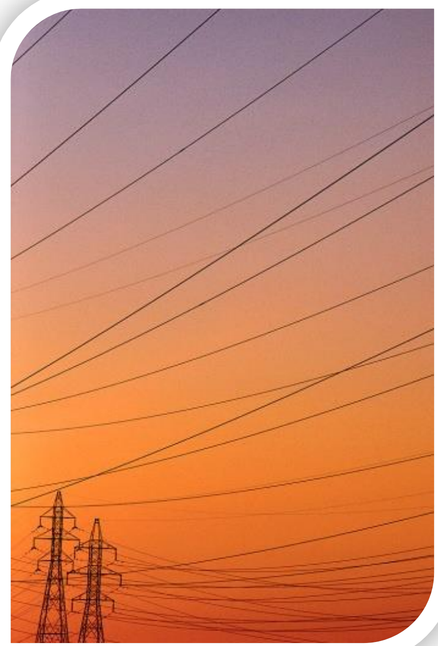
Pre-Determination Conference for ElectraNet 6 November 2017



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Overview

- Revenue Summary
- Consumer Engagement
- Opex
- Capex
- Rate of Return and Tax
  - Inflation
  - Gamma and Tax

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Customer engagement & prudent expenditure in a time of change

- ElectraNet has faced unprecedented level of policy changes and operational challenges over the last 18 months
- CCP9 acknowledges ElectraNet's approach to these challenges
  - Supported by an effective approach to consumer engagement in the past
  - Keeping consumers and regulators updated going forward
- ElectraNet has not used this uncertainty to justify an excessive capex program in their revenue proposal
- CCP9 therefore supports the AER's DD to approve ElectraNet's capex and opex; but going forward:
  - close scrutiny of the contingent projects by the AER
  - enhance co-ordination between SAPN and ElectraNet
  - enhance investigation of non-network options
- Many challenges remain:
  - ElectraNet has demonstrated its ability to adopt prudent solutions to many of these problems
  - Rigorous assessment and innovative thinking to manage cost impacts and establish expenditure priorities
  - Continued customer engagement to assist making these tough decisions

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Revenue Summary

- Draft Decision reduces proposed revenue by $144m (8.3%) from $1736m to $1592m (nominal) over the 2018-23 regulatory period
- This reflects:
  - Higher estimate of inflation expectations which reduces the real WACC and revenues by $61m (through lower depreciation)
  - A reduction of $42.1m in tax primarily due to the higher gamma
  - A reduction of $22.8m in return on capital due to updating the nominal WACC for latest interest rates
- Draft Decision accepts Capex ($459.1m) and Opex ($440.1m) proposed by ElectraNet
- Decision does not include contingent project costs - ElectraNet has proposed 5 contingent projects but costs are uncertain and subject to RIT-T

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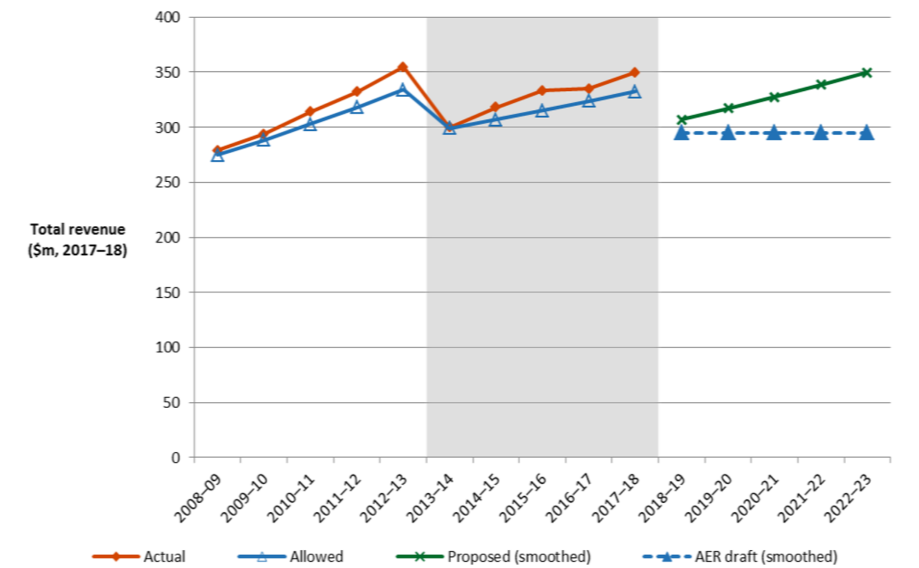
Revenues and prices

Figure 1.1 ElectraNet's past total revenue, proposed total revenue and AER draft decision total revenue allowance ($million, 2017-18)



Source: AER analysis.

- 0.9% ave. decline in MAR
  - 13.5% fall in first year
  - Then ave increase of 2.5%
- Small Trans cost decline - $27.9/MWh in 18/19 to $27.5/MWh in 22/23
- Trans. is <10% of bill so bill impact is small
- But what if contingent projects proceed?

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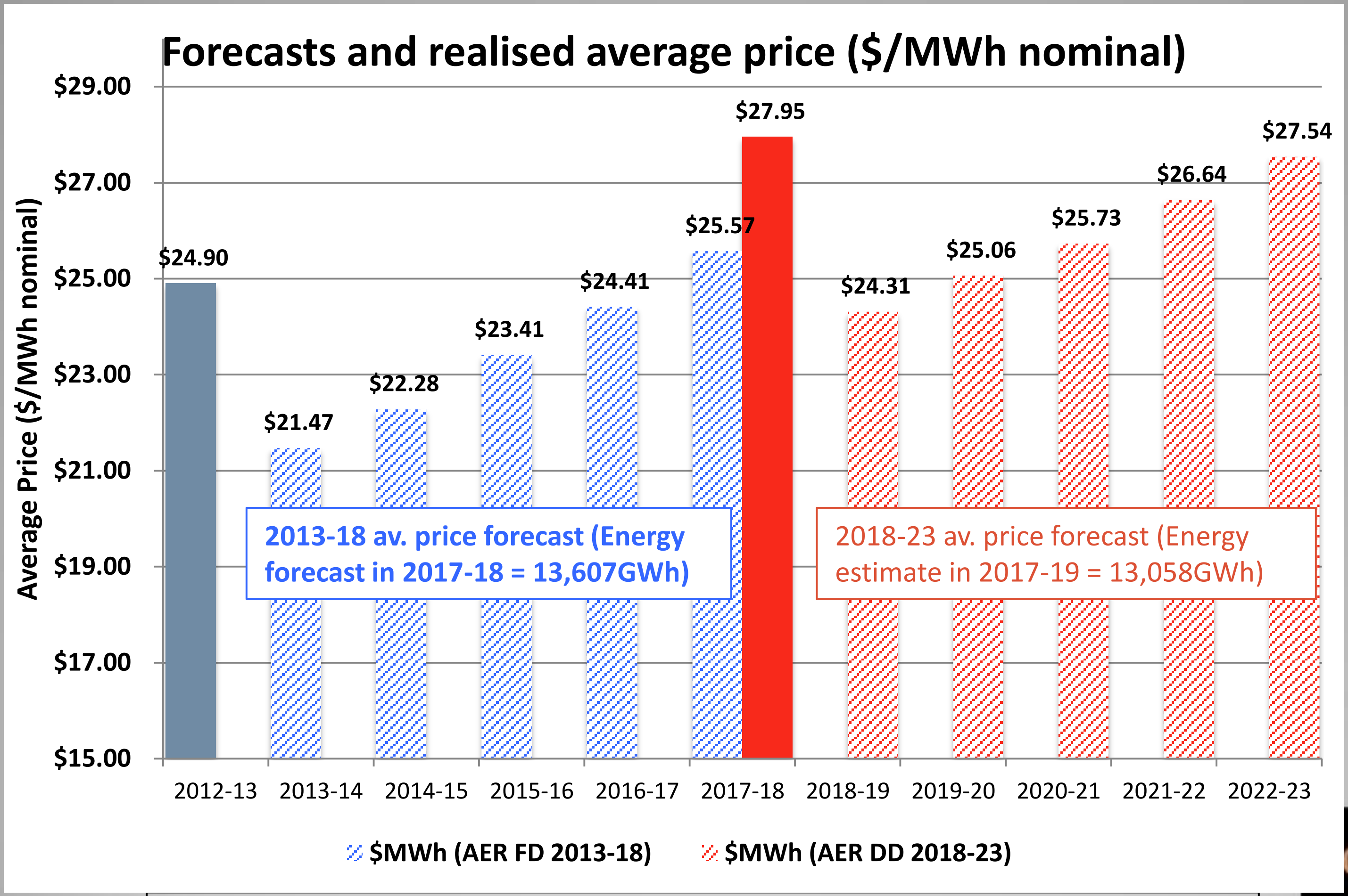
Key risks – demand & price (1)



Source: Post Tax Revenue Model 2013-18; Post Tax Revenue Model 2018-23:

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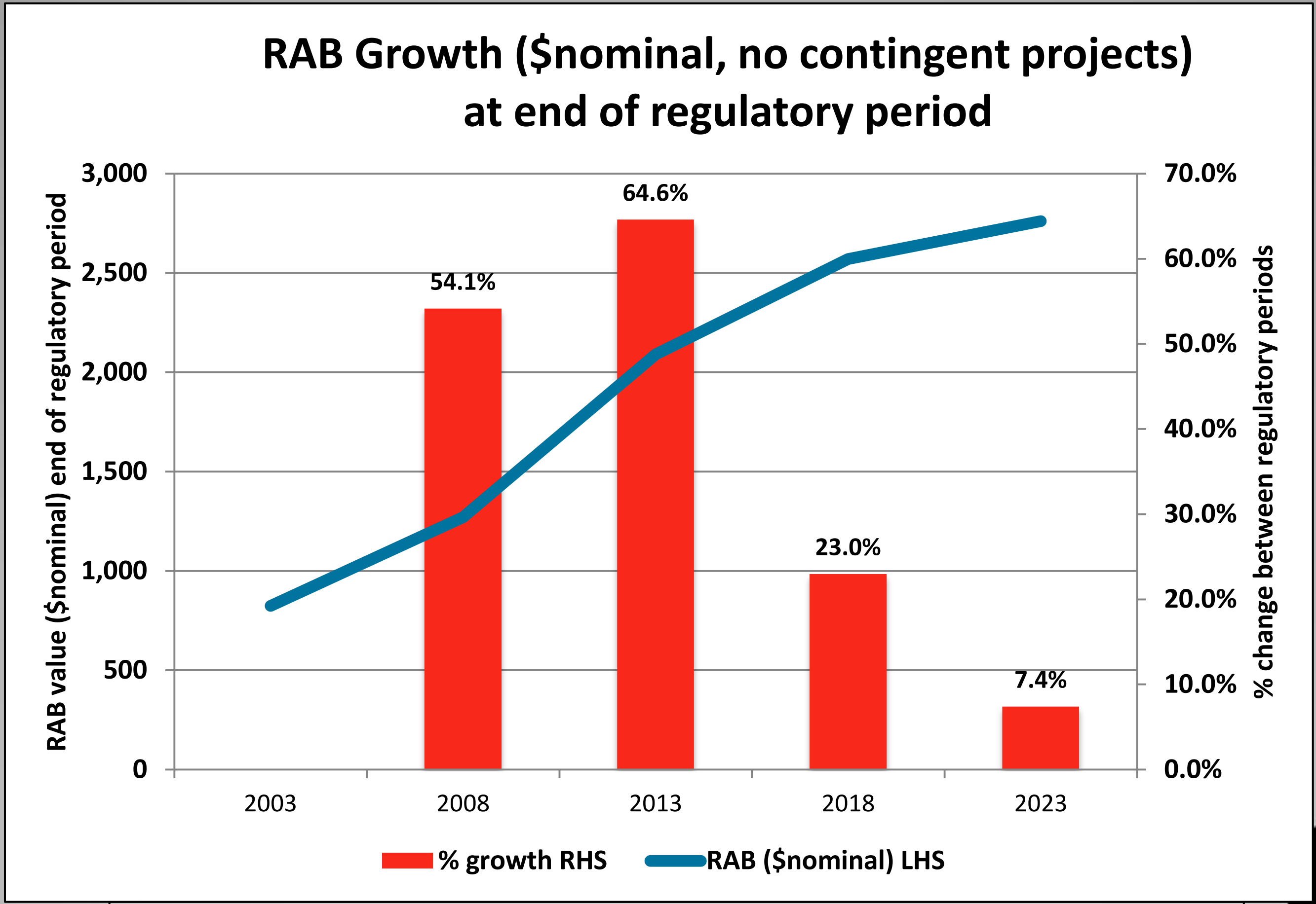
Key risks: RAB growth (2)



Source: Post Tax Revenue Model 2013-18; Post Tax Revenue Model 2018-23:

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Effectiveness of ElectraNet's Customer Engagement (CE)

- What we did:
  - Attended a number of meetings of the Customer Advocacy Panel (CAP) & the CAP Working Group
  - Meetings with ElectraNet's management and its external independent consultation and facilitator
  - One-on-one meetings with some CAP members
- What we said re ElectraNet's approach to CE
  - Largely very positive response from participants, although some concerns with process, representativeness and 'fast track'
  - Clear communications and development of 'trust' between Electra Net and stakeholders
  - extended and well-structured program, use of deep dives"
  - Management support for the program
  - Innovative e.g.:. Preliminary Revenue Proposal and a "no surprises" philosophy
- Where too now? – resolving differences

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Effectiveness of Engagement

- What the AER concluded in the Draft Determination (DD)
  - AER generally agreed with CCP9's observations
  - Noting CCP9's concerns but also taken the view that Electra Net's CE "is of a high standard" (Overview, p. 35)
  - Recognizes that early CE cannot act as a substitute to the AER's formal decision making process & rigorous assessment required under the Rules
- CCP9 strong supports these conclusions by the AER
  - We welcome opportunity to attend Electra Net's next CAP meeting which will discuss the AER's DD & Electra Net's response
  - Given the many challenges ahead, many of which will require additional expenditures, CCP9 hopes ElectraNet maintains its open consultative approach
  - We also consider this is important for the RIT-T processes.
- Where too now – resolving differences and maintaining relationships

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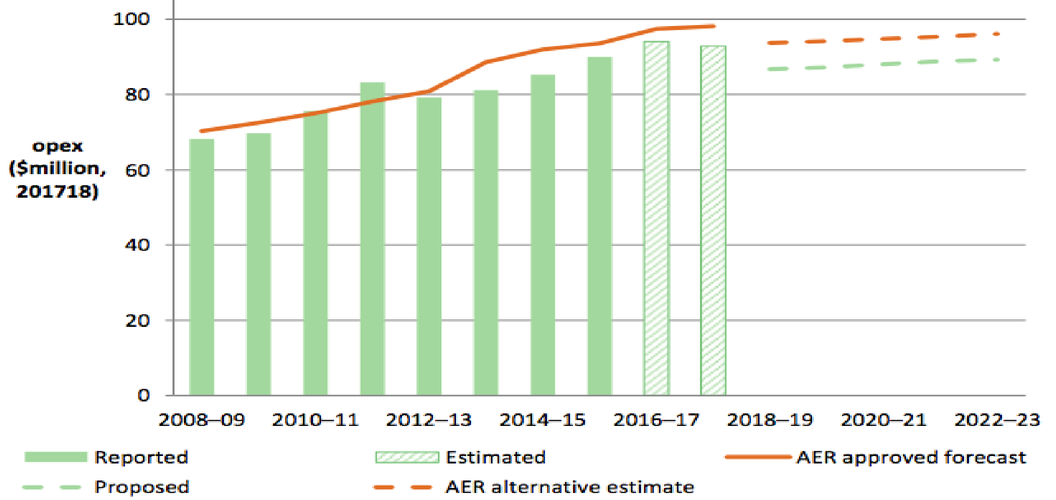
AER Draft Decision: Opex

- AER accepts ElectraNet's overall opex proposal of $440.1m ($2017-18) for the 2018-23 period
  - Although differences in components of the forecast
- CCP supports the DD – subject to analysis of risks/costs

Historical & forecast annual opex ($m, $2017-18)



Source: ElectraNet, *Regulatory accounts 2008–09 to 2015–16*; ElectraNet, *Revenue proposal*, *Opex model*, March 2017; *Revenue proposal*, *PTRM*, March 2017; AER analysis.

Note: Includes debt raising costs and movements in provisions.

Source: AER, Draft Determination, Attachment 7, Oct 2017, Figure 7.1, p.7-7

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AER Draft Decision Opex (2)

- Differences in opex components. The AER:
  - Accepts ElectraNet's 2015-16 base opex (after excluding movements in provisions and network support costs)
  - Uses the AER's approach to forecast 2017-18 opex,
  - Rate of change in real costs of 0.66%/pa (TG proposed 0.61%/pa)
    - **Price growth**: largely consistent with ElectraNet: Labour price growth based on updated average growth in SA wage price index (WPI) & CPI for non-labour price growth.
    - **Output growth**: AER forecasting some growth in output, ElectraNet assumes zero growth (subject to contingent projects)
    - **Productivity growth:** AER forecast +0.2%/pa, ElectraNet assumes 0%/pa over the five years
  - Step changes: both AER and ElectraNet propose no step changes
  - Category specific costs:
    - debt raising costs – AER uses its benchmarking approach
    - network support costs ($41.9m) – similar to ElectraNet, but more transparent as it's a identified pass through cost

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The disciplined approach to opex welcome - but with some questions…

- Total and partial productivity trends in the 'wrong' direction
- Contingent projects may increase opex as well as capex
- ElectraNet's letter to AER re update of cost pressures (6/10/17) identified additional risks to opex forecasts from:
  - AEMC System Security Market Frameworks Review: requirement to provide minimum specified levels of inertia & system strength, or alternative equivalent services
  - Transmission Connection & Planning Framework Rule Change: obligation to facilitate contestability in the provision of dedicated connection assets
  - Regulatory Investment Test (RIT-T) Rule Change: Extends RIT-T process to replacement capital expenditure
  - Potential outcomes of the Finkel review of future NEM security
  - Pending AEMC Review of the SA System Black Event
- While looking for offsetting efficiencies, ElectraNet still has some concerns about its ability to pass these costs through
- Overlapping government policy agendas risk creating expenditure inefficiencies. Also lack of coordination

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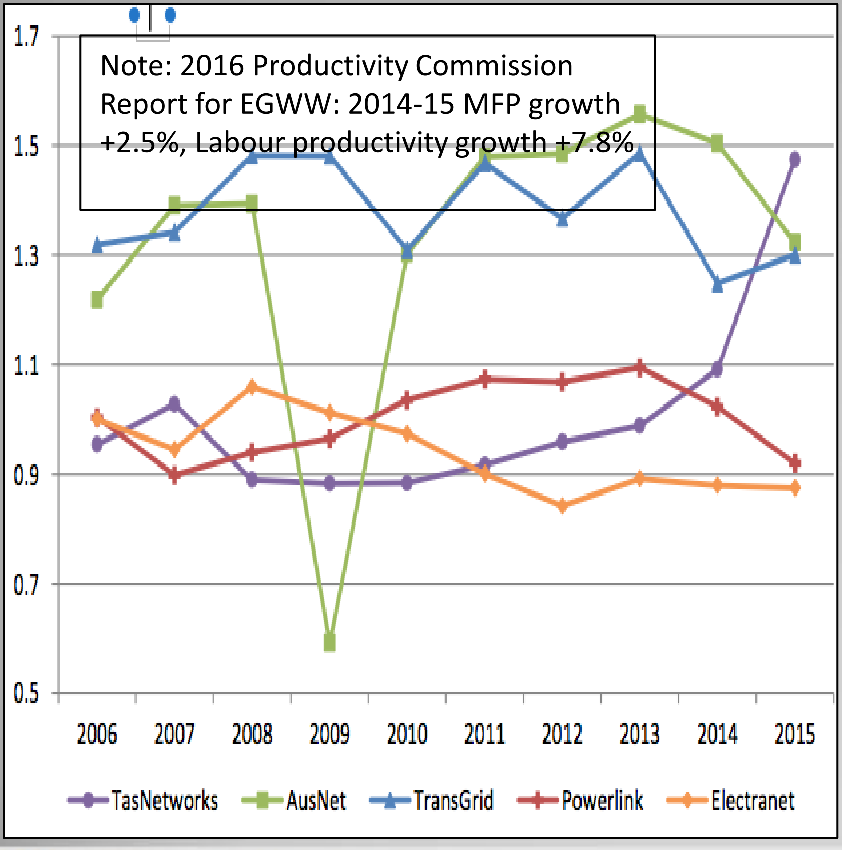
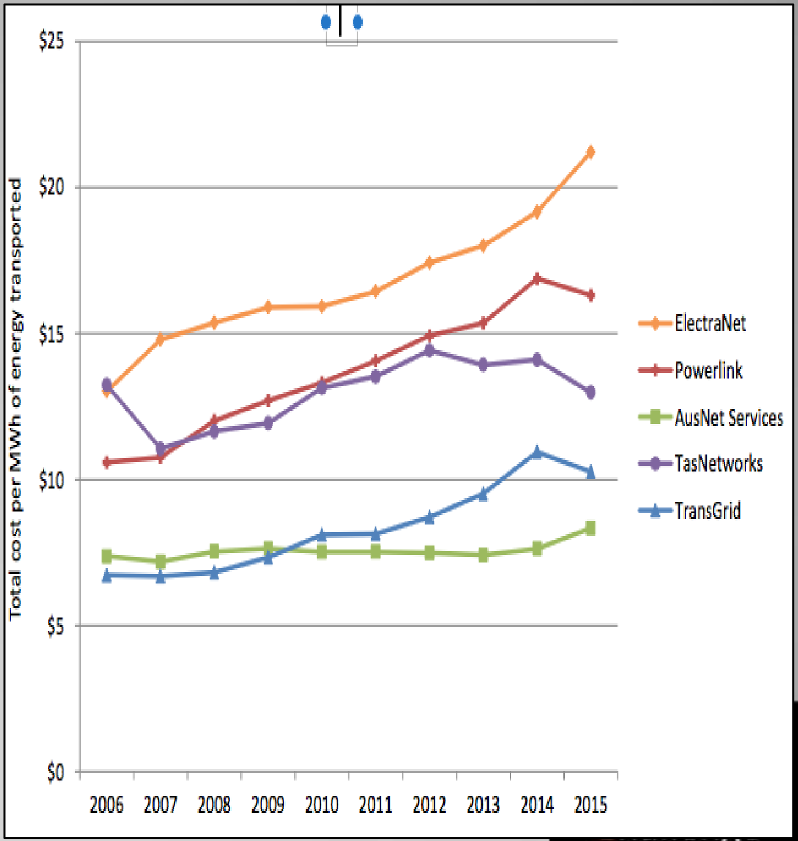
Productivity trends? Against background of improved EGWW industry-wide trends

Opex partial factor productivity index, 2006-2016



Total cost per MWh of energy transported ($2015))



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Source: AER TNSP Annual Benchmarking report, November 2016. Note, comparisons between transmission firms to be treated with caution

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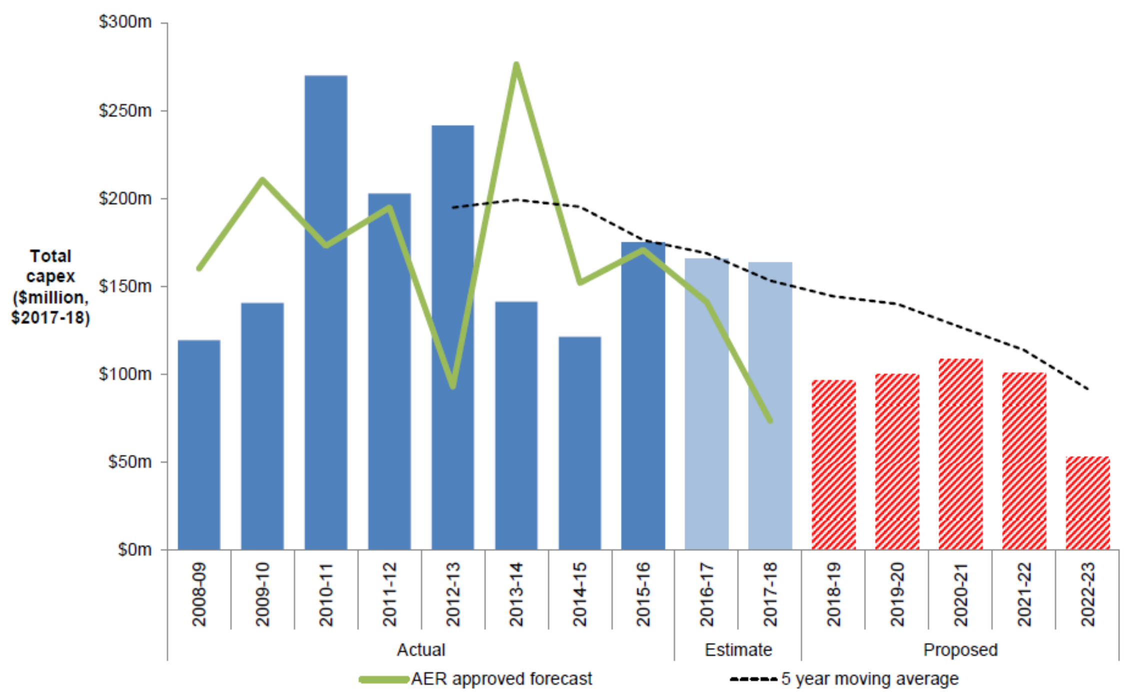
Capex

Figure 6.3 ElectraNet total capex - historical and forecast ($2017–18)



Source: ElectraNet, *Forecast Capital Expenditure Model*, March 2017; AER analysis.

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Capex (2)

- AER Draft Decision accepts ElectraNet's proposed $459.1m
- Found Gawler East Load Driven capex of $6.3m to not be prudent and efficient
- ESCRI-SA Battery at Dalrymple ($5.8m) to be removed from 2018-23 Reg Period and be completed in 2017-18.
- May be reflected in revised proposal or replaced by equivalent expenditure on 'previously deferred projects' (p6-38).
- Consumers may prefer to see a reduction in the capex allowance given the other upward pressures on expenditure (new obligations, contingent projects)

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October Update on Cost Pressures

- ElectraNet wrote to the AER and stakeholders on 6 October 2017 re the changing context
- Numerous new obligations clarified, some yet to be finalised and some to be reflected in RIT-T processes.
- Opex impact estimated at $1m to $2m per annum
- Capex to be reflected in SA Energy Transformation and Main Grid System Strength Contingent Projects / RIT-T processes … $200-500m & $60-80m respectively.
- Contrast with Draft Decision: Capex ($459.1m) and Opex ($440.1m) as proposed by ElectraNet.

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5 Contingent Projects

- Eyre Peninsula Reinforcement ($200m – incl $80m ex-ante)
- South Australian Energy Transformation ($200-500 million)
- Main Grid System Strength Support ($60-80 million)
- Upper North-East Line Reinforcement ($60 million)
- Upper North-West Line Reinforcement ($110 million)

- CCP sought presentation of potential consumer impacts
- ElectraNet indicated residential impact of about $4 pa for the $120m Eyre Peninsula Project and about $8 for a $250m SAET project (from the time of commissioning)
- AEMO declared a Network Support and Control Ancillary Services gap for SA in September: MGSS project likely
- Seems modest but relative to a typical residential TUoS of $150 pa will challenge the media release headline
  - "*AER draft decision to provide stability in transmission charges for South Australian customers*"
- Impact on Large Users could be even greater % of total electr[icity] costs

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Regulatory Asset Base (RAB)

- Key indicator for an NSP
- Capex remains a commercial imperative over Opex:

"Currently there is no commercial upside and considerable potential downside (through cost recovery risk, cash flow risk, and contractual risk and compliance risk) associated with procuring non-network solutions, which are subject to cost pass through under the current regulatory framework"

ElectraNet submission to ESCOSA's Eyre Peninsula reliability Inquiry

- Contingent Projects tend to hide RAB growth during Regulatory Determinations
- Following charts illustrate the Draft Decision – which shows an eventually falling RAB + a range of plausible RAB scenarios from info provided by ElectraNet about likel increases

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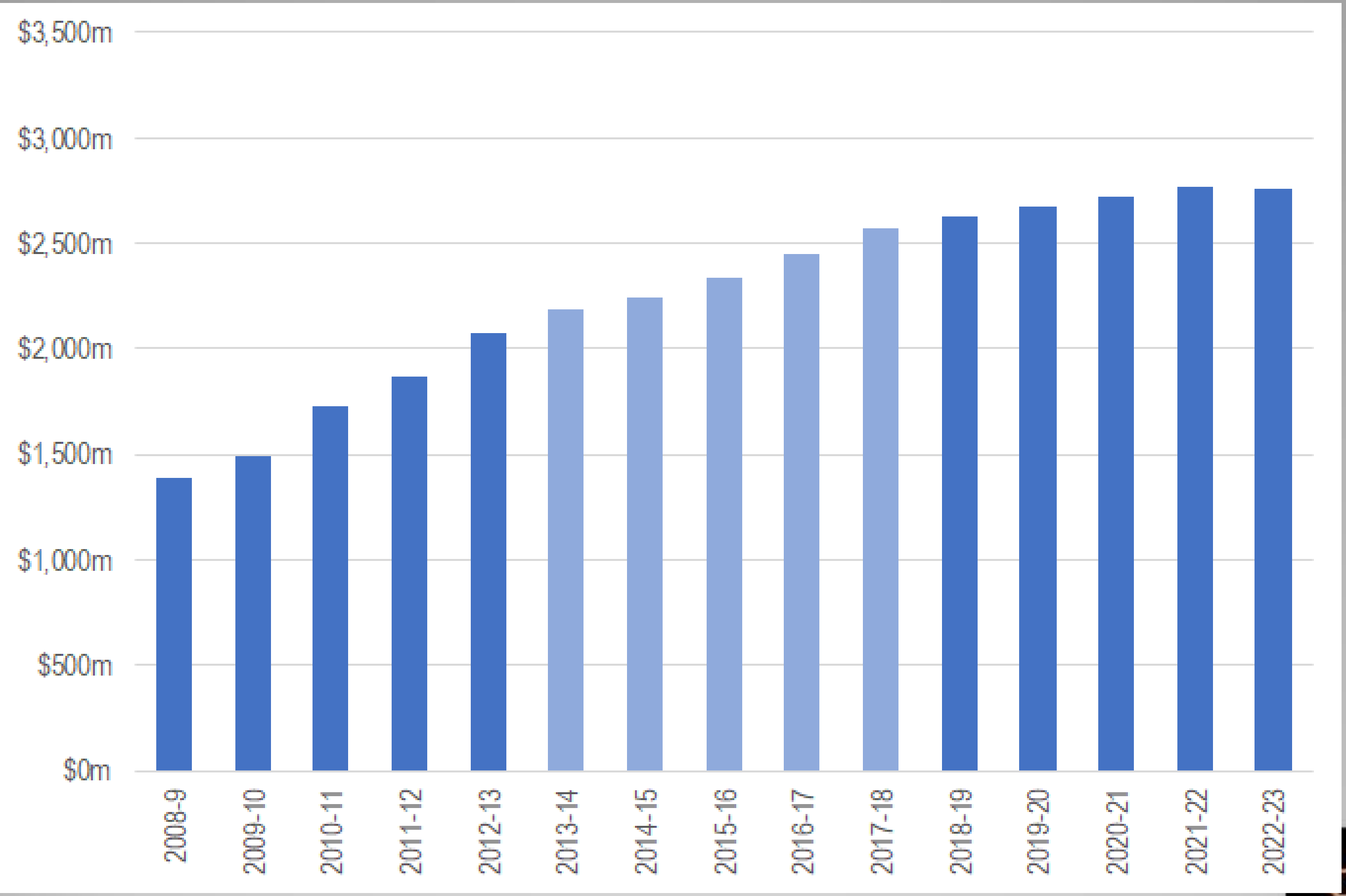
Closing RAB (ex-ante Draft Decision)



Source: AER Final Determination ElectraNet 2013-18, Draft Decision 2018-23, Nominal $

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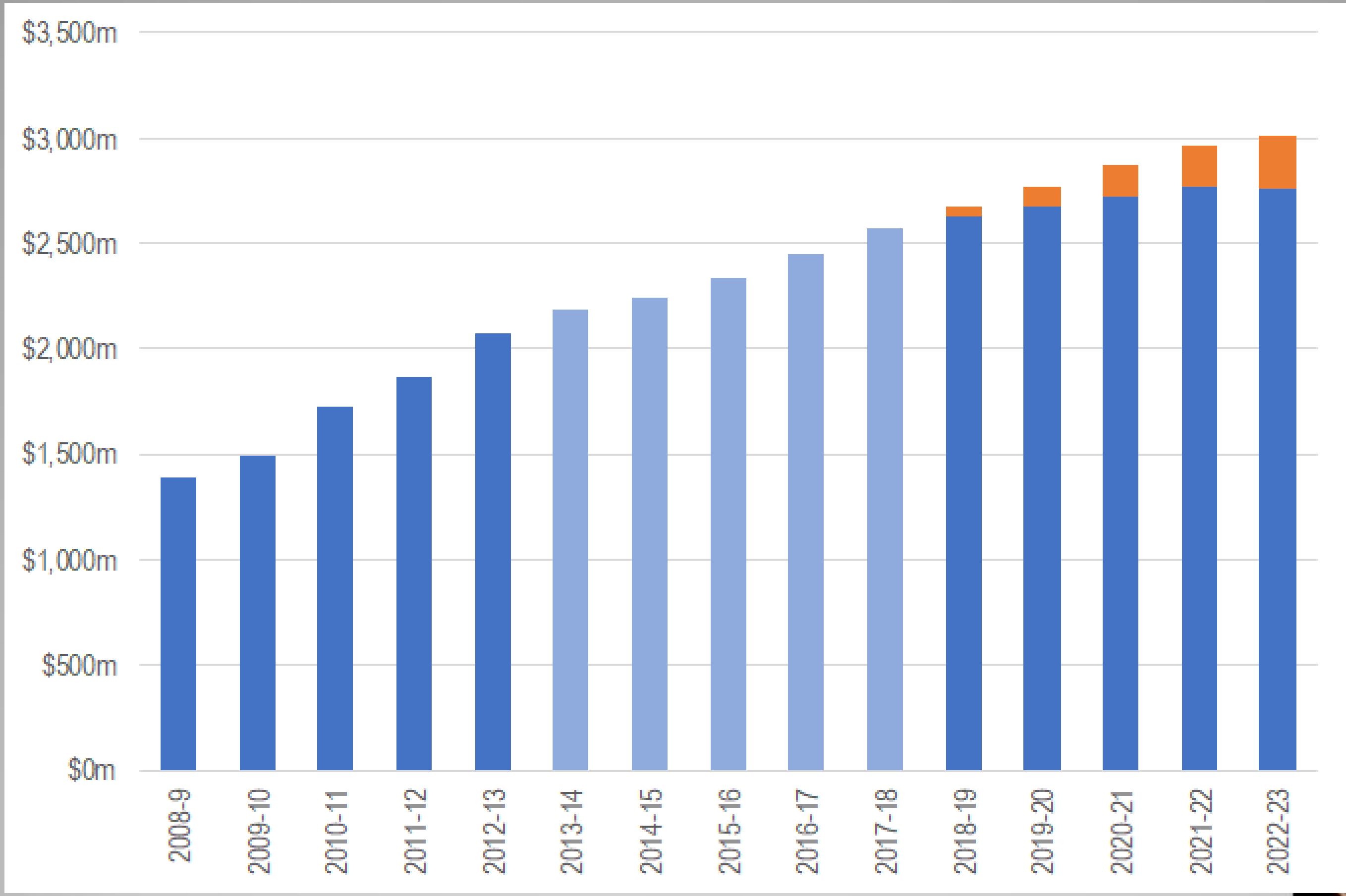
Closing RAB (add $250m in stages)



Source: AER Final Determination ElectraNet 2013-18, Draft Decision 2018-23, Nominal $

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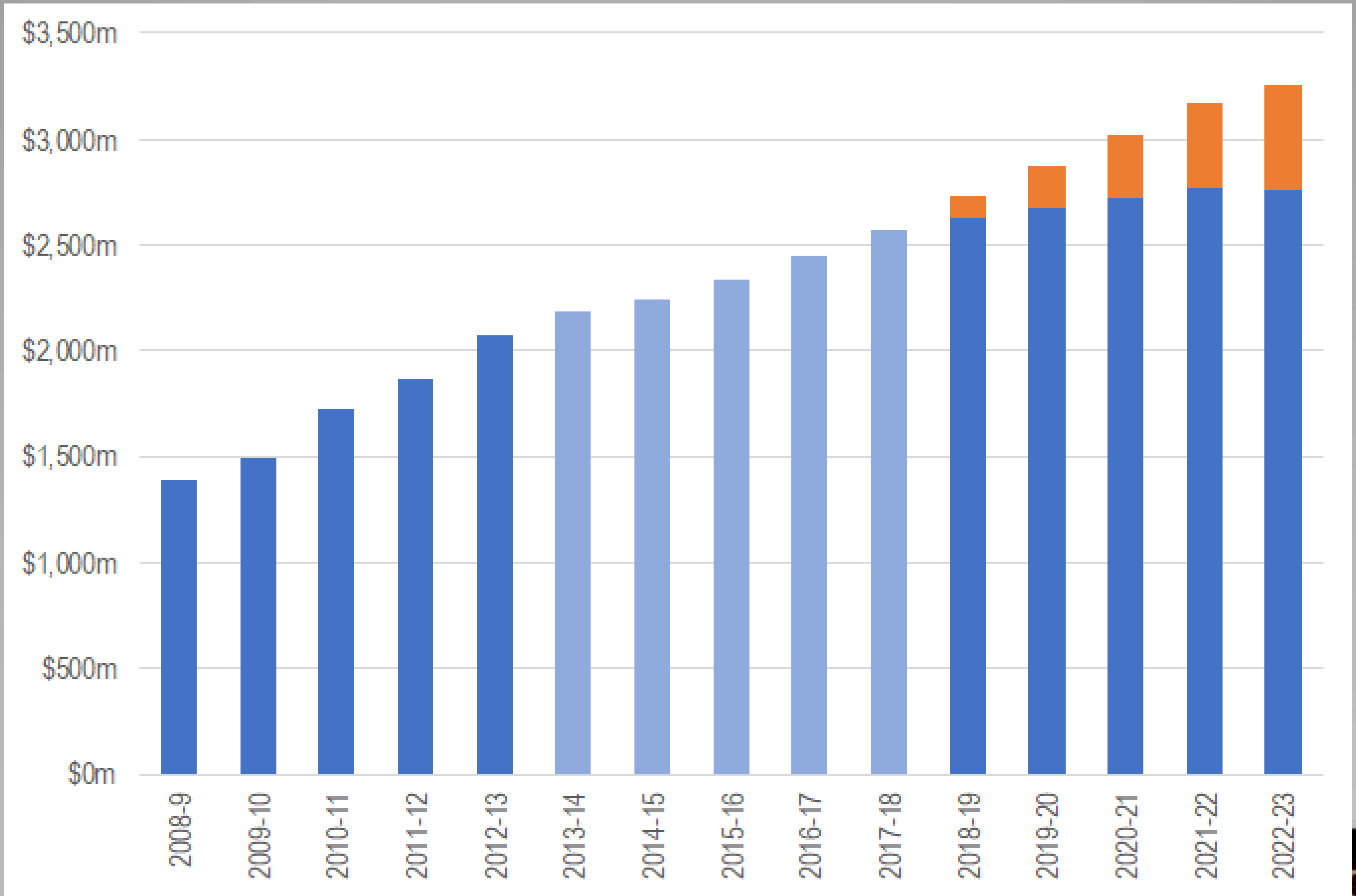
Closing RAB (add $400m in stages)



Source: AER Final Determination ElectraNet 2013-18, Draft Decision 2018-23, Nominal $

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WACC and Tax

- Proposed WACC was 6.02% (vanilla, nominal)
- ElectraNet's proposal differed from AER guidelines on:
  - Gamma (which affects tax) - 0.25 rather than 0.4
  - Inflation (which affects the real WACC) - 1.97% based on bond yields rather than 2.5% under AER's current approach
- CCP 9 advice:
  - Evidence suggests current approach errs of the high side
  - AER should reject variations from the RoR guidelines
- AER draft decision:
  - Nominal WACC of 5.7% (vanilla) – differs due to timing
  - Inflation of 2.5% resulting in lower real WACC (via depreciation)
  - Gamma of 0.4 resulting in lower tax allowance
  - Consistent with current guidelines and CCP 9 advice.

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Draft Decision on WACC

- CCP 9 supports the AER decision on WACC
  - AER has applied the current guideline having regard to:
    - Current market conditions
    - Recent decisions of the ACT and Federal Court
- We accept the decision should not pre-empt the Rate of Return review just commenced.
- But evidence suggests the current approach errs on the high side, as indicated by
  a. Strong investment proposed
  b. The premium paid above RAB for regulated businesses
- Decision supports (a) but doesn't engage on (b)

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Inflation

- AER model is based on real WACC (i.e. nominal WACC less inflation). Inflation assumption has major impact.
- ElectraNet: 1.97% based on implied yield approach
- CCP 9 recommended retention of current approach
  - Rate of Return & Inflation reviews underway. Change could pre-empt this.
  - Strong case for change has not been made.
- Draft decision: maintain current approach (2.5%)
- CCP9 supports draft decision. Review underway has:
  - Increased doubts about implied yields (RBA comments)
  - Demonstrated that differences between actual and expected inflation do not affect achievement of the real WACC.
- AER approach compared to breakeven approach addressed by Victorian Tribunal in *Application by ActewAGL Distribution* [2017] ACompT2. The Tribunal concludes):
  - AER's assessment "fair and balanced & not in error" (@[476])
  - The networks knew in 2008 that the B/E approach was flawed and has not attempted to address these flaws in its recent application (@ 478)
  - No substantive evidence that the RBA forecasts should be discounted (@[481])
  - Historical coincidence between actual inflation outcomes and mid-point of AER's forecasts & intentions of monetary authorities to encourage inflation increase, Tribunal considers RBA's target range provides best possible inflation forecasts for the time being (@ [482])
  - The AER had a reasonable basis for its view (having considered the alternative) for reaching its views (@[487])

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Imputation Credits and Tax

- ElectraNet proposal: Tax allowance of $79m, 0.25 gamma
- CCP 9 advice:
  - Use gamma of 0.4, per guideline, subject to Federal Court decision
  - Review the approach to estimation of taxable income in the context of the WACC review - current approach appears to overstate tax.
- AER draft decision: Tax allowance of $37m, 0.4 gamma.
  - Federal Court Decision found no error in AER approach
- CCP 9 supports gamma of 0.4 but there are residual question about estimation of taxable income.
  - Does the current approach overstate taxable income in practice?
  - Why give stronger incentives to reduce tax than increase efficiency?

  But this cannot be changed in this review.

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