Submission to the Australian Energy Regulator (AER) on its Draft Decision on Aurora Energy's Regulatory Proposal 2012-2017 and Aurora Energy's Revised Proposal

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Executive Summary

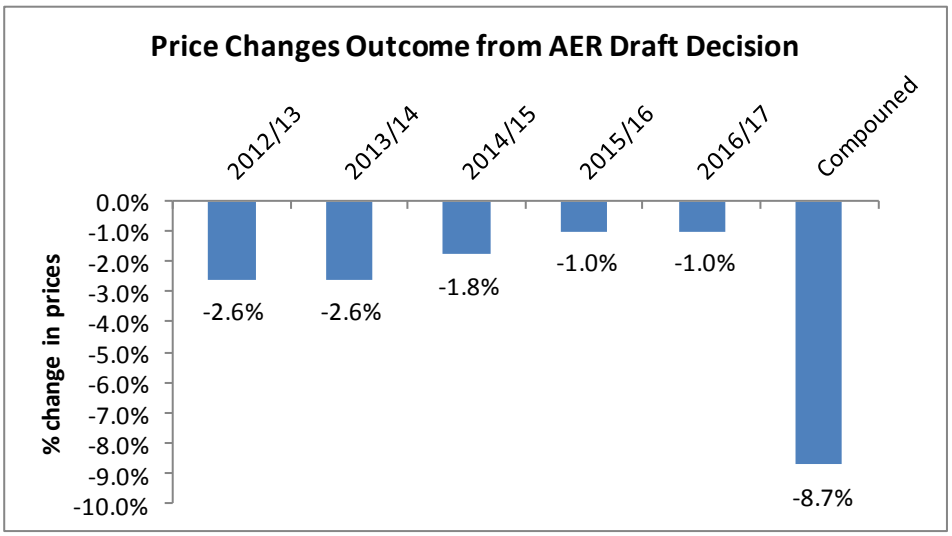
In this submission we set out the Energy Users Association of Australia's (EUAA) views on the AER's draft decision on Aurora Energy's revenue proposal for the 2012/13 to 2016/17 regulatory period and Aurora Energy's revised regulatory proposal. The EUAA has over 100 members, many of whom are large electricity users. A number of our members have operation in Tasmania and this includes some of the biggest energy users in the State as well as some smaller ones.

Electricity distribution costs would generally comprise more than 40 per cent of our members' delivered cost of electricity. We have a number of members in Tasmania who are connected to Aurora's distribution network. Those members also depend on distribution services to deliver a reliable supply of electricity with high power quality levels to their sites. We therefore have a strong interest in this review and in the outcomes determined by the AER. The EUAA has been involved with all of the distribution network reviews that the AER has undertaken since it assumed the regulation of the distribution networks. In total the mainland networks have been granted approximately $40 billion in revenues which they will collect from their customers via higher network charges. This is a very significant amount of money which has also grown substantially since the AER assumed its role.

The resulting prices from the AER's draft decision indicate that there will be real price decreases The AER has applied positive X factors (real price decreases) over the next regulatory period[1]. The price decreases are shown in Figure 1.

[1] The AER applies X factors in a distribution regulatory determination which are real price changes. These factors can be positive or negative, a positive factor indicates real price decreases and a negative x factor indicates real price increases.

Figure 1: Distribution price changes[2]



The first two years of the regulatory period would see real price decreases of 2.6 percent followed by smaller decreases from 2014/15 to 2016/17. The EUAA believes that these price outcomes, involving as they do average distribution price reductions, are along the lines of what the Tasmanian community (businesses and households) are looking for, given recent significant electricity price increases and their impact on the cost of living and of doing business. We can detect no appetite for an AER regulatory determination that would involve price increases. We also note that this would be insensitive to the current plight of the Tasmanian economy, which is going through a difficult period and is suffering from the impacts of the high dollar-high cost-low productivity dilemma that characterizes States that are more reliant on manufacturing, processing and non-resource based industries. These industries are under considerable pressure from a range of cost increases and further increases in electricity distribution charges at this time would place them under even more pressure. The EUAA therefore supports the lower real price changes resulting from the AER's draft decision.

The EUAA is largely supportive of the AER's draft decision on Aurora Energy's regulatory proposal in relation to the 20% reduction in capital expenditure (capex); the 8.5% reduction in operational expenditure (opex); the AER's reduced WACC, which reduces Aurora Energy's return on capital over the next regulatory period by 25%, or $208 million (nominal); and the 17% reduction in nominal revenues from Aurora's proposed $1.57 billion to $1.31 billion.

In regard to the energy forecast, the AER has accepted Aurora Energy's forecast of electricity consumption and has not developed an alternative forecast. The logic behind this reasoning is that an energy consumption forecast is not relevant in determining prices for distribution

[2] We have shown the positive x factors as decreases to highlight the fact that the AER's draft decision results in price decreases.

network service providers (DNSPs) under revenue cap regulation. While the EUAA sees the logic behind this reasoning, it is not consistent with recent practices especially for the Queensland distribution network service providers, Energex and Ergon Energy. At the very least there should be some analysis of the electricity consumption forecast to ensure that the drivers of the inputs correlate with the maximum demand and customer number forecasts.

In assessing Aurora's proposal the AER determined that the proposed connections forecast is consistent with historical trends and growth expectations but at the higher end of the range. We would suggest that growth expectations at the higher end of the range for Tasmania may be optimistic considering forecasts of economic growth are not strong and that Aurora Energy has acknowledged that the economic outlook for Tasmania is weak.

The EUAA supports the AER's reasoning behind its maximum demand forecast. However, analysis of Aurora's revised maximum demand forecast finds that it is 1.5% higher per annum on average compared to the AER's forecast. We therefore seek confirmation that this increase is an accurate forecast of maximum demand.

We note the benchmarking undertaken by the AER's consultants regarding Aurora Energy's capex proposal. The EUAA has concerns that the consultancy's statements on its use of benchmarking limits the scope of benchmarking to assessing efficiency and not in assessing the costs incurred by the various DNSPs. The EUAA has concerns that the revised capex proposal results in Aurora's customer connection capex (per new customer connection) being well above its recognised peers Powercor and SP Ausnet; and Aurora Energy's capex to meet maximum demand is significantly above that incurred by Powercor and SP Ausnet. The EUAA queries whether the revised capex is reflective of the prudency and efficiency criteria in the National Electricity Rules (NER).

The EUAA supports the AER's 8.5 percent reduction in Aurora Energy's opex and shares the AER's concerns that Aurora Energy applied a 3% efficiency factor to limit its opex forecast, in the absence of substantiating which projects would be decreased to meet Aurora Energy's goal of reducing its opex over the next regulatory period. The EUAA has concerns over Aurora Energy's revised opex forecast especially as it is $16 million above its original proposal and $45 million above the AER's draft decision. EUAA analysis points to an increase in routine network maintenance opex as the main driver; our analysis indicates that there is a step change in this expenditure for the next regulatory period compared to the current regulatory and we ask whether this is reflective of the prudency and efficiency criteria in the NER given Aurora Energy's relatively young asset profile.

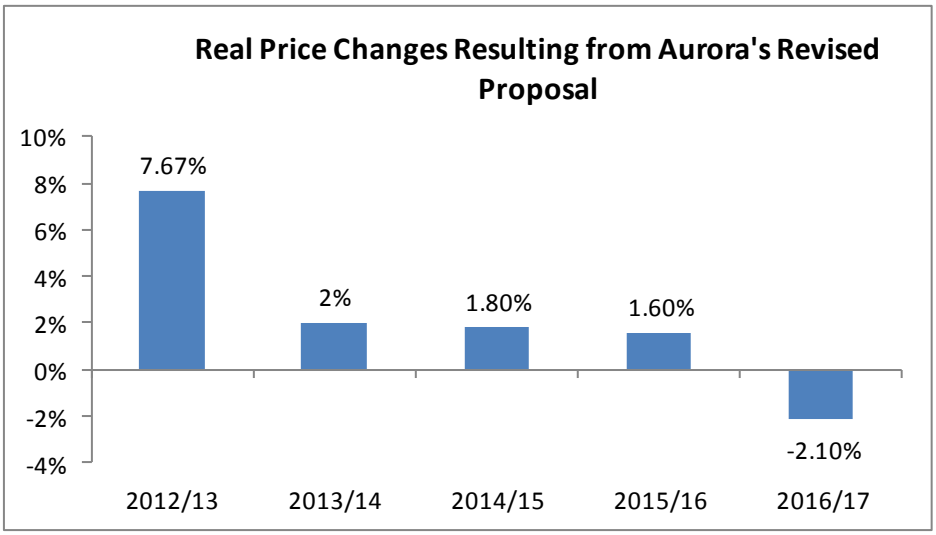
The EUAA supports the AER's lower cost of capital which reduces Aurora Energy's total return on assets and its annual revenues by $208 million. The EUAA aggress with the AER's reasoning on the lower risk free rate and debt risk premium (DRP). We have concerns over Aurora Energy's revised cost of capital of 9.97 percent. Aurora's continued use of the Bloomberg fair value curve is out of touch with recent Australian Competition Tribunal findings which have allowed the AER to

depart from previous practices when practicable. Aurora's assertion that there has been a structural break in markets from the global financial crisis is out of touch with overseas regulators who have found that there has not been a structural break.

Figure 1: Distribution price changes

Aurora's revised regulatory proposal would see price increases from 2012/13 to 2015/16 and a small decrease of 2.1 percent in 2016/17. This is shown in Figure 2.

Figure 2 Distribution price changes from Aurora Energy's revised proposal



EUAA would argue that further electricity price increases at a time of already significant increasing prices are unwelcome in Tasmania where the economy is struggling and is forecast to continue to struggle. Whilst acknowledging Aurora's sensitivity to the issue of further electricity price increases – a point they have made consistently since before they submitted their original proposal to the AER and reflected in it – we feel that their revised proposal would result in unacceptable real price increases. We also believe that there are some key aspects of their revised proposal that are difficult to justify which contribute to these price increases.

Contents

1. Energy Consumption forecasts

This section discusses the EUAA's response to Aurora's growth forecasts for the next regulatory period and the response in Aurora Energy's revised regulatory proposal.

The AER has not provided an alternate energy growth forecast and has accepted Aurora Energy's forecast of electricity consumption. The logic behind the AER's reasoning is that as Aurora Energy will be regulated under a revenue cap mechanism and an electricity consumption forecast is not necessary to determine the revenue caps.[3] The EUAA understands the AER's logic behind this reasoning given that the revenue cap for individual tariff classes is determined by the side constraints formula in the National Electricity Rules (NER), which does not take into account an electricity consumption forecast. While the EUAA sees the logic behind this reasoning, it is not consistent with recent practices especially for the Queensland distribution network service providers, Energex and Ergon Energy.

We note that during the regulatory review of the Queensland distribution businesses (which are regulated under a revenue cap) the AER made determinations on energy consumption forecasts for the Queensland distribution networks Energex and Ergon Energy. In the case of Ergon Energy it found that the energy consumption forecasts proposed by Ergon Energy did not provide a realistic expectation of the demand forecast required to achieve the capex and opex objectives[4]. As the AER has previously made some assessment of energy consumption forecasts for distribution networks that are regulated under revenue caps, we feel that the AER should maintain consistency with previous practices at least for the last determination in the current round of electricity distribution revenue resets. As an alternate forecast has not been developed by the AER or a consultancy firm the EUAA has been denied an opportunity to comment on energy consumption forecasts by the regulator. At the very least there should be some analysis of the electricity consumption forecast to ensure that the drivers of the inputs correlate with the maximum demand and customer number forecasts.

The remainder of this section is limited to a discussion of Aurora Energy's revised energy consumption forecast.

1.1. Revised Energy Consumption Forecast

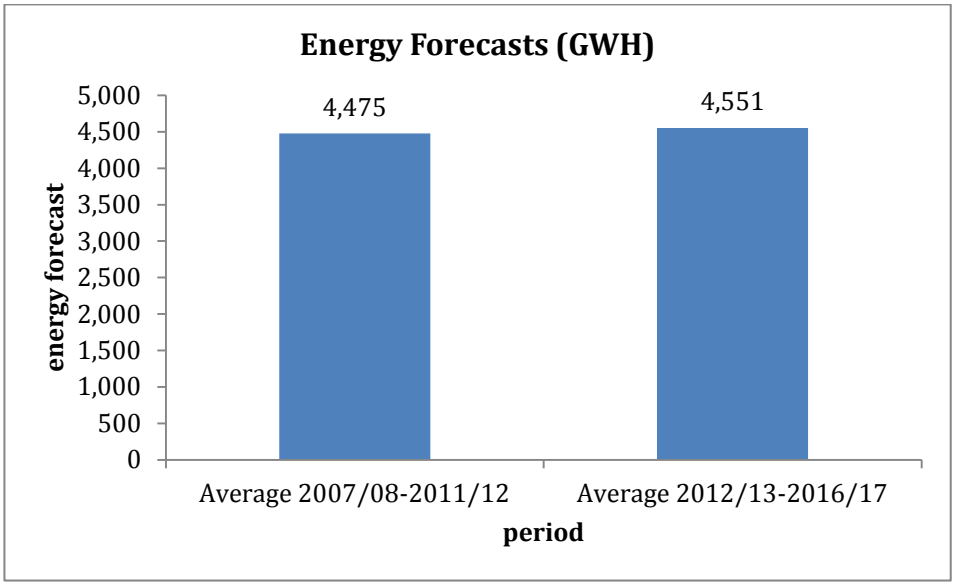
Aurora's revised energy forecast indicates that an average of 4,551 gigawatt hours of energy per annum to be consumed over the next regulatory period;[5] an increase of 1.69 percent over the current period. This is shown in Figure 3.

[3] ibid

[4] AER Final Determination, Queensland Distribution, May 2010, p.38

[5] Using Aurora Energy's medium growth scenario

Figure 3: Average Electricity Distributed (GWh)



We note that the AER accepted Aurora's energy consumption forecasts as it found that the forecasting methodology was robust.[6] Aurora Energy has placed some weight on its energy consumption forecasts as the consultancy it employed to produce the forecast took into account population growth forecasts produced by the Australian Bureau of Statistics (ABS). The consultancy took into account the ABS' midpoint outlook for population growth in Tasmania in deriving its forecast.[7] Considering recent economic statements by Tasmanian Treasury and an acknowledgement by Aurora Energy that the economic outlook for Tasmania is not strong, we submit that the use of a midpoint scenario seems to be optimistic in these circumstances.

1.2. Customer Connection Forecasts

The AER has forecast a total of 15,758 gross new customer connections over the 2012-2017 regulatory period, a 22 percent reduction from Aurora's original regulatory proposal. In assessing Aurora's proposal, the AER determined that the proposed connections forecast is consistent with historical trends and growth expectations but at the higher end of the range.[8] Recent statements in the Tasmanian state budget for 2011-2012 point to a weaker economic outlook and slower rate of recovery compared to previous forecasts.[9] The business sector has seen an easing in business confidence and the outlook for business investment is not strong.[10] The EUAA would argue that utilizing historical trends and growth expectations that are at the higher end of the range in the AER Determination is questionable given the weak economic outlook for Tasmania.

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[6] AER Aurora 2012–17 draft distribution determination 2012-2017, p.11.

[7] Aurora Energy Revised Regulatory Proposal 2012-2017, January 2012, p. 38.

[8] AER Draft Determination, Aurora Energy Pty Ltd, 2012/13 to 2016/17, November 2011, p.80.

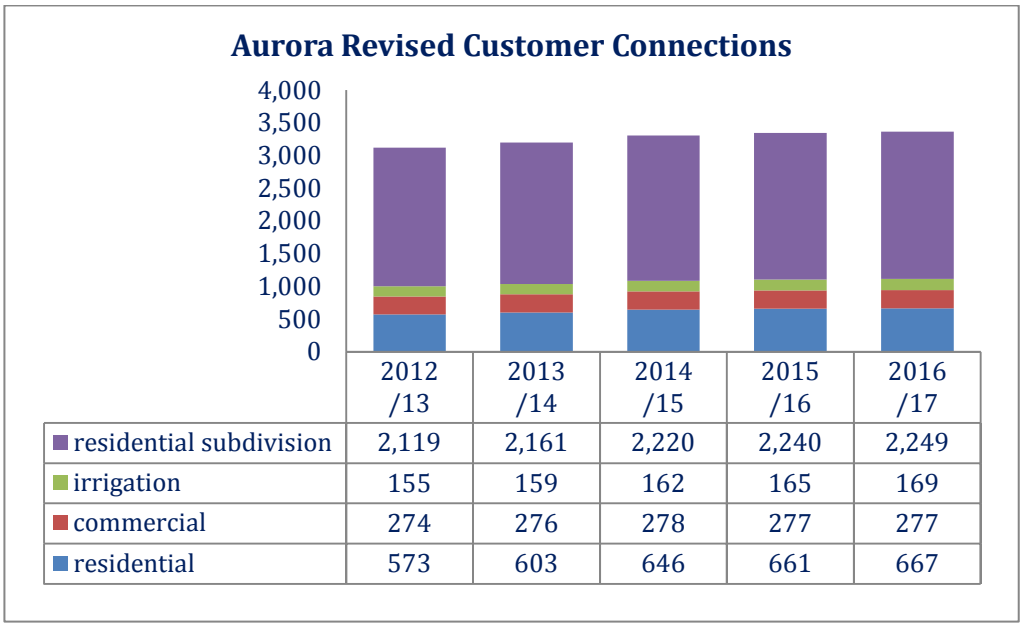
[9] Department of Treasury and Finance, Tasmania, *2010-11 Mid-Year Financial Report* p.15.

[10] Parliament of Tasmania, *Budget Paper No. 1, The Budget* p.2.11.

Comments on Aurora Energy's Revised Regulatory Proposal

Aurora has forecast 16,311 new customer connections in its revised regulatory proposal, an increase of 3.6 percent from the AER's draft forecast. Figure 4 shows the revised gross customer connections forecast.

Figure 4: Revised Gross Customer Connection Forecasts



	2012 /13	2013 /14	2014 /15	2015 /16	2016 /17
residential subdivision	2,119	2,161	2,220	2,240	2,249
irrigation	155	159	162	165	169
commercial	274	276	278	277	277
residential	573	603	646	661	667

The AER has stated that while Aurora Energy's forecast was consistent with historical trends and growth expectations they are at the higher end of the range. Aurora has responded that:

> *The outlook for the Tasmanian economy is relatively weak. As a state that is not generally participating in the resources-led boom which is benefitting resource-rich states such as Queensland and Western Australia, Tasmanian economic activity is being detrimentally affected by the strong Australian dollar (relative to the US dollar).*[11]

Given that the AER has found that the original forecast was at the higher end of the range, the EUAA asks if the revised customer number forecast, which is still higher than the AER proposed in its Draft Determination, is reflective of the growth expectations taking into account the acknowledgement by Aurora Energy that the outlook for the Tasmanian economy is weak and the statements by the Department of Treasury and Finance in Tasmania.

2.3 Maximum Demand Forecast

The EUAA is supportive of the AER's reduced maximum demand forecast, which sees average annual growth in maximum demand reduced to 1.11% for the winter period 2010 to 2017 from Aurora Energy's proposed 1.54% average annual growth over the same period.

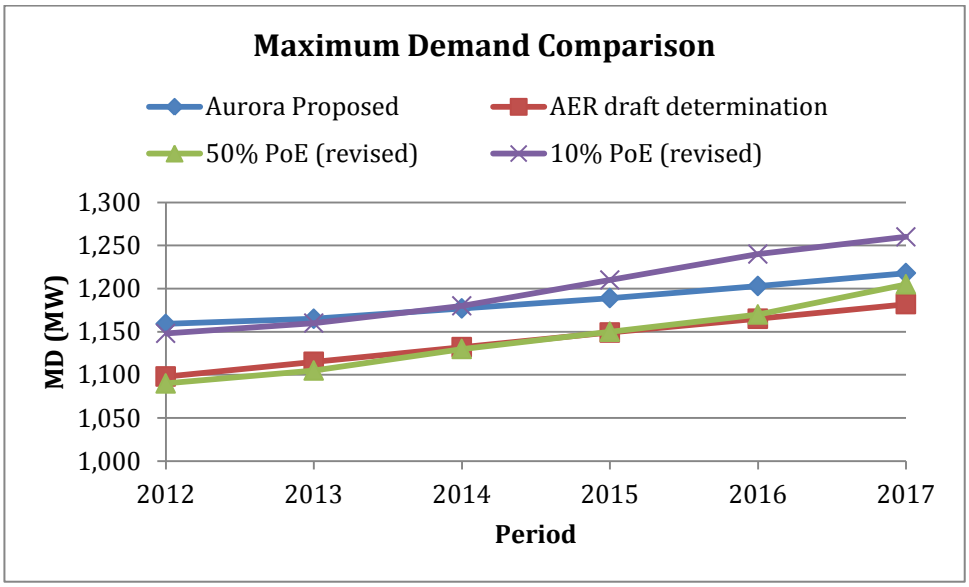
[11] Aurora Energy, Revised Regulatory Proposal 2012-2017, January 2012, p. 37.

The AER expressed concerns with Aurora Energy's forecasting methodology which included non-business days in assessing the long run median temperature impact analysis and excluded non-business days in their assessment of the impact of temperature on maximum demand. This approach differed from the approach taken by the transmission network Transend; Transend excluded non-business days from both is long run median temperature analysis and the correlation between demand and temperature.[12] The EUAA agrees with the AER's reasoning that when reconciling maximum demand forecasts between distribution networks and transmission networks the methodology should be consistent.

Comments on Aurora Energy's Revised Regulatory Proposal

Aurora Energy's revised proposal forecasts maximum demand that is at least 1.5 percent higher at the 50% POE (probability of exceedence) level than the AER's draft decision on the original regulatory proposal. This is show in figure 5:

Figure 5: Maximum Demand Forecast Comparison



Given the significantly higher forecast of maximum demand in the revised proposal, the EUAA asks if the forecast addresses the AER's concerns over Aurora's forecasting methodology.

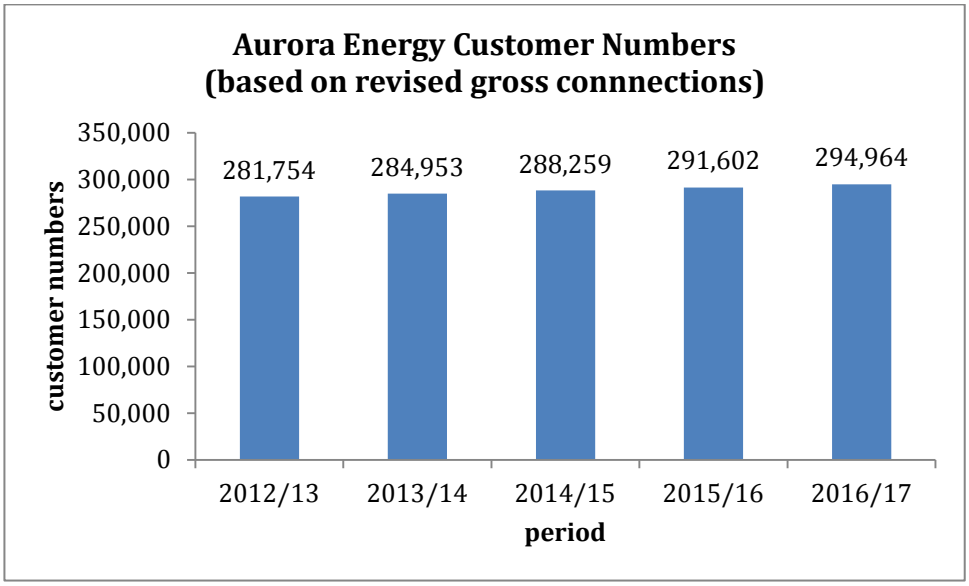
2.4 Customer Numbers

The EUAA notes that a customer numbers forecast was not provided by Aurora Energy and therefore the AER has not provided analysis of customer numbers for Aurora even though it has for the regulatory reviews undertaken in New South Wales, Queensland and South Australia. Despite the lack of data and analysis, the EUAA has obtained what we believe to be a reasonably reliable data set.[13] Figure 6 shows the expected growth in customer numbers over the next regulatory period.

[12] AER Draft Determination, Aurora Energy Pty Ltd 2012/13 to 2016/17, November 2011, p.89.

[13] Using a combination of data sourced from the AER and Aurora Energy's gross new customer connections forecast from its revised regulatory proposal.

Figure 6: Customer Numbers



Aurora's forecast of gross customer connections indicates that the average growth in customer numbers over the next regulatory period is 1.15 percent per annum. Aurora Energy has been able to provide analysis of population growth in Tasmania and has stated that increasing residential customer numbers are driven by household formation arising from population growth and that Tasmania's population growth has been at 0.9%[14].

We note that the lack of customer numbers forecast is also out of touch with previous practices by the AER. In the review of the Queensland distribution networks Energex and Ergon Energy both networks stated that The network businesses have stated that customer numbers are an input into the forecast of maximum demand and energy consumption[15]; furthermore Ergon Energy stated that population growth was an important input into determining maximum demand and electricity consumption. We infer from Aurora's regulatory proposal and revised proposal that Aurora Energy do not know how many customers are attached to its network. This is out of touch with the distribution businesses in Queensland, New South Wales, Victoria and South Australia who have all submitted customer numbers forecasts in their regulatory proposals and their revised proposals. If customer numbers are an input into the maximum demand forecasts and energy consumption forecasts in the other States then it stands to reason that they must also be an input into the maximum demand and energy consumption forecasts. The EUAA has been denied the opportunity to comment on customer numbers and we feel that an analysis of customer numbers is justified to ensure that customer number growth reflects the economic outlook and population growth outlook for Tasmania.

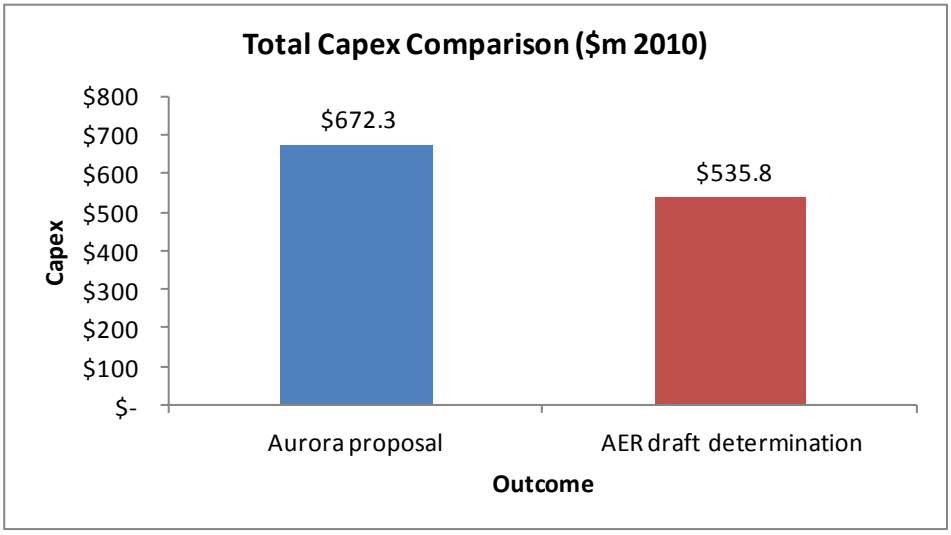
[14] [14] Aurora Energy, Revised Regulatory Proposal 2012-2017, January 2012, p. 38.

[15] Energex, *Regulatory proposal*, July 2009, pp. 149–154.

2. Capital expenditure

Aurora Energy has forecast a total capital expenditure of $672.28 million ($2010) over the next regulatory period and the AER's draft decision reduces this by 20 percent to $535.8 million ($2010). Figure 7 shows the result of the AER's decision.

Figure 7: Capex outcome



The EUAA notes that the consultancy employed by the AER to investigate Aurora Energy's original capex proposal found that Aurora Energy had not demonstrated that its overall capex can be considered to be prudent and efficient.[16] The consultants report found that the comparable businesses to Aurora Energy for benchmarking purposes are the Victorian distribution networks, specifically the largely rural distribution networks SP Ausnet and Powercor.[17]

The EUAA notes that Aurora Energy's reinforcement capex to meet maximum demand is significantly higher than the average for the Victorian DNSPs[18], especially as peak demand growth is forecast to be significantly higher in Victoria. The EUAA also notes the AER's concerns that some of the projects designed to deal with maximum demand only have small components that actually meet maximum demand issues.[19] The EUAA would be concerned if projects slated to address maximum demand but have little to do with the stated aims of the project were approved by the AER.

[16] Nuttal Consulting, *Report, Principal Technical Advisor Aurora Electricity Distribution Revenue Review – final report,* November 2011, p.i.

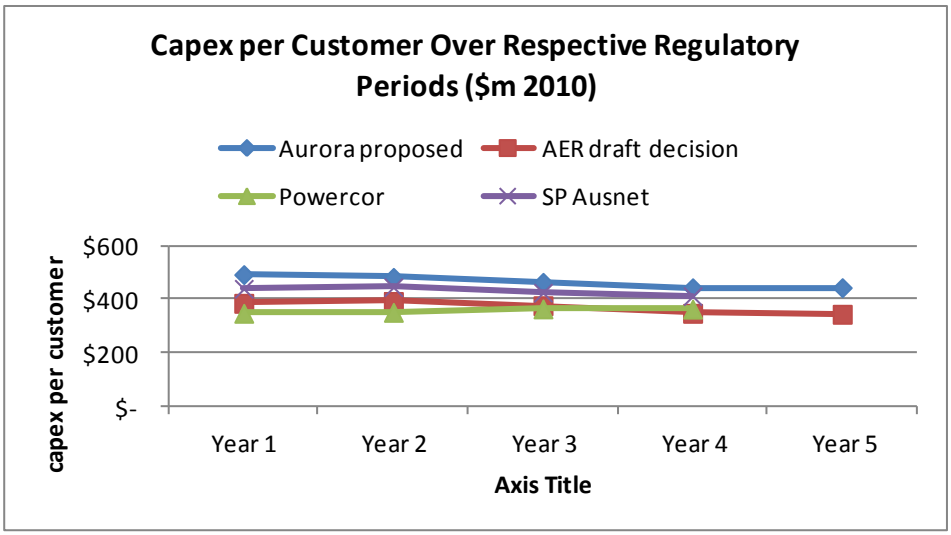
[17] Ibid p. 9

[18] AER draft distribution determination Aurora Energy Pty Ltd 2012/13 to 2016/17. November 2011, p.138

[19] Ibid, p.137

The AER's reduction in Aurora's capital expenditure makes Aurora Energy's capex comparable to its peers in Victoria. This is demonstrated in Figure 8 which compares the capex per customer for the respective regulatory periods.

Figure 8: Capex per customer[20]



Aurora Energy's original proposal had capex per customer an average of 30 percent higher *per annum* than Powercor; and an average of 9 percent *per annum* higher than SP Ausnet. The AER's draft decision places Aurora Energy' capex per customer on par with its Victorian peers.

We note that the consultancy employed by the AER undertook benchmarking against the other DNSPs in the NEM. We view this as an encouraging step and welcome the AER's decision to do so. The EUAA has been an advocate of benchmarking in the previous DNSP regulatory resets that we have been involved in given the important role that is can play in informing the regulator about the efficient costs of the distributors and in setting expenditures for the forthcoming regulatory period. Given this, the EUAA has concerns over statements in the consultancy report. The AER's consultancy states that:

> *While we consider that the results of our high-level benchmarking analysis are reasonably compelling, these results have not been used to set expenditure targets directly. Rather, the primary purpose of the benchmarking has been to gauge the overall level of efficiency of Aurora compared to other NEM DNSPs, and in turn, inform the in-depth review of targeted matters.*[21]

Benchmarking is a valuable tool for assessing the level of efficiency of electricity network businesses. Benchmarking can also be a tool for looking at why certain businesses incur greater costs than other businesses, including why some distribution networks incur greater costs than other comparable ones.

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[20]Based on total capex divided by customer numbers. Aurora Energy's regulatory period is from 2012/13 to 2016/17 and the Victorian distributors' regulatory period is from 2011 to 2015.

[21] Nuttal Consulting, *Report, Principal Technical Advisor Aurora Electricity Distribution Revenue Review-final report* November 2011, p.8

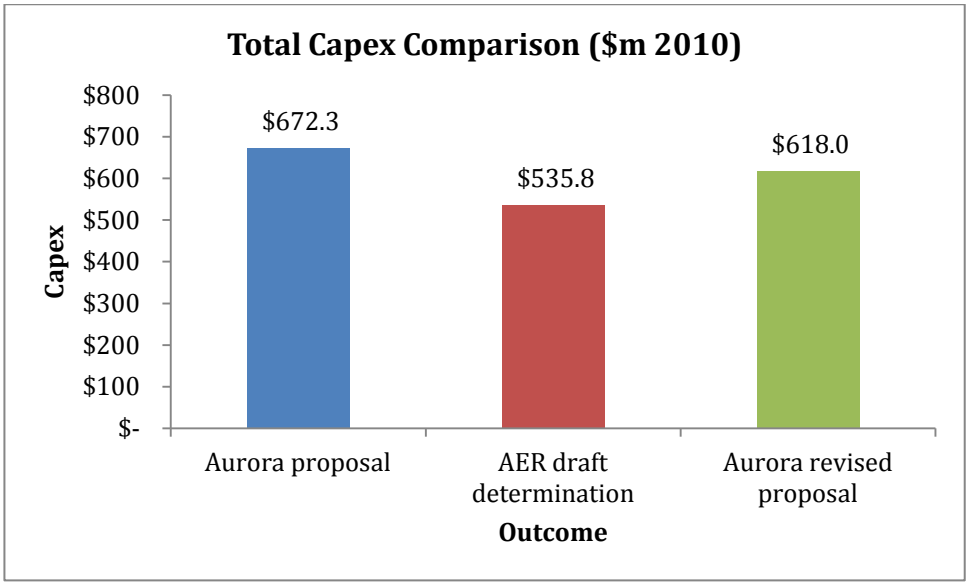
Capex has a great bearing on the revenues that DNSPs generate from their tariffs as the return on assets is the largest contributor to the total revenues. In the case of Aurora Energy, the AER's return on capital makes up 50% of the total annual revenue requirement in its draft determination.

Failing to use the benchmarking of capex in setting expenditure targets can also be seen to be out of touch with the National Electricity Objective. Finally, we are unclear as to why the AER has not utilized the benchmarking that its consultant has undertaken to help it set Aurora's expenditure targets? This applies especially as the consultant has stated that "*the results of our high-level benchmarking analysis are reasonably compelling"*.

Comments on Aurora Energy's Revised Regulatory Proposal

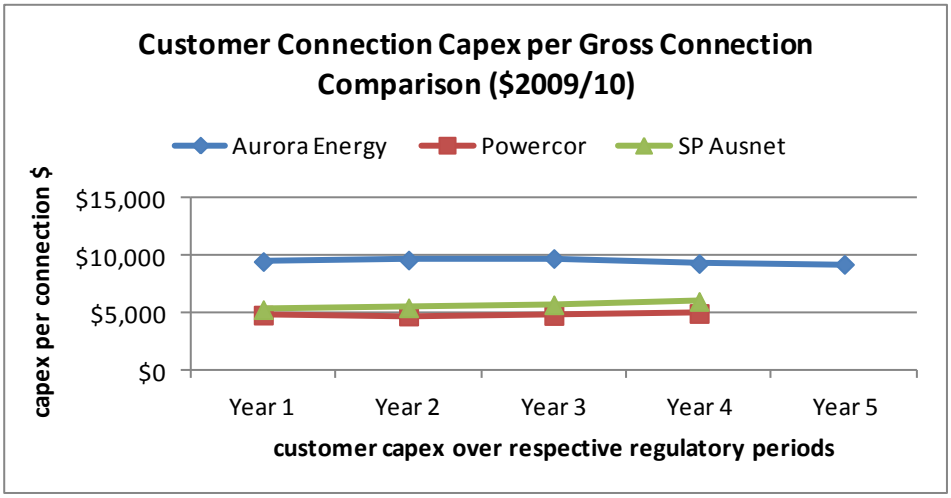
Aurora Energy's revised capex requirement for the next regulatory period totals $618 million ($2010), a 15% increase over the AER's draft decision. Figure 9 compares the capex outcomes from Aurora's proposals and the AER's draft decision.

Figure 9: Total Capex Comparison



Analysis of Aurora Energy's revised capex proposal finds that its expenditure is well above the expenditure incurred by its Victorian peers. This is shown clearly in Figure 10, which compares the customer connection capex per new customer connection between Aurora Energy, Powercor and SP Ausnet.

Figure 10: Customer connection capex per gross customer connection



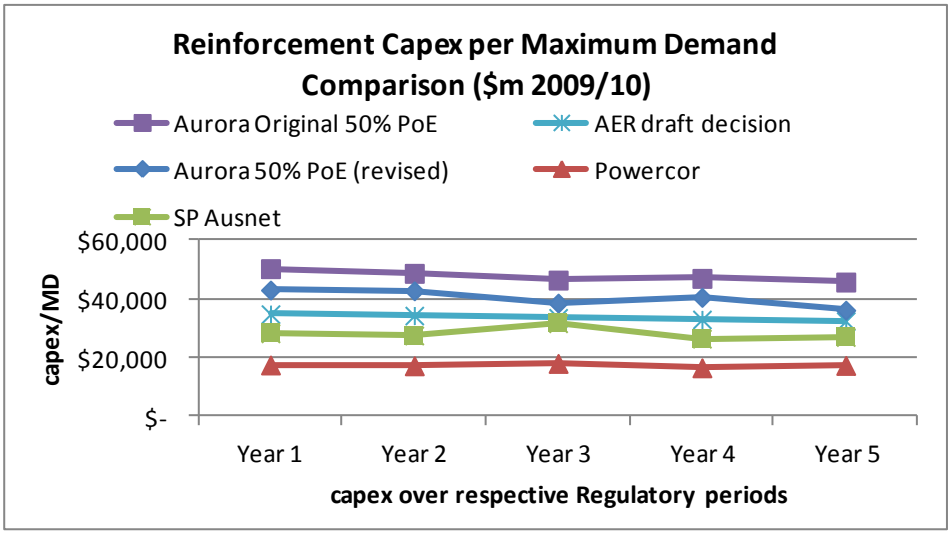
This analysis indicates that Aurora Energy's customer connection capex per gross new customer connection is on average 98% higher than Powercor's and approximately 71% higher than SP Ausnet's expenditure.

The AER's consultant found that Aurora Energy had not demonstrated that its original capex proposal could be considered to be prudent and efficient.[22] Given the significant differences between the expenditure profiles of the three network businesses, we have concerns that Aurora Energy's revised customer connection capex would not meet the prudency and efficiency requirements of the NER?

EUAA analysis finds that Aurora Energy's revised reinforcement capex (capex to meet maximum demand) is also above its Victorian peers. This is shown in Figure 11.

[22] Nuttal Consulting Report – Principle Technical Advisor Aurora electricity Distribution Revenue Review November 2011,p. i

Figure 11: Reinforcement capex per maximum demand



Our Analysis shows that Aurora Energy' revised reinforcement capex per maximum demand is 130 percent higher on average than Powercor's expenditure and 43 percent higher than SP Ausnet's expenditure. The AER has not provided a year by year breakdown of the maximum demand capex over the regulatory period, based on Aurora's assessment of the AER's demand related capex allowance of $189.9 million (or an average of $37.97 million per annum); Aurora Energy's revised proposal is 19 percent higher on average than the AER's draft decision.

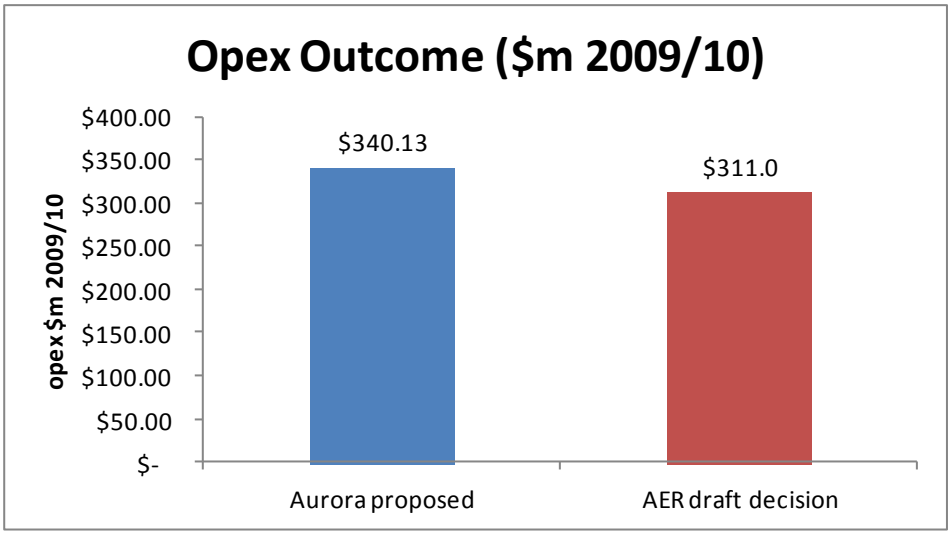
The AER's consultancy has benchmarked the reinforcement capex to meet maximum demand against the Victorian DNSPs. Its analysis found that Aurora's forecast capex to meet peak demand growth is twice as high as the Victorian DNSPs forecast levels and twice as high as the historical levels of reinforcement capex.[23] Given the concerns expressed by the AER's consultant, we question whether the revised reinforcement capex meets the prudency and efficiency criteria in the NER?

[23] [23] Nuttal Consulting Report – Principle Technical Advisor Aurora electricity Distribution Revenue Review November 2011 p.ii

3. Operational Expenditures

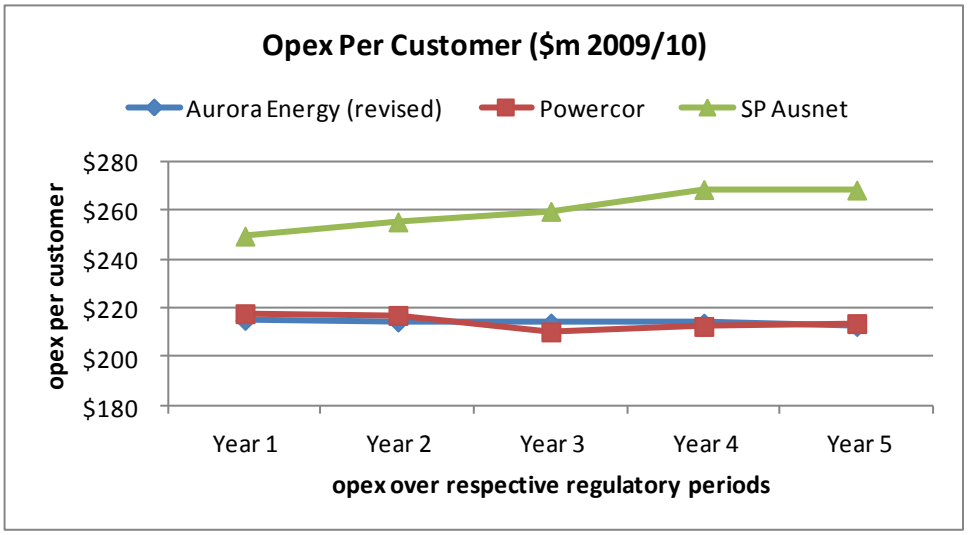
Aurora Energy proposed opex totalling $340.12 million ($2009-10) over the next regulatory period. The AER reduced this to $311 million ($2009/10), a reduction of 8.5%. This is shown in Figure 12.

Figure 12: Opex Outcome



The AER's draft decision on Aurora Energy's opex proposal puts Aurora Energy's opex on par with its comparable peers in Victoria. This is show in Figure 13 where Aurora Energy's opex per customer is on par with Powercor's and below SP Ausnet's opex per customer.

Figure 13: Opex per Customer Comparison



The EUAA is largely supportive of the AER's reduction in Aurora Energy's opex for the forthcoming regulatory period. The EUAA notes the AER's concerns on the use of a 3 percent efficiency factor by Aurora as a means of forecasting its opex shares the AER's concerns that Aurora Energy applied a 3% efficiency factor to limit its opex forecast, in the absence of

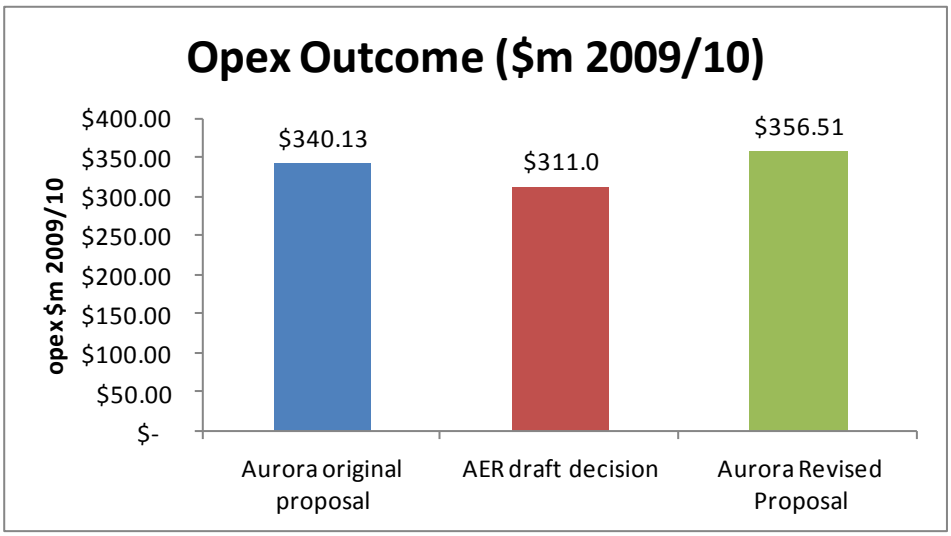
substantiating which projects would be decreased to meet Aurora Energy's goal of reducing its opex over the next regulatory period[24].

In developing an opex forecast, the AER selects a base year that will have recurrent costs that will occur in the next regulatory period. Part of this methodology involves the removal of non-recurrent costs from the base year, essentially removing these costs from the opex forecast. The EUAA supports the AER's removal of non-recurrent costs from the base year opex and notes that this approach is consistent with the AERs previous regulatory decisions.

Comments on Aurora Energy's Revised Regulatory Proposal

Aurora Energy's revised opex proposal totals $356.5 million ($2010). This is 5 per cent higher than its original proposal, which totalled $340 million; and approximately 15% above the AERs draft decision. This is shown in Figure 14

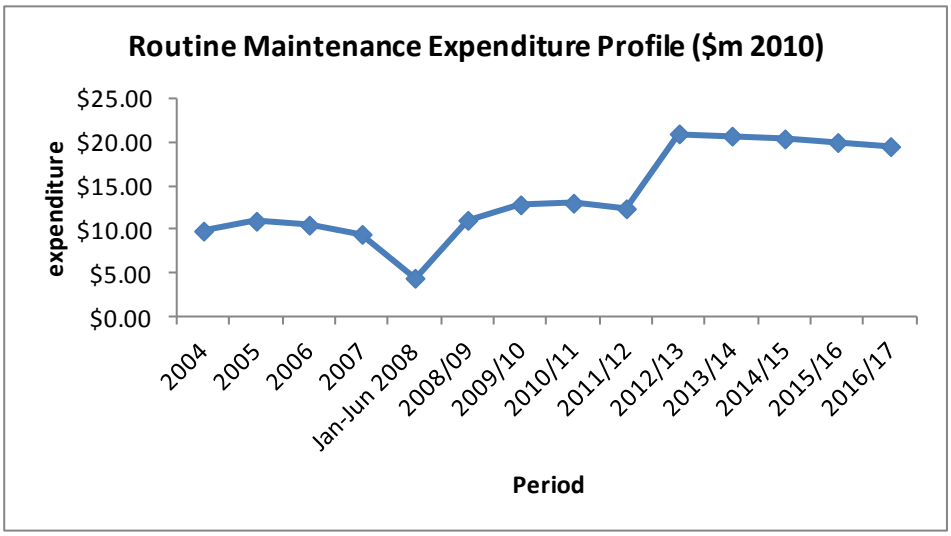
Figure 14: Opex Outcome Comparison



The main driver behind the increase is a $10.9 million increase in routine maintenance expenditure. Figure 15 shows the routine maintenance expenditure profile.

[24] AER draft distribution determination Aurora Energy Pty Ltd 2012/13 to 2016/17. November 2011, p.138

Figure 15: Routine maintenance expenditure profile



While the level of routine maintenance expenditure levels out over the next regulatory period, the increase in expenditure between 2011/12 and 2012/13 is significant at 49%. The EUAA addressed concerns over the level of routine maintenance expenditure given the relatively young age of Aurora Energy's assets in its previous submission.[25]

The EUAA acknowledges and welcomes that Aurora Energy's original opex proposal and revised opex proposal are below their actual opex expenditure and the opex expenditure determined by the Office of the Tasmanian Energy Regulator (OTTER) in the current regulatory period. It would be useful for the AER to undertake the same benchmarking approach that was undertaken to assess Aurora Energy's original opex forecast when assessing Aurora Energy's revised opex to ensure that it meets the prudency and efficiency requirements in the NER.

[25] EUAA, Submission to the AER on Aurora Energy's Regulatory Proposal 2012-2017, August 2011, p. 16.

4. Cost of capital

Aurora Energy asked for cost of capital of 10.33% in its original regulatory proposal and the AER's draft determination provided for an 8.08% cost of capital. The result of the reduced cost of capital was a $207.7 million (nominal) reduction in Aurora Energy's total return on capital over the next regulatory period.

The EUAA notes the reasoning and logic behind the AER's lower cost of capital, specifically:

- The lower debt risk premium (DRP) given that the AER has found that the Bloomberg BBB+ 7 year fair value curve (FVC) does not reflect improving conditions. The AER points to the availability of a larger sample of data on Australian bond market conditions, which the AER sees as being representative of the Australian corporate bond with a 10 year return to maturity (the AER feels this is more representative of improving market conditions).

- The lower market risk premium (MRP), which is based on a robust outlook for the Australian economy; the consistent approach by Australian regulators in providing for and MRP of 6 percent; and surveys of financial market participants which indicate that an MRP of 6 percent has been maintained despite the global financial crisis.

- The lower risk free rate derived from improved market conditions since Aurora Energy developed its cost of capital prior to the submission of its original regulatory proposal.

Comments on Aurora Energy's Revised Regulatory Proposal

Aurora Energy's revised proposal has a return on capital (WACC) of 9.97%. The revised WACC capital results in a total return on capital of $695.9 million (nominal) over the next regulatory period. Aurora differed from the AER on the DRP (3.98% from 3.14% respectively) and on the MRP (6.5% from 6%).

Aurora's higher DRP is based on its continued use of the Bloomberg 7 year BBB+ FVC. Aurora states that it is an observable benchmark that is easy to apply[26]. Aurora has argued that conditions in financial markets are no less uncertain currently than what they were when the AER determined a 6.5% MRP in previous decisions and that continued use of a 6.5% MRP is the most appropriate.

The National Electricity Rules (NER) in Clause 6.5.2(e) provides a specific definition of the DRP as: "*… the margin between the annualised nominal risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a maturity equal to that used to derive the nominal risk free rate and a credit rating from a recognised credit rating agency*". A numbers of things should be noted from this:

- the maturity for the derivation of the nominal risk free rate is 10 years, so the benchmark that the Rules require for setting the DRP should be based on bonds that are redeemed in 10 years time;

[26] Aurora Energy Revised Regulatory Proposal 2012-2017, January 2012 p.

- the credit rating that the AER has recommended in its Statement of Regulatory Intent SORI is BBB+;
- the requirement is for a rate that is "observed" not calculated or inferred.

We note that the provider of the Bloomberg FVC has stated that it not mean to be used as predictive source of pricing information[27] and that the curve derived from estimates made by a market data provider, clearly the FVC as an estimation/calculation does meet the criteria of Clause 6.5.2 (e) of the NER. Based on this the AER's reasoning for departing from the FVC is justified.

Aurora have not provided any justification for their continued use of the FVC in their calculation of the FVC other than that they believe that it is an observable benchmark that is easy to apply[28]. The FVC is not an observable benchmark as it the proprietary techniques (i.e. intellectual property) used to produce the yield estimates cannot be assessed by third parties[29], furthermore the ability of interested parties to gauge the efficiency of the underlying estimates, or to what extent they reflect the available market observed data cannot be undertaken. Aurora Energy have stated that the surveys which the AER used to guide their reasoning on the MRP are not robust in that the AER has not reported on how the survey respondents measured the risk free rate or the assumptions on gamma[30]. We infer from this statement that Aurora Energy finds it acceptable to have a data source included in the DRP calculation that cannot be assessed by third parties when it benefits them but not when data sources have results that maybe detrimental to Aurora Energy.

We note that Aurora Energy have not developed a contrary argument against the Australian Competition Tribunal finding that in a robust market the AER can depart from previous practice and calculate a yield on particular representative bonds issued in Australia[31].

We note that Aurora Energy has suggested that the risk premium that investors require for holding risky assets is substantially higher than prior to the GFC[32]. We note that Ofgem has rejected the notion that there had been a fundamental shift in the cost of debt following the GFC[33].

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[27] Bloomberg, *Letter to the AER,* October 2011, quoted in AER draft distribution determination Aurora Energy Pty Ltd 2012/13 to 2016/17. November 2011, p. 243.

[28] Aurora Energy Revised Regulatory Proposal 2012-2017, January 2012.

[29] AER draft distribution determination Aurora Energy Pty Ltd 2012/13 to 2016/17. November 2011, p. 243

[30] Aurora Energy Revised Regulatory Proposal 2012-2017, January 2012, p.97

[31] Australian Competition Tribunal, *Application by ActewAGL Distribution*, September 2010, paragraphs 74–75, quoted in AER draft distribution determination Aurora Energy Pty Ltd 2012/13 to 2016/17. November 2011, p. 239.

[32] Aurora Energy Revised Regulatory Proposal 2012-2017, January 2012, p.97.

[33] Ofgem, December 2009. "Electricity Distribution Price Control Review Final Proposals – Allowed Revenues and Financial Issues", page 10.

Many Australian corporate bonds are often not traded daily Australian financial markets. The daily bond prices provided by Bloomberg do not necessarily reflect executed trades in the market on the day. For some days when there are not enough trades in the market, Bloomberg's daily bond pricing is only an approximate market value of the bond. As for the sample of bonds chosen by the AER, Aurora considers that Coke Cola Amatil bond should not be included since it was issued in the European market; however the Sydney Airport Bond should have been included in the sample. The EUAA is of the view that illiquidity in the bond market has constrained the ability of the AER to have a large representative sample easily. Further, the EUAA takes the view that it does not really matter much if a particular bond is issued overseas providing that it has been swapped into Australian dollars. This view is cognizant of the fact that regulated entities are allowed and do in fact source some of their finance from overseas jurisdiction.

Basic statistics suggest that a given sample should be large and randomly selected. In selecting the sample of bonds, there is a trade-off between having a large enough sample to obtain reliable results that are not unduly influenced by a small number of outliers, and having bonds that are truly representative with regard to terms to maturity and credit ratings. However the lack of suitable long term bonds in Australia makes this difficult in practice. Whether a particular bond should be included or not is always going to be contentious. It is not difficult to select a particular characteristic of a bond and argue that it should not be included. As to the proposition that the Sydney Airport bond should be included in the sample, the EUAA is of the view that the AER has a transparent methodology for screening bonds for inclusion. This is in marked contrast to the BFV curve. The onus of proof is on Aurora to demonstrate that the selection criterion developed by the AER is inefficient or to show evidence that the AER has not applied its selection criterion correctly; Aurora Energy has not done this in their revised proposal.

The idea espoused by Aurora Energy that the AER should combined the two approaches (AER and BFV curve) seems compelling at first but is suspect under close inspection. At first it may seem sensible to use the information from two different sources. Why would not a regulator use all the information available? Surely, this will lead to a better estimation of the DRP.

The EUAA however does not agree with this proposition. The reasoning is as follows. If one method of estimation (AER) is superior to another (BFV) than it makes more sense to just use the relatively superior method, i.e. combing the two will lead to a worse estimate.

The key challenge is judging which method is superior on a net basis. The EUAA is of the view that the direct approach taken by the AER is a superior method of estimating the DRM therefore the EUAA does not see much to gain by combining the two methods. Conversely, if the judgment is that the FVC is superior than the FVC alone should be employed.

Furthermore, Aurora overstated the true nature of the choice set. Aurora Energy fails to point out that the BFV curve can't be used as it is since it does not have any bonds with terms of maturity greater than 7 years. Somehow, the BFV has to be 'extrapolated' to get a 10 year bond yield. There are many legitimate ways to extrapolate and estimate. It is inevitable that different stakeholders will come up with different numbers. There is also the practical issue of who should do the extrapolation and how are the two methods to be combined.

The EUAA also submits that it is not prudent to combine the two different methods since they are fundamentally different. The AER method is a direct method of estimating the DRP that is simple, transparent and replicable. On the other hand, the BFV methodology is private. The EUAA asks

whether it is prudent to combine a method that is transparent with another method that is non-transparent and has to be 'extrapolated' by somebody. Furthermore, Aurora Energy have not developed a contrary argument against the Australian Competition Tribunal finding that in a robust market the AER can depart from previous practice and calculate a yield on particular representative bonds issued in Australia.

We note that a lot of the arguments put forward by Aurora Energy against the AER's reasoning in setting the cost of capital are similar and at times the same as those put forward by Powerlink in their revenue reset yet Powerlink's cost of capital is much closer to the AER's draft decision (8.68% to the AER draft decision of 8.31%), whereas Aurora's revised cost of capital is far greater at 9.97% compared to 8.08%. Given the similarity between Powerlink's arguments against the AER's draft decision and Aurora Energy's arguments we question the large disparity between Aurora Energy's revised cost of capital and the AER's cost of capital in the draft decision.

5. Cost pass through and additional pass through events

We do not support pass-throughs as a matter of principle as they allow low risk network monopolies to avert risk to a greater degree than competitive firms. We also note that pass through events are inherently asymmetrical in favouring cost increases over decreases, thus working to the disadvantage of energy users and in favour of regulated entities.

The EUAA notes that the AER has shared our concerns regarding pass though risk avoidance as it has stated that under the application of section 7A (3) of the National Electricity Law:

> "*It is limited in its application as it has the potential to undermine the incentive to effectively manage risk in a least cost manner."*[34]

We welcome this comment and urge the AER to ensure this is not the case in the current determination.

Aurora Energy has proposed additional pass through events in its regulatory proposal on account of:

- Natural disaster events
- Bushfires events
- Storms events
- Industry restructure events
- Retailer of last resort events
- Carbon tax events
- Insurer credit risk events
- Liability above insurance cap events.

The AER has rejected most of the proposal pass-through events as they are seen to be able to be applied for under pre-existing pass through events.

The AER agreed with most of the EUAA's arguments against the proposed pass through events. Notwithstanding the EUAA's misgivings about pass through events in general, the EUAA supports the AER's decision on Aurora's nominated pass through events.

The EUAA disagrees with the AER's allowance of a carbon tax event for Aurora Energy as this event was largely foreseeable as it was announced by the Government on the 24th of February 2011 and was legislated in September 2011 and passed in the Senate on November 8th 2011. Hence, it should have been foreseeable by Aurora Energy.

Under the Clean Energy Futures (CEF) package firms that produce products that are open to international competition receive assistance for the energy used to produce those products but

[34] AER *Queensland Draft Determination 2010-11 to 2014-15* November 2009, p. 331

not full assistance which is limited to 66 percent assistance and 94.5 percent assistance[35]. Electricity networks do not face international competition or competition at the domestic level. Those firms facing competition at the domestic level in their respective markets are not always able to pass on additional costs associated with a carbon constrained economy. The definitions in the NER of what constitutes a pass through do not have any discipline imposed on the networks when applying for the additional pass through. When applying for pass throughs associated with a carbon constrained economy there should be limits applied to what can be passed through that reflect the constraints that commercial firms operating in competitive markets face in their ability to pass on additional costs.

Comments on Aurora Energy's Revised Regulatory Proposal

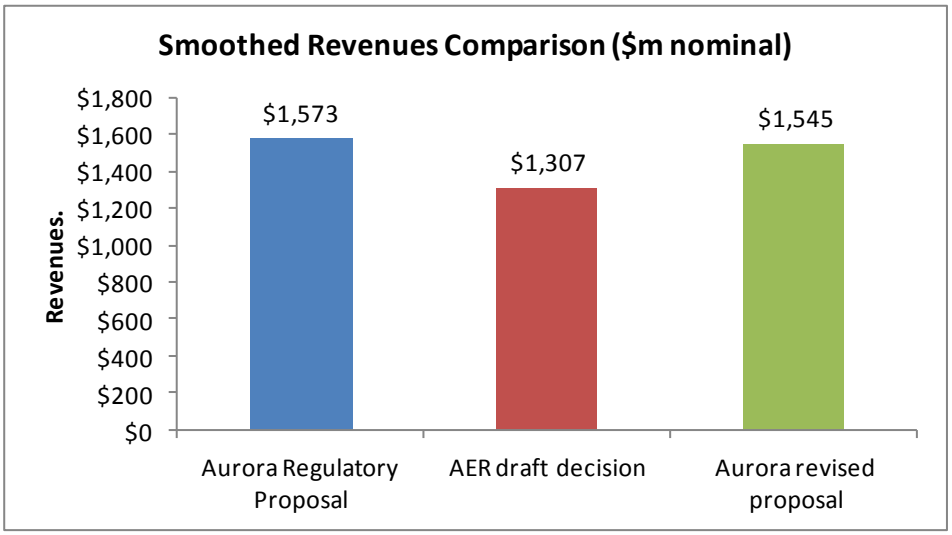
Aurora Energy has agreed with the AER's draft decision and it has asked for clarification that the nominated pass through events are able to be applied for under pre-existing pass through events. Given that the AER has already provided this assurance in its draft decision the EUAA has no further comments.

[35] Department of Climate Change and Energy Efficiency *Securing a Clean Energy Future* p.115

6. Revenue Requirement

Aurora originally proposed 1.57 billion (nominal) for the 2012/13 to 2016/17 regulatory period, the AERs draft decision proposed a revenue allowance of $1.31 billion (nominal), down 17 percent. Figure 16 compares the AER's draft decision with Aurora Energy's original proposal and their revised proposal.

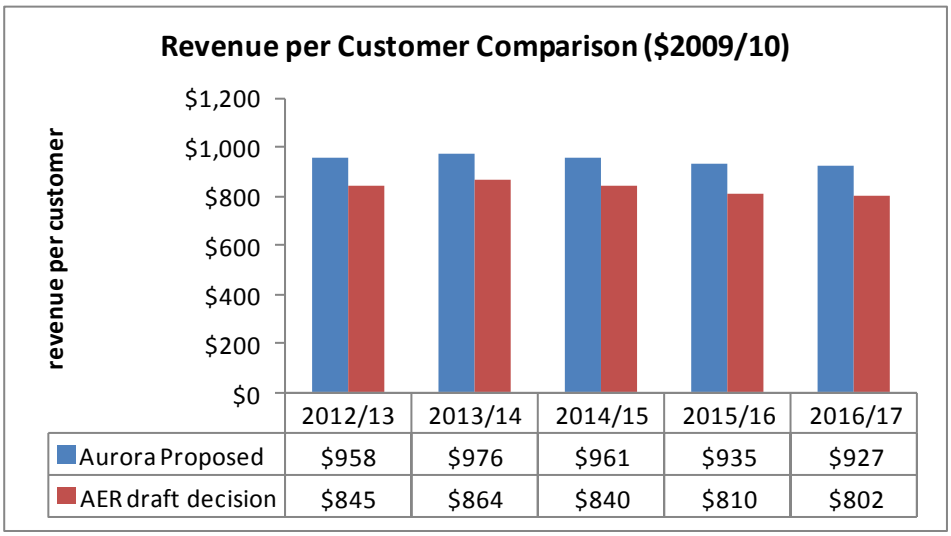
Figure 16: Revenue Comparison



The main drivers of the lower revenues are the lower cost of capital, which reduced Aurora Energy's total return on assets by $207.7 million to $628.9 million (nominal) and the lower opex. These components make up 75 percent of the total revenues.

The AERs draft decision reduces the revenue per customer from Aurora Energy's proposal by an average of 13% per annum over the next regulatory period. Figure 17 compares the revenue per customer resulting from Aurora Energy's original proposal and the AER's draft decision. The EUAA notes the lesser burden that this would entail for business and household electricity consumers in Tasmania who are already struggling with higher electricity costs which are adding significantly to their cost of doing business and cost of living. Now would not be the right time to add to this burden. Given that the cost of capital in Aurora Energy's revised proposal is the biggest driver of the increase and given the EUAA's concerns about the revised cost of capital the revised revenue requirement too high.

Figure 17: Revenue per customer comparison



	2012/13	2013/14	2014/15	2015/16	2016/17
Aurora Proposed	$958	$976	$961	$935	$927
AER draft decision	$845	$864	$840	$810	$802

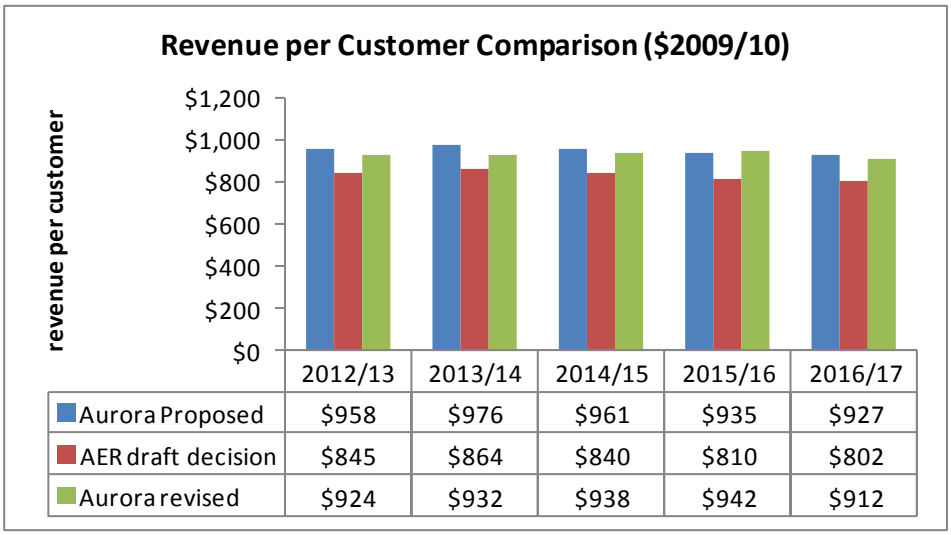
Despite the lower revenues per customer that Aurora Energy would collect over the next regulatory period should the AER's draft decision stand, the EUAA would argue that further electricity price increases at a time of already significant increases in electricity prices, the cost of doing business and the costs of living are unwelcome in Tasmania where the economy is struggling and is forecast to continue to struggle.

Comments on Aurora Energy's Revised Regulatory Proposal

Aurora Energy's revised proposal asks for $1.55 billion nominal ($1.35 billion $2009/10) over the next regulatory period, an increase of 18 percent in nominal terms over the AER's draft decision. The main drivers of the increases are the higher cost of capital and the higher opex.

The revised revenues results in a significant increase in the revenues per customer that Aurora Energy would collect from its customers if the revised revenue is allowed to stand by the AER in its final decision. Figure 18 adds the revenue per customer that would apply if Aurora Energy's revised proposal were to stand.

Figure 18: Revenue per customer comparison



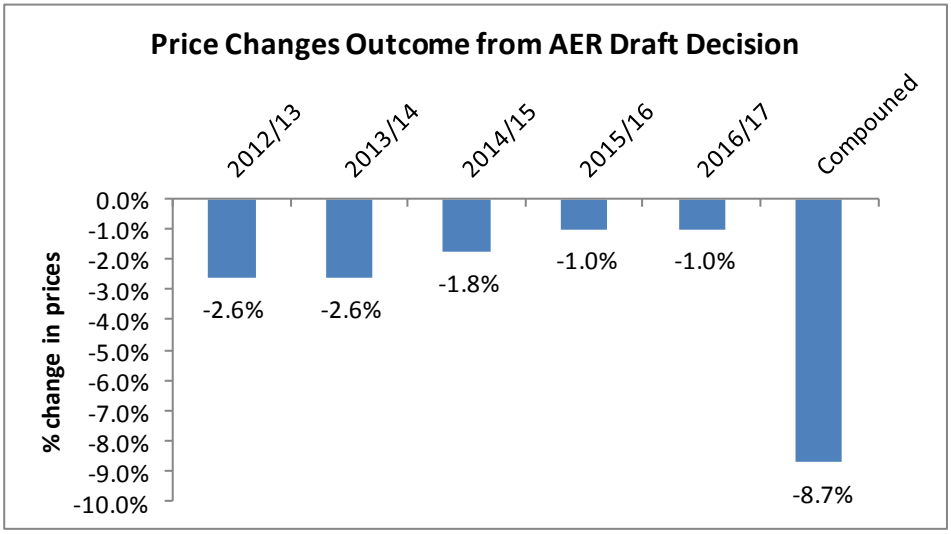
	2012/13	2013/14	2014/15	2015/16	2016/17
Aurora Proposed	$958	$976	$961	$935	$927
AER draft decision	$845	$864	$840	$810	$802
Aurora revised	$924	$932	$938	$942	$912

Aurora Energy's revised revenues increase the revenue per customer by an average of 10 percent per annum over the AER's draft decision. These increases would be unwelcome in Tasmania especially when its economy is struggling and is forecast to remain weak and electricity consumers are already struggling under the weight of higher electricity costs feeding into increases in their cost of living and doing business. The AER needs to take this into account and ensure an outcome that imposes less of a burden on Tasmanian electricity consumers.

7. Aurora's Prices

The AER's draft decision results in real price decreases over the next regulatory period. This is show in Figure 19.

Figure 19: Distribution Price Changes (X factors, real)[36]



The EUAA welcomes the price decreases over the next regulatory period and urges the AER to maintain similar price outcomes in its final decision due in April/May of this year.

As noted in the previous section, this would entail a lesser burden on business and household electricity consumers in Tasmania who are already struggling with higher electricity costs which are adding significantly to their cost of doing business and cost of living. Now would not be the right time to add to this burden. It is also clear that electricity consumers across the nation, including in Tasmania, are not supportive of further price increases at this time.

Comments on Aurora Energy's Revised Regulatory Proposal

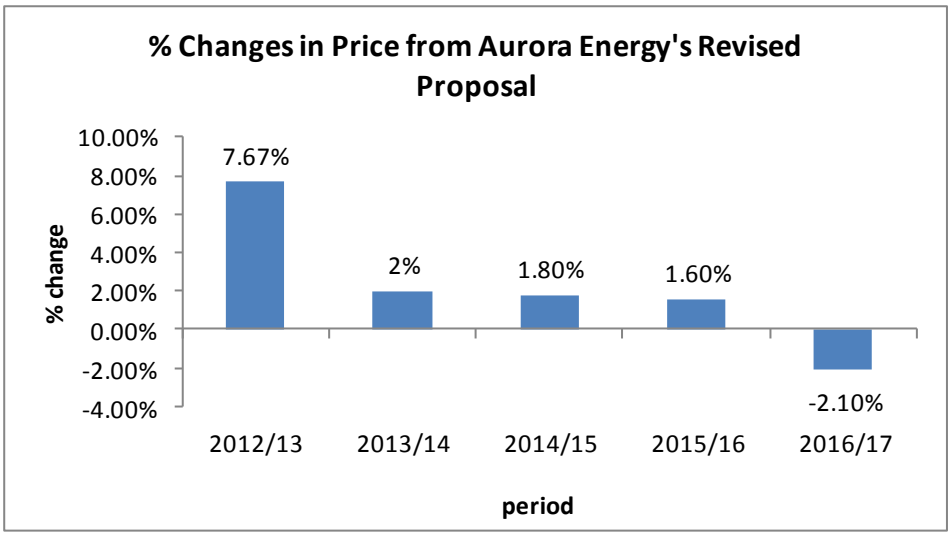
Aurora Energy indicated even before it lodged its original proposal that it expected to lodge a regulatory proposal with the AER that involved significantly lower expenditure increases than other distributors in the NEM and that its prices over the next regulatory period would reflect this.[37] We welcomed Aurora's sensitivity to the issue of higher electricity prices in Tasmania and its indication of actions to support this. Its revised proposal would result in real price increases for the first four years of the regulatory period followed by a 2.1 percent decrease in the final year

[36] When the AER provides the X factors they can be positive or negative. Positive X factors indicate real price decreases under the CPI-X formula and negative X factors indicate real price increases under the CPI-X formula. Figure 17 shows the price changes as negatives to indicate that they are based on positive X factors for ease of understanding. The X factors are used in a formula to determine the average price changes that will apply to a DNSPs tariff classes for a particular year.

[37] Presentation by Peter Davis, CEO, Aurora Energy to EUAA *Tasmanian Energy Forum*, Launceston, April 2011.

of the regulatory period. These price increases are certainly lower than for other distributors in the NEM and Aurora should be congratulated on this. This is shown in Figure 20.

Figure 20: Distribution Price Changes (X factors, real)[38]



The significant increase in Aurora's distribution charges in the first year of the next regulatory period is a matter of some concern, especially given the comments above about the impact of rising electricity prices on Tasmanian and their appetite for further increases at this time.

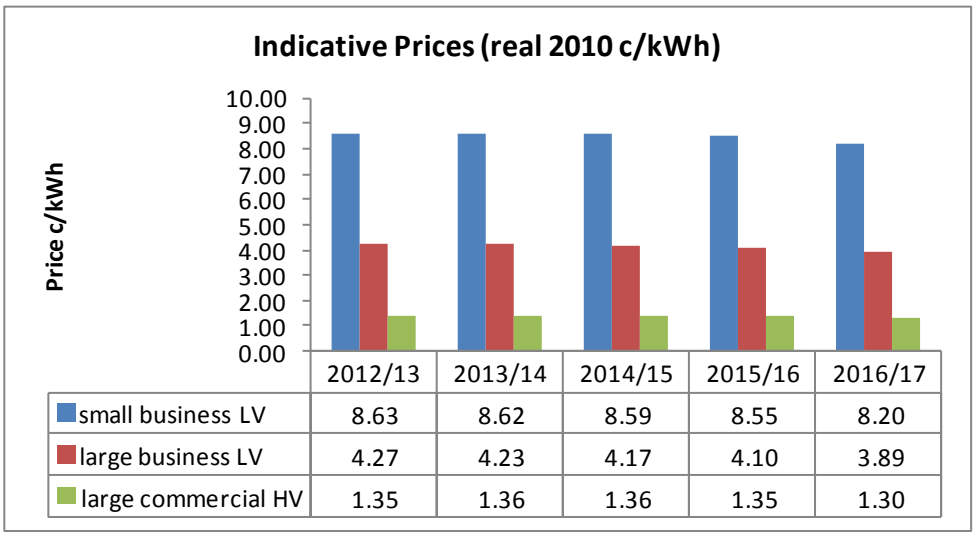
Aurora stated at the AER's public forum held in Hobart on July 18th that it could be prepared to consider lower price increases and also to consider 'smoothing' of its proposed price changes over the next regulatory period. It also said that its Board was not bound to apply the maximum prices emerging from the AER's determination. We welcome this statement by Aurora and believe that it would be worth more detailed discussion. We also ask if this was considered when Aurora Energy developed their revised regulatory proposal.

Aurora Energy has provided some indicative price changes resulting from its revised regulatory proposal. We acknowledge and welcome Aurora Energy's effort to better inform their customers of price changes by doing so. This will allow customers to better plan for price changes moving forward and we thank Aurora Energy for this approach. We would also urge Aurora to continue to inform its customers of final price changes following the AER's final determination and to provide as much notice of these as possible.

A sample Aurora Energy's indicative prices are shown in Figure 21. The flatness of the three tariffs shown is apparent with the Large Business LV tariffs actually showing real decreases throughout the next regulatory period.

[38] When the AER provides the X factors they can be positive or negative. Positive X factors indicate real price decreases under the CPI-X formula and negative X factors indicate real price increases under the CPI-X formula. Figure 17 shows the X factors as negatives to indicate that they are based on positive X factors but inverted for ease of understanding.

Figure 21: Indicative Distribution Prices (c/kWh $2009/10)



	2012/13	2013/14	2014/15	2015/16	2016/17
small business LV	8.63	8.62	8.59	8.55	8.20
large business LV	4.27	4.23	4.17	4.10	3.89
large commercial HV	1.35	1.36	1.36	1.35	1.30