expect the AER to undertake as much analysis on this expenditure as it has previously undertaken on all other expenditure.

We accept that the East Rowville terminal station is significant and that appropriate monitoring by AusNet Services has not identified extra ordinary asset decline prior to developing the original revenue proposal.

It is the CCP view that this sort of ‘discovery’ is relatively common, namely that routine inspection coupled with experience identifies maintenance and replacement capital expenditures that become a higher priority than had previously been anticipated. The standard response then is for management of the business to revise expenditure priorities within the available budget and to efficiently allocate funds to deal with the highest priority maintenance and capex expenditures. This is exactly how East Rowville should be considered, it is expenditure to be considered against other competing priorities and funds allocated accordingly.

Had the situation at East Rowville be identified six months later, this is exactly how all AusNet Services would have approached the situation. We do not consider that the fact that a revenue review is in progress should change the treatment of a specific expenditure that becomes a higher priority. The revised proposal should not provide a basis for a final attempt to bid up the capex allowance.

##  Demand forecast

AusNet Services says[[52]](#footnote-52)

*“AusNet Services accepts the use of updated demand forecasts, and considers that both summer and winter forecasts should be updated. It does not accept the automatic application of AEMO’s forecasts, and has provided more information on its principles-based approach to applying demand forecasts.”*

While we recognise that AEMO has a more direct transmission planning role in Victoria than it has in other states, we are sceptical of any merit in AusNet Services rejection, even partial rejection, of AEMO forecasts. We encourage the AER Board to closely consider any divergence from AEMO forecasts as we recognise AEMO expertise in this area, notwithstanding the inherit difficulties in the art of forecasting.

## Additional capital expenditure

The other capex issue that we wish to comment upon briefly is that of ICT where AusNet Services disagrees with the draft decision. We understand that there is some ongoing discussion between the AER and AusNet services regarding the specific ICT capex proposals.

In general, we regard ICT as an established part of the business and an area of generally declining costs, particularly for hardware. We are wary about the value for consumers of additional ICT capex, over and above prevailing levels.

# Depreciation

The AER’s Draft Decision approved $521.3 million (nominal), a reduction of $81.4 million or 13.5% compared to AusNet Services’ initial revenue proposal of $602.8 million (nominal). Most of the AER’s reduction was because it rejected AusNet Services’ proposal for accelerated depreciation on assets acquired after 1 July 2017. AusNet Services’ Revised Proposal for forecast depreciation is $624.2m (nominal) for 2017-22. AusNet Services has accepted the AER’s Draft Decision to disallow its proposed accelerated depreciation, which accounts for a reduction of roughly $87 million (nominal).

We have referred to the impact of changes to forecast inflation in an earlier section of this report.

##### Table 6. Depreciation from Proposals and Draft Decision ($million, nominal)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | initial revenue proposal | AER’s Draft Decision  | AER's Draft Decision reductions from initial revenue proposal | Revised Proposal | Revised Proposal's increase over AER Draft Decision | Revised Proposal’s (decrease)/ increase over initial revenue proposal |
| Nominal depreciation | 996 | 920 | -8% | 895 | -3% | -10% |
| Less indexation on opening RAB | -393 | -399 | 2% | -271 | -32% | -31% |
| Regulatory depreciation | 603 | 521 | -14% | 624 | 20% | 4% |

Sources: AER Draft Decision tables 5.1 and 5.2 in attachment 5 and AusNet Services Revised Regulatory Proposal table 10.9

We will leave audit of the depreciation model provided by AusNet Services to the AER, but make the following comments about the principles adopted by AusNet Services.

We stand by the comments made in our previous submissions in relation to the proposal to accelerate depreciation on new assets. None of that is out of date. AusNet Services had not established the nexus between changes to the energy market and its proposal to accelerate depreciation. Stakeholders did not support the proposal.

In its Draft Decision, the AER left the door open on accelerated depreciation, by approving *“a new ‘accelerated depreciation’ asset class for those particular assets being identified as being (or becoming) unused over the next regulatory period.”[[53]](#footnote-53)* AusNet Services has now identified a small amount of assets in this category and proposes to accelerate depreciation on them. They consist of connection assets at Yallourn and Hazelwood Power Stations. Rumours abound that Hazelwood may be closed, although this has been denied by its owner. It has been reported that the “French owner of the Hazelwood power station, ENGIE, says it has no immediate plans to close the plant despite reports it could be shut down in the first half of next year.”[[54]](#footnote-54) We are unaware of any plans to close Yallourn, which is owned and operated by privately owned Energy Australia. It is quite possible that these two inefficient coal-fired generators would need to close in order that targets of 25% renewable energy by 2020 and 40% by 2040 might be met. However, there are a range of possibilities, and it is certainly not a suggestion that has been discussed at length by stakeholders.

AusNet Services claims some stakeholders suggested that *“targeting existing assets that were most likely not to be required in future (such as Latrobe Valley assets) was most appropriate.”[[55]](#footnote-55)* Our recollection is that at a stakeholder forum run by AusNet Services there was modest support for the proposal but certainly not convincing support from a majority present.

It is our view that AusNet Services has not established that the Hazelwood and Yallourn assets are or will become unused during the next regulatory period, nor that insufficient consultation has taken place on the proposal, and consequently the accelerated depreciation should be rejected by the AER.

We suggest that more work could be done on fleshing out what the AER’s means by *“those particular assets being identified as being (or becoming) unused over the next regulatory period.”* Better guidelines about the circumstances in which depreciation at faster than normal rates is appropriate would give certainty to both consumers and networks.

# Incentive schemes

We understand that both AusNet Services and the AER have agreed on application of the Efficiency Benefit Sharing Scheme (EBSS) and the Capital Expenditure Sharing Scheme (CESS) and so we also support the application of both schemes without being entirely convinced that there is a material benefit for consumers from these schemes.

Regarding the Service Target Performance Incentive Scheme (STPIS), we also note that both AusNet Services and the AER have agreed to not include the Frequency Control Ancillary Service (FCAS) component for the 2017-22 regulatory period. We accept that in the current environment a transmission business has limited control over some frequency control services. This said, frequency control is likely to be an ever more important aspect of future network functioning and so we would want FCAS to be actively considered for the 2022-2027(most likely) regulatory period.

Other incentive aspects agreed between AER and AusNet Services are also supported by the CCP.

# Consumer engagement

Regarding consumer engagement, we repeat the comment we made in our response to Draft Decision which was lodged less than a month ago, and remains an accurate reflection of our perspective regarding AusNet Service’s approach to consumer engagement.

*“One of the roles of the Consumer Challenge Panel is to provide observation to the AER about the extent and value of consumer engagement undertaken by network businesses. The 2013 Better Regulation, consumer engagement guideline provides a useful base for both network businesses and for commentary.*

*In our initial response to the AusNet Services proposal, we said that it was our opinion that AusNet Services has made genuine effort to effectively engage with the breadth of consumer interests. We also recognise that transmission businesses have historically been regarded as perhaps too ‘upstream’ to need to engage with end consumers. A view has been put in the past that the customers of a transmission business are generators, distribution businesses and a handful of very large, transmission connected, energy intensive businesses. However, transmission businesses are part of the price stack that becomes the electricity bill for any customer, so engagement with the breadth of customers is vital for transmission businesses, particularly now that customers have somewhat more choice about their energy use and energy sources. For some households and businesses, going ‘off grid’ is becoming cost competitive with retaining grid connection.*

*Since AusNet Services lodged its 2015 revenue proposal, we have observed genuine and continuing efforts to engage with end consumers. A discussion paper regarding accelerated depreciation has been prepared and circulated to interested stakeholders with a forum conducted by AusNet Services in June 2016. A further forum was held in August 2016, shared with AEMO, with a significant number of stakeholders, to consider key aspects of the AER Draft Decision on the promise that was made by a senior member of the AusNet Services staff that “we will respond to all stakeholder feedback.”*

*We have no questions about the sincerity and desire of AusNet Services to actively and meaningfully engage with stakeholders, including consumer interests and we continue to observe good progress being made in efforts to engage.*

*An observation of ours is that sometimes AusNet Services (and other NSP’s, we note) has tended to regard stakeholder engagement processes as mechanisms to convince stakeholders of an AusNet Services ‘position’, when more open methodologies would be more helpful. AusNet Services has been keen to embrace this feedback.*

*Our other observation relates to the use of the IAP2 spectrum for public participation, copied below, where to progress has been made in moving towards the right of the spectrum regarding the “public participation goal”, where there have seen processes at ‘inform’, ‘consult’, ‘involve’ and ‘collaborate’ levels. However the aspect of the spectrum dealing with the “promise to the public” is less developed and we assess that at this stage the ‘promise to the public’ action is somewhere between ‘inform’ and ‘consult’ aspects of the spectrum.”*

It is recognised that AusNet Services has not had the opportunity to formally respond to these comments.

We also note that AusNet Services conducted a forum for stakeholders on 16th August, which was preceded by a joint forum with AEMO that had a focus on network planning issues for Victoria. A CCP member attended and considered the forums to be helpful and involving active stakeholder participation.

We also note that AusNet Services has included questions that stakeholders have asked as part of their revised revenue proposal, these are given as ‘breakout boxes’ throughout the revised revenue proposal. It is also clear to us that responses provided to stakeholder questions by AusNet Services in the revised regulatory proposal and forum cannot be inferred to have been accepted by a majority of stakeholders, particularly accelerated depreciation as well as other issues raised by stakeholders as part of discussions with AusNet Services.

# Concluding comments

We have appreciated the openness of AusNet Services staff in their dealings with us and are impressed by the culture of the business, including their embedding of safety into the psyche of all staff.

After considering an initial regulatory proposal and now a revised regulatory proposal from AusNet Services for Victorian electricity transmission, dozens of appendices and responding through submissions to the initial proposal, the AER’s draft decision and now the revised proposal, we are suggesting one word to try and capture all that has been considered: “umlaufrendite”. A general translation of umlaufrendite is ‘current bond yield, ‘but this misses the point. Umlaufrendite is also being used in the context of negative nominal Bundesbank (German central bank) bond rates (while Swiss and Japanese central banks have also both issued bonds during 2016 with negative nominal interest rates.)

This financial market reality is incredibly different from that prevailing 2 regulatory periods ago and very different to 5 years ago. So on top of declining electricity demand, the rise of renewable energy and the (imminent) arrival of an array of storage opportunities, flat to negative interest rates is also ‘new territory’ for energy network businesses. This regulatory proposal, like those of AusNet Service’s peers, is seeking to minimise risk and uncertainty for the business at a number of levels. Proposed measures to shore up certainty in financial return for AusNet Services in this proposal include: challenging inflation rates and forecasts, seeking step changes in opex (including for decommissioning of an asset that will not be replaced) and embedding safety risk criteria in most proposed capex projects. We have responded to these proposals in this submission.

The reality is still that energy network businesses in Australia, including AusNet Services, are low risk businesses with guaranteed revenue and continuity, very solid balance sheets and a high degree of future viability. End users of the essential services of electricity on the other hand face increased uncertainty in employment / business environment, income and housing markets and large numbers already struggle to pay for the electricity that they need. Umlaufrendite means that energy markets operate in a changing and different environment, however the AER still needs to ensure that

* end consumers pay for the efficient costs of receiving energy services and not one cent more
* regulated networks face strong incentives to operate efficiently and prudently, and understand that they must innovate to achieve that.
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2. http://www.aemc.gov.au/Australias-Energy-Market/Markets-Overview/National-electricity-market [↑](#footnote-ref-2)
3. Revised Revenue Proposal, page 5/246 [↑](#footnote-ref-3)
4. http://www.businessdictionary.com/definition/fallacy-of-composition.html [↑](#footnote-ref-4)
5. Better Regulation Rate of Return Guideline December 2013, available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline> [↑](#footnote-ref-5)
6. Revised Revenue Proposal, page 23/246 [↑](#footnote-ref-6)
7. Revised Revenue Proposal, page 68/246 [↑](#footnote-ref-7)
8. Revised Revenue Proposal, page 23/246 [↑](#footnote-ref-8)
9. Revised Revenue Proposal, page 137/246 [↑](#footnote-ref-9)
10. Better Regulation Explanatory Statement Rate of Return Guideline December 2013, available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline> [↑](#footnote-ref-10)
11. Better Regulation Rate of Return Guideline December 2013, available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline> [↑](#footnote-ref-11)
12. Revised Revenue Proposal, page 196/246 [↑](#footnote-ref-12)
13. Revised Revenue Proposal, pages 153 and 154/246 [↑](#footnote-ref-13)
14. For example, [Subpanel 1 - Submission on NSW DNSPs regulatory proposals 2014-19 - 15 August 2014](https://www.aer.gov.au/system/files/Consumer%20Challenge%20Panel%20%28updated%29%20-%20Subpanel%201%20submission%20on%20NSW%20DNSPs%20regulatory%20proposals%202014-19%20-%2015%20August%202014.docx), available at https://www.aer.gov.au/about-us/consumer-challenge-panel/statements-and-advice#subpanel-1 [↑](#footnote-ref-14)
15. Revised Revenue Proposal, page 143/246 [↑](#footnote-ref-15)
16. All indicative for first year of regulatory period [↑](#footnote-ref-16)
17. Note D.4 Net finance costs, AusNet Services Limited Annual Report, Page 103, available at http://www.ausnetservices.com.au/CA257D1D007678E1/Lookup/BusinessReports/$file/AusNet%20Services%202016%20Annual%20Report%20FINAL.pdf [↑](#footnote-ref-17)
18. Ibid, page 34 [↑](#footnote-ref-18)
19. Available at <https://www.aer.gov.au/about-us/consumer-challenge-panel/statements-and-advice#subpanel-5> [↑](#footnote-ref-19)
20. Better Regulation Rate of Return Guideline December 2013, available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline> [↑](#footnote-ref-20)
21. Better Regulation, Rate of Return Guideline, December 2013, page 23, available at <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline> [↑](#footnote-ref-21)
22. Initial revenue proposal, 2015, page 281/332 [↑](#footnote-ref-22)
23. Revised Revenue Proposal, page 179/246 [↑](#footnote-ref-23)
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34. Available at http://www.afma.com.au/data/AFMR [↑](#footnote-ref-34)
35. Revised Regulatory Proposal, page 190/246 [↑](#footnote-ref-35)
36. Both Japan and Switzerland have also issued ten year bonds with negative yields so far in 2016. [↑](#footnote-ref-36)
37. Based on confidential anecdotal evidence known to the writer. [↑](#footnote-ref-37)
38. Australian Financial Review, “Rate fears exaggerated says US Fed’s Evans, 12 October 2016, page 7 [↑](#footnote-ref-38)
39. “Germany reaches negative rate milestone”, Financial Times, June 7, 2016, by [Thomas Hale](https://www.ft.com/stream/authorsId/Q0ItMDQxMTMzOQ%3D%3D-QXV0aG9ycw%3D%3D) and [Elaine Moore](https://www.ft.com/stream/authorsId/Q0ItMDAwMDgxOQ%3D%3D-QXV0aG9ycw%3D%3D) [↑](#footnote-ref-39)
40. Revised Revenue Proposal, page 188/246 [↑](#footnote-ref-40)
41. Available at [http://www.aer.gov.au/system/files/Consumer%20Challenge%20Panel%20-%20Subpanel%205%20-%20Submission%20on%20AusNet Services%20Services%20electricity%20transmission%20regulatory%20proposal%202017-22%20-%208%20February%202016.pdf](http://www.aer.gov.au/system/files/Consumer%20Challenge%20Panel%20-%20Subpanel%205%20-%20Submission%20on%20AusNet%20Services%20electricity%20transmission%20regulatory%20proposal%202017-22%20-%208%20February%202016.pdf), page 26 [↑](#footnote-ref-41)
42. Available at <http://www.aasb.gov.au/admin/file/content102/c3/AASB116_07-04_ERDRjun10_07-09.pdf> [↑](#footnote-ref-42)
43. Better Regulation Expenditure Forecast Expenditure Guideline for Electricity Transmission November 2013 , available at <http://www.aer.gov.au/system/files/Expenditure%20Forecast%20Assessment%20Guideline%20-%20Transmission%20-%20FINAL.pdf>, page 24 [↑](#footnote-ref-43)
44. Better Regulation Explanatory Statement Expenditure Forecast Assessment Guideline November 2013, page available at <https://www.aer.gov.au/system/files/Expenditure%20Forecast%20Assessment%20Guideline%20-%20Explanatory%20Statement%20-%20FINAL.pdf> [↑](#footnote-ref-44)
45. Original Regulatory Proposal, 2015, page 130 / 332 [↑](#footnote-ref-45)
46. If the proposed new capex of $21.5m (real 2016-17) is deducted from this $210m, the Revised Proposal (decrease)/increase over initial revenue proposal for major stations replacement is -2%, consistent with the other capex categories. [↑](#footnote-ref-46)
47. Households in the Dark, June 2016, available at https://www.vinnies.org.au/content/Document/VIC/2016-June-Households-in-the-dark2.pdf [↑](#footnote-ref-47)
48. Revised Revenue Proposal, page 34/246 [↑](#footnote-ref-48)
49. AusNet Services, transmission, Victoria, revised regulatory proposal, appendix 6.3, page 3 [↑](#footnote-ref-49)
50. CEG, AER interpretation of the ARORO, Executive summary, pg 4 given as appendix 6C [↑](#footnote-ref-50)
51. Paragraph 273 of decision released 13 July 2016, available at <http://www.judgments.fedcourt.gov.au/judgments/Judgments/tribunals/acompt/2016/2016acompt0010> [↑](#footnote-ref-51)
52. Revised regulatory proposal, page 23/246 [↑](#footnote-ref-52)
53. AER Draft Decision Attachment 5, footnote 71 on page 27 [↑](#footnote-ref-53)
54. The Age, “Hazelwood shutdown: Victoria's dirtiest power station set to close early next year”, 24 September 2016, by Josh Gordon and Adam Morton, available at http://www.theage.com.au/victoria/hazelwood-shutdown-victorias-dirtiest-power-station-set-to-close-early-next-year-20160923-grn0ph.html [↑](#footnote-ref-54)
55. Revised Regulatory Proposal, page 130/246 [↑](#footnote-ref-55)