A response to AusNet revenue reset proposal for the 2017-2022 period.

Prepared by the Energy Consumers Coalition of Victoria

An affiliate of the

Major Energy Users Inc.

Assistance in preparing this submission by the Energy Users Coalition of Victoria (EUCV) was provided by Headberry Partners Pty Ltd. The content and conclusions reached are the work of the EUCV and its consultants.

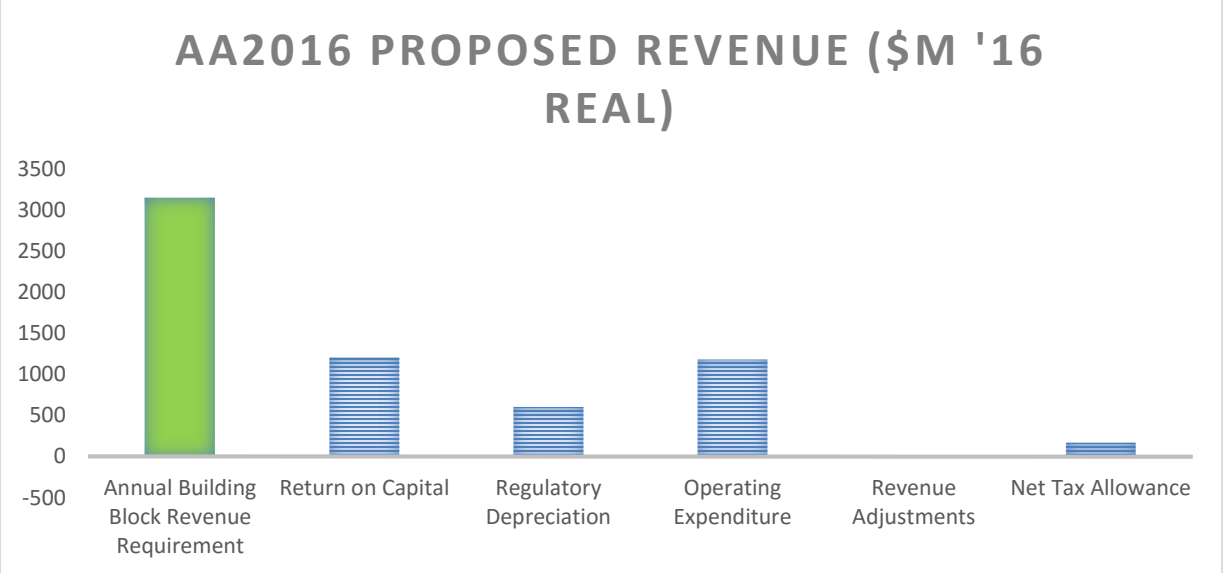
Energy User Coalition of Victoria
AusNet transmission reset 2017/22
Response to initial proposal

Executive Summary

The Energy Users Coalition of Victoria (EUCV) welcomes the opportunity to provide its views on AusNet's revenue proposal for providing the electricity transmission network services for the 2017/22 period (AA2016). Representing the commercial interests of consumers with a specific presence within regional areas of Victoria, the EUCV sees this revenue allowance has the potential to significantly impact the operations of its members and the many people within this jurisdiction who rely on our industries for employment. Indeed, our members not only support our local residents by providing employment opportunities but also play a central role in our local economies by sustaining small businesses, such as suppliers and service organisations. With that in mind, it transpires that its members' commercial interests reflect those of all consumers of energy within Victoria.

The EUCV notes that AusNet have claimed an 8% increase in revenue sought for the AA2016 revenue reset period, of which a significant proportion is comprised of capex and opex. The EUCV notes that this revenue sought comes at a time of falling consumption, and after previous reset periods marked by high capex and opex allowances by the Australian Energy Regulator (AER) coupled with historical underruns in expenditure by AusNet. Additionally, we note that AusNet is not responsible for augmentation of their network and this revenue sought only seeks to maintain a current network, not increase its capacity.

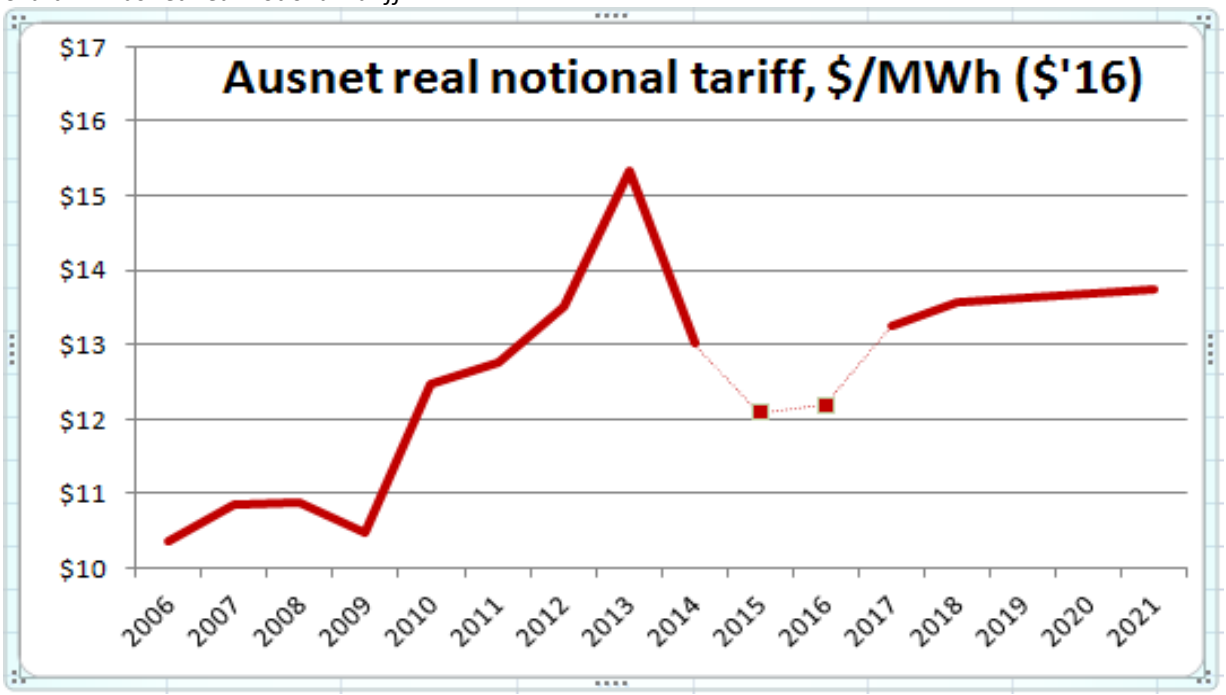
Chart 1.1 Proposed Revenue AA2016



One key area of significant importance is to highlight a claim made by AusNet that their notional tariff has tracked inflation since 2004 and that this supports a view that its proposal maintains its place as the lowest cost TNSP. However, what AusNet does not consider is that its tariffs are based on a low cost of capital, and that if a long term average cost of capital were used, we would view significantly different

results as highlighted below in graph 1.2 which depicts the real notional tariff[1] over time. The AusNet proposal maintains the current high prices that consumers are being currently charged

Chart 1.2 AusNet Real Notional Tariff



Of most concern is the potential risk a return to long term average costs of capital places on future consumers. If the cost of capital were to rise to a long term average level, tariffs would increase significantly. This is discussed in greater length in section 6.3.

At a high level, we accept that AusNet have made attempts to reduce the revenue allowance from past reset periods. However, upon investigation into the manner in which AusNet have structured their proposal, our analysis highlights some concerning themes which raise questions into the validity of some of their claims. More specifically, we have concerns regarding the following:

- ✓ The capex proposal maintains the inflated high Regulatory Asset Base (RAB) levels from the current period and it is only the proposed accelerated depreciation that starts to bring the RAB back to more acceptable levels.
- ✓ High levels of capex sought to maintain legislative and regulatory requirements
- ✓ High levels of capex sought despite a stable reliability of service provided to consumers
- ✓ Continuing growth in RAB highlights an excess in capex allowances
- ✓ A lack of flow on savings and benefits from prior capex allowances
- ✓ A spike in controllable opex for the coming reset period, despite claims of "smoothing" by AusNet

[1] The notional tariff is the revenue divided by consumption

- ✓ Claims that output growth should be calculated as done for other networks that are responsible for augmentation of their network, unlike AusNet

These areas will be discussed in greater length within this document.

Additionally, we hold serious concerns over the structure of AusNet's consumer engagement process, and the manner in which they have used this to justify many of their claims for revenue, notably within capex. We view their engagement processes as incomplete and moreover misleading, evidently structured to reach conclusions that are in the best interests of AusNet services and not that of their consumers.

AusNet state that they have "developed this [revenue reset] with the price impact in mind [2]". Whilst we appreciate the sentiment of this statement, the EUCV questions the intent as a we have noted many areas within this proposal that have been developed without the concern of further financial burdens they are placing on consumers who must use AusNet services.

[2] Page 9 – Revenue Proposal: AusNet Services 2017 - 22

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1. Introduction

The EUCV acknowledges that AusNet Services currently services an electricity transmission network area of 6,574 kilometres within Victoria and whose purpose is "to provide our customers with superior network and energy solutions" [3].

The EUCV members are significant consumers of electricity within Victoria, and collectively consume a significant proportion of the state's electricity supply. The AER highlights that "Consumer engagement in energy network regulatory processes in Australia have been considered limited to date"[4] and that "Consumer engagement is about working openly and collaboratively with consumers and providing opportunities for their views and preferences to be heard and to influence service providers' decisions"[5].

With that in mind, and in reference to AusNet's purpose as stated above, representing a significant amount of electricity within Victoria, the EUCV welcomes the opportunity to respond to AusNet Services transmission revenue proposal for the 2017-2022 period. We trust that our views outlined within this document will be strongly considered by the AER and AusNet for the remainder of this review process.

1.1 The EUCV

The Energy Users Coalition of Victoria (EUCV) is a group representing large energy consumers in Victoria. The EUCV is an affiliate of the Major Energy Users Inc. (MEU), which together comprise some 20 major energy using companies in NSW, Victoria, SA, WA, NT, Tasmania and Queensland.

The EUCV welcomes the opportunity to provide comments on the application for AusNet's revenue reset for the Victorian electricity transmission system.

Analysis of the electricity usage by the members of EUCV shows that in aggregate they consume a significant proportion of the electricity generated in Victoria. As such, they are highly dependent on the transmission network to deliver efficiently the electricity so essential to their operations. Being heavily dependent on suppliers of hardware and services, members also have an obligation to represent the views of their local suppliers. With this in mind, the members require their views to not only represent the views of large energy users but also those of smaller power using facilities, and even of the residences used by their workforces.

The companies represented by the EUCV (and their suppliers) have identified that they have a strong interest in the **cost** of the energy networks services as this comprises a large cost element in their electricity (and gas) bills.

Although electricity is an essential source of energy required by each member company in order to maintain operations, a failure in the supply of electricity (or gas) effectively will cause every business affected to cease production, and members' experiences are no different. Thus the **reliable supply** of electricity (and gas) is an essential element of each member's business operations.

[3] Page 2 – AusNet: Revenue Review 2017-2022
[4] AER's Consumer Challenge Panel: description, Charter and evaluation criteria
[5] AER – Better Regulation: Consumer Engagement Guideline for Network Service Providers"

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of energy supplies has become increasingly important with the focus on the performance of the distribution businesses because they primarily control the quality of electricity and gas delivered. Variation of electricity voltage (especially voltage sags, momentary interruptions, and transients) by even small amounts now has the ability to shut down critical elements of many production processes. Thus member companies have become increasingly more dependent on the quality of electricity and gas services supplied.

Each of the businesses represented by EUCV has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is required. If sustainable supplies of energy are not available into the future these investments will have little value.

Accordingly, EUCV (and its affiliate MEU) are keen to address the issues that impact on the **cost, reliability, quality** and the long term **sustainability** of their gas and electricity supplies.

The members of EUCV have identified that transmission plays a pivotal role in the electricity market. This role encompasses the ability of consumers to identify the optimum location for investment of their facilities and providing the facility for generators to also locate where they can provide the lowest cost for electricity generation. Equally, consumers recognise that the cost of providing the transmission system is not an insignificant element of the total cost of delivered electricity, and due consideration must be given to ensure there is a balance between the two competing elements.

1.2 The scope of this review

This review will initially provide a high level overview of the key developments outlined within AusNet's proposal, focusing on areas of significance that that the EUCV considers to be highly contentious or detrimental to AusNet consumers. It will then proceed to provide a more detailed analysis of capex and opex sought by AusNet and outline concerns identified by EUCV, notably areas that have been identified as key drivers behind the revenue sought for capex and opex. Within this context, the EUCV will also provide comment on matters of identified efficiencies that can be achieved within their proposal that align with consumer interest.

As the EUCV shares the AER position that consumer engagement is of importance to ensure that services provided align with consumer interests, and that of an overall supply of energy, the EUCV will comment on AusNet's consumer engagement program and highlight areas of concern, as well of areas that we view are to be commended.

This review will then discuss matters relating to, service provision and targets, Weighted Average Cost of Capital, depreciation, allowed revenue and tariffs and conclude by providing a concise summary of views on AusNet's proposal and suggestions for improvement.

1.3 An overview of the AusNet Application

The EUCV notes the 8% increase in revenue sought by AusNet for the coming reset period, over that for the current period. The EUCV further notes that AusNet asserts that this translates to an annual transmission price increase of 1.8% above inflation for Victorian consumers.

1.4 Consumer engagement

As discussed above, the EUCV acknowledges and welcomes all methods in which networks actively engage with their customers and consumers. We support the position of the AER and agree that effective consumer engagement is central to the ongoing viability of the NEM and ensure that consumer views direct the ongoing supply and reliability of the network.

The EUCV further acknowledges that AusNet services has undertaken their consumer engagement program by building upon the consumer program undertaken in the past revenue reset period, which they actively state was done so before the Consumer Engagement Guidelines were released by the AER. We further note AusNet's position that they state that this program was considered "robust" and "effective"[6] and claim support from the AER and consumer groups to this effect. However, the EUCV notes some key concerns within their current consumer engagement program. These are:

- ✓ Actively acknowledging that they did not engage residential consumers to reduce costs of the program, rather focusing primarily on large users
- ✓ Limited engagement activities with major projects, despite purporting the community support and appreciation of these activities.
- ✓ AusNet's use of AEMO's VCR estimate was used from a national study, not that relating specifically to Victorian consumers
- ✓ Low level of input on key issues, including the low level of responses received on their TRR engagement program 4/50 questions sent
- ✓ Overall effectiveness of the design of the consumer engagement process

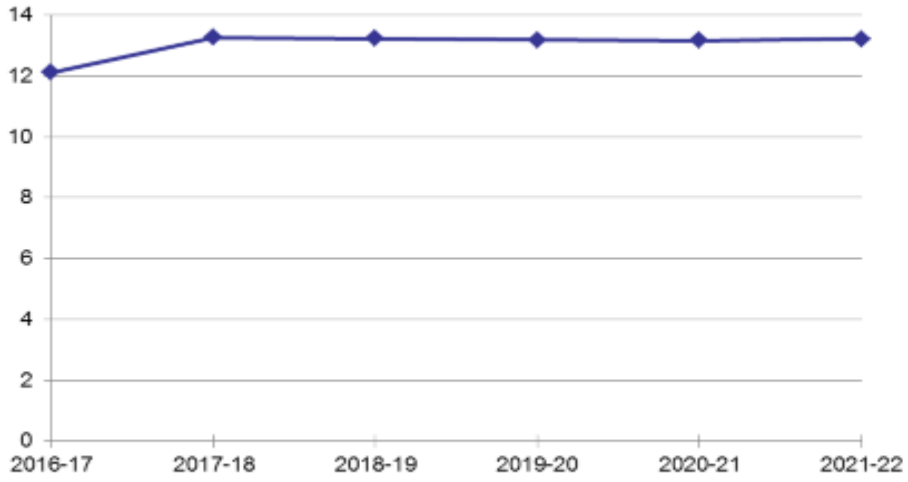
These will be discussed in greater length in section 4 of this report.

1.5 Summary

The proposal from AusNet results in a 10% real increase in tariffs followed by real increases of 0.62% pa thereafter for the next 4 years. This change is shown in AusNet's forecast real price path.

[6] Page 40 – AusNet: Revenue Proposal

Chart 1.3 Future Real Price Path for AusNet Services ($/MWh)



Source: AusNet Services PTRM

Despite a fall in the return on assets due to a lower cost of capital, all other costs rise, including depreciation, opex and the tax allowance. This increase is despite a falling or flat consumption noting that AusNet is not responsible for augmentation of the network.

EUCV does not see how AusNet can justify the increases it claims. EUCV views that what AusNet is proposing will perpetuate the already apparent shift by consumers away from use of the networks due to their high costs and potential lower cost solutions already and projected to be available to allow consumers to minimise their exposure to these burgeoning network costs.

2. Capital Expenditure (capex) Allowance

2.1 Overview

The EUCV acknowledges that AusNet Services are claiming forecast capex of $754.6M for the forthcoming regulatory period, of which 85% is made up of network capex, particularly major station projects. The EUCV further acknowledges that this claim of capex comes at a time of lesser demand in the network than occurred in the past.

AusNet makes the claim that a significant driver within their capex program is "the need to replace assets that reaching the end of their serviceable lives". Indeed, AusNet purports that key drivers behind this capex program are:

1) ***Requirement to continue to meet our Obligations***
2) ***Asset Age and Condition***
3) ***Change in Key planning assumptions***
4) ***Emerging Energy Market Trends***

The EUCV will discuss these areas individually, outlined below.

At the most fundamental level, capex, coupled to depreciation drives the size of the RAB which when multiplied by the weighted average cost of capital (WACC) becomes the single largest element of the building block approach to setting the allowed revenue.

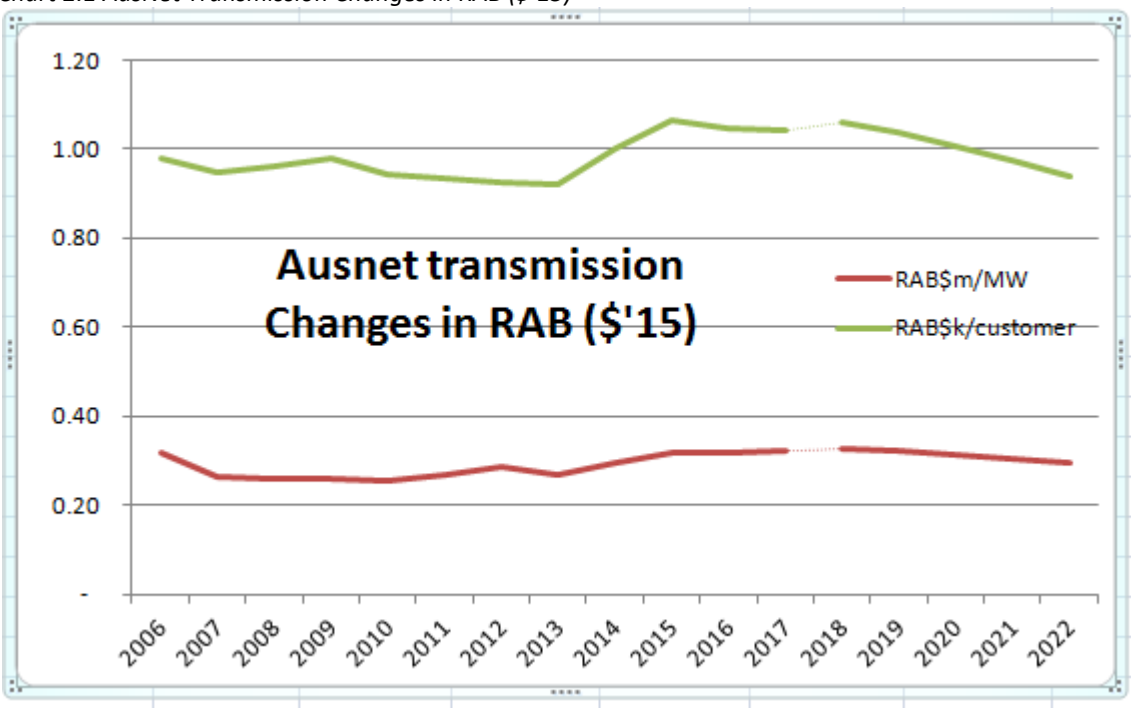
The EUCV (along with its affiliates) is becoming increasingly aware that the regulatory values of the National Energy Market (NEM) electricity transport assets (transmission and distribution) are becoming an increasing burden on all electricity users. As a direct result of the cost of these assets, end users are increasing their attempts to limit their exposure to the costs that this massive investment is imposing on them. At the same time, end users are also seeing the utilisation of these assets falling, implying that much of the investment they are paying for lies idle. It is clearly inefficient that consumers pay for something that is not needed or used.

The RAB is impacted in two main ways - primarily by the addition of new investment (either for augmentation or replacement of assets) and removal of assets (either by depreciation or sale of assets not needed). The EUCV is aware that AusNet is not responsible (directly at least) for the augmentation of the transmission network as this work is carried out by AEMO. Therefore, replacement of assets is AusNet's prime use for capex. As the sale of assets is a very small element of AusNet's activities, it is depreciation that is the core driver of RAB reduction.

This review by the EUCV will address both of these issues in some depth as it sees the growth in the RAB is not only increasing the costs to current consumers but will transfer a responsibility for significant cost imposts onto future consumers as well.

The EUCV has examined the growth of the AusNet RAB over time and the following chart shows how AusNet RAB has changed over this time relative to the peak demand and number of Victorian customers ultimately connected to the transmission network.

Chart 2.1 AusNet Transmission Changes in RAB ($'15)



Source: AusNet applications, AEMO data, AusNet RINs, EUCV analysis

On the face of the data, it would appear that after seeing a significant rise in RAB in relative terms during the current regulatory period, the AusNet proposal leads to a reduction in RAB in relative terms giving apparent support for the proposed capex programme. However, the RAB is heavily influenced by regulatory depreciation and AusNet has advised that its proposal is based on accelerated depreciation of assets, particularly of new assets. Accelerated depreciation results in a transfer of costs from future customers to current customers, and such a transfer is not in the long term interests of consumers.

What is clear from the chart, is that the current three-year regulatory period exhibits an excessive increase in RAB (and therefore an excess in capex) compared to the historic relative RAB outcomes. This shows that using the current period for trend analyses would provide an incorrect basis for comparison. EUCV considers that the current capex needs should be more compared to the long term capex, such as in the decade before the current period, as replacement capex (repex) which is the main capex cost to Ausnet exhibits a strong relationship to reliability of service.

Excluding the effect of the accelerated depreciation, when seen at a high level, the capex proposal maintains the inflated high RAB levels from the current period. In this regard, the EUCV comments that RAB is a core element of the building block as it impacts both the return on assets calculation and the regulatory depreciation allowances included in the allowed revenue determination

This high level assessment identifies that the proposed capex is most likely too high.

2.2 Requirement to continue to meet obligations

The EUCV acknowledges that AusNet Services must comply with all applicable regulatory and legislative requirements outlined within the National Electricity Rules (NER) and also must comply with all health and safety, environmental and security obligations of the operation of the network. AusNet claims that these obligations have a "substantial bearing" on the amount of forecast capex claimed for the next regulatory period, as they must still be met despite changes in their current operating environment.

A recurring theme throughout all four 'key areas' identified by AusNet as drivers within the forecast capex, is that of forecasting demand. Indeed, AusNet claims that, "despite the future uncertainty, current obligations to plan a safe, reliable and secure transmission service remain paramount"[7]. This matter is discussed in greater depth below in section 2.4 below.

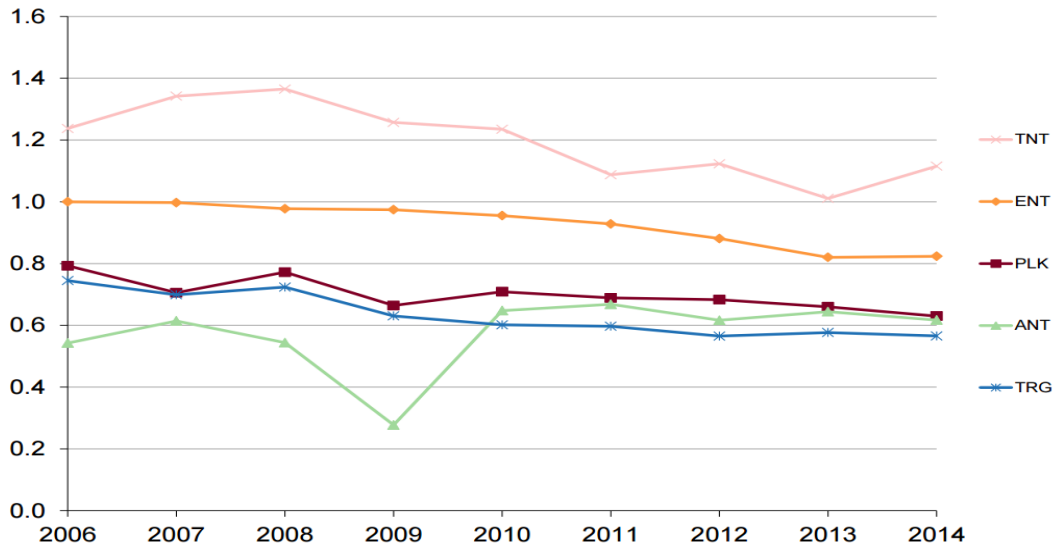
However, in relation to the meeting of obligations, one significant claim made by AusNet is that of their assets are considered old compared to those of other TNSP's, both local and abroad. In addition, AusNet claims that their assets are also operating in physical environments that compound this issue and cause a deterioration of these assets faster than is common. The EUCV does not accept this claim. All TNSP's within Australia operate in climates that could be considered an influencing factor on the reduction of the life of an asset. The EUCV sees that to introduce a view that the Victorian environment is worse than that of other regions in the NEM overlooks the very clear view that AusNet assets have been operating in Victoria for decades and the historic performance of the AusNet assets does not support a view that the environment is a cause for increased repex. Indeed, the more recent historical performance of AusNet (i.e. in the first decade after deregulation) shows that the reliability performance of AusNet assets was similar to the current performance but with considerably less repex. The EUCV has been involved in every regulatory reset involving the AusNet assets since deregulation, and has heard at every reset the need for increased repex to address the "bow wave effect" of ageing assets that "were provided in the middle of last century", yet the level of repex actually used in recent years has not resulted in a reduction of reliability. With this experience, EUCV does not accept the assertions in the new proposal that more repex is needed to avoid a loss of reliability.

Additionally, what is of significant concern to EUCV is that it notes a continued increase in capex sought from AusNet over the past 4 reset periods, despite a relatively stable reliability of service provided.

The view that AusNet capex is not efficient is highlighted in the AER benchmarking report on transmission networks where it notes that the capital partial factor productivity of AusNet is one of the least efficient in the NEM and in the early years clearly the worst[8]. The EUCV notes that AusNet counsels against any determinative conclusions being drawn from the AER and Economic Insights benchmarking, but the EUCV does consider that the benchmarking does highlight that AusNet is not the most efficient in its use of capital.

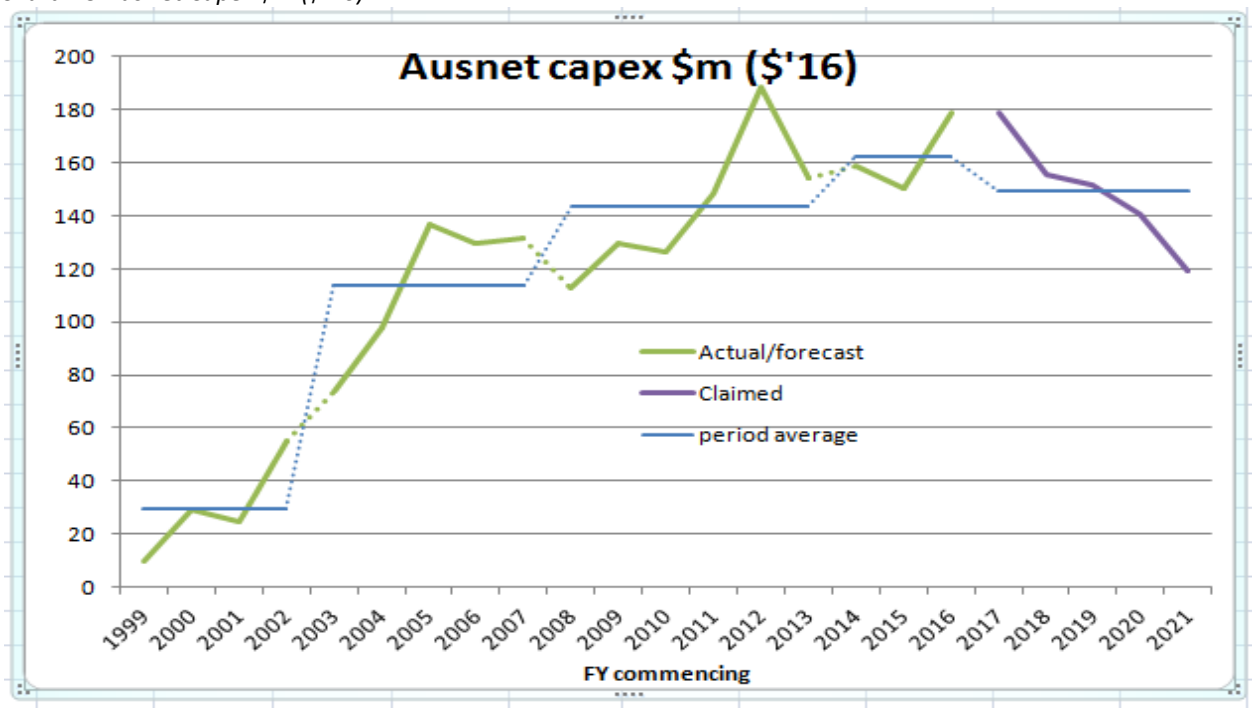
[7] Page 34 – AusNet: Revenue Proposal
[8] in this regard EUCV notes that the capex sought over these periods for AusNet do not include any network augmentations

Chart 2.2 Capital partial factor productivity for 2006-14[9]



The EUCV has tracked the use of capex over the years and identifies that consistently AusNet has increased its capex and notes, particularly in the latter years, it has significantly under-run its allowances

Chart 2.3 AusNet Capex $m ($'16)



Source: AusNet proposals, AER decisions, EUCV analysis

[9] AER - Annual Benchmarking Report –2015

In its revised proposal for the 2014/2017 regulatory period, AusNet commented (page 26)

> *"In preparing the capital expenditure (capex) forecast for its original Revenue Proposal, SP AusNet sought to identify an overall program of capital work that will maintain the quality, reliability and security of supply of prescribed network services at an efficient level of long-run cost to customers. This approach is consistent with the National Electricity Objective (NEO) and the capital expenditure objectives and criteria in the National Electricity Rules (NER). The Revenue Proposal also explained that a lower level of capex would expose customers to performance risk that would undermine the achievement of the NEO*."

Similar comments were made in the previous proposal. What is important about this and other such observations, is that AusNet has consistently maintained the levels of reliability and at times exceeded these. At the same time, AusNet also significantly under-run both its claimed capex and the allowed capex. This clearly shows that either AusNet has over-claimed the capex it needs or has found other lower cost ways to maintain reliability or both. At the same time, AusNet has benefited greatly from its lower use of capex than was allowed.

With this in mind, the EUCV considers that there is a grave concern that the capex sought by AusNet is significantly overstated. That the impact of the capex program will still lead to an increase in the RAB despite there being few drivers to substantiate the need for such large amounts of capex in the 2017/22 period.

EUCV also notes that the high capex program for the initial 2-3 years of the next period are due to the completion or works already commenced.

2.2.1 Legislative Requirements

AusNet makes claim that associated pressures of meeting all Victorian and NER legislative requirements continues to add significant pressure on capex sought. Over the past 7 years, EUCV records indicate that AusNet have claimed in excess of $150M, or $16.7M annually in revenue to ensure they are meeting these requirements.

Table 2.1 Capex sought to maintain safety and regulatory requirements for the 2008 – 17 periods

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	Total
Safety & compliance ($m)	16.5	20.2	16.8	30.9	23.5	3	14.9	13.4	12.2	151.4

The EUCV is of the view that maintaining appropriate safety standards are of significant importance, as is ensuring that all Transmission Network Service Providers (TNSPs) maintain their regulatory requirements. However, the EUCV does question the continually high amount of capex sought to achieve this aim. Surely many of these requirements, particularly those that are legislative, are ongoing and would be embedded into AusNet's systems and processes. It is the view of the EUCV that the capex

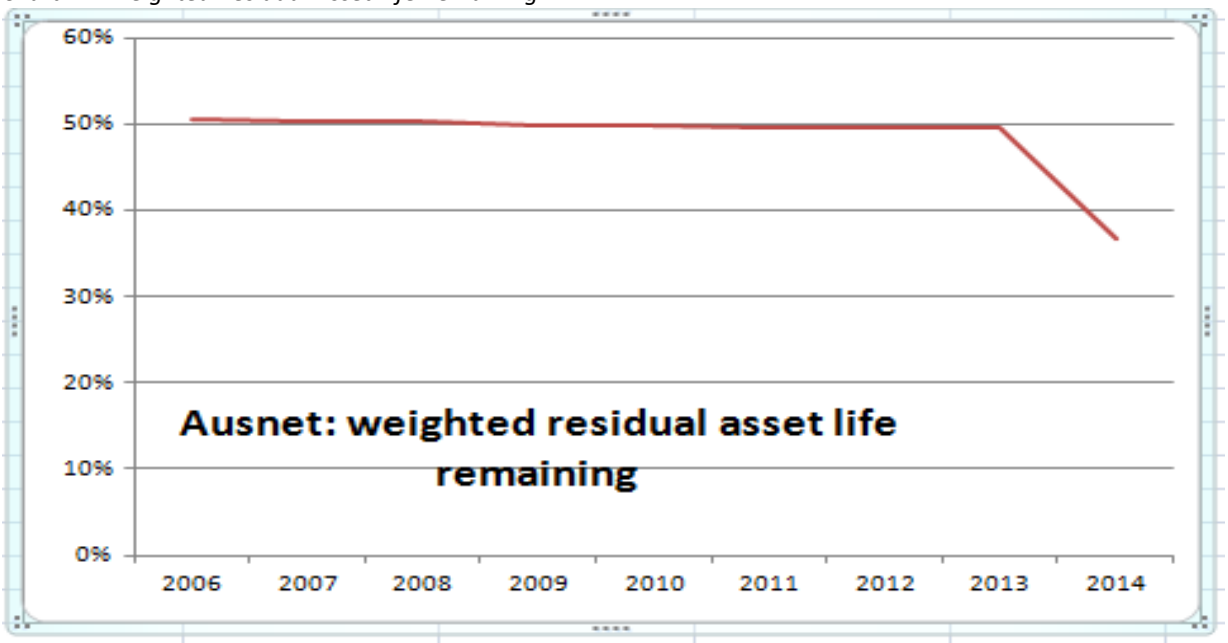
sought for this purpose is an inflated and these inflations are an unnecessary financial burden on the consumer.

2.3 Asset Age and condition

AusNet make claim within the proposal that asset age and condition are a major driver behind their capex program. They further state that a "significant proportion "of their asset base is coming to the end of its economic life. This repeats comments made by AusNet at every previous reset yet despite this apparent need, AusNet still used less capex than was allowed. The EUCV considers that the statements of need and decision not to use the available capex are mutually incompatible

A review of the RIN data shows that up to 2013, AusNet had a weighted average asset residual life of ~50% of expected life. The following chart shows the weighted[10] average residual life remaining for assets as a proportion of the total expected life of the assets

Chart 2.4 Weighted Residual Asset Life Remaining



Source: AusNet economic RIN data, EUCV analysis

This highlights that the levels of repex since 2006 has maintained the average life of the assets, except for 2014. The sudden drop in 2014 remaining residual life is attributable to a sudden 10 year drop between 2013 and 2014 on overhead asset life remaining from 36 years to 26 years and a sudden drop of 8 years between the same years for switchgear, substation and transformer assets from 21 years to 13 years. It is inconceivable that these assets lost so much residual life over just one year.

Whilst we agree that a staggered approach to asset replacement and undertaking replacement works just before the asset service life is completed is prudent, we view this claim for capex has been made

[10] Weighted by value of each asset class in each year

prematurely, especially on the back of an existing high capex use in the two past revenue periods, and that of falling consumption and demand more broadly.

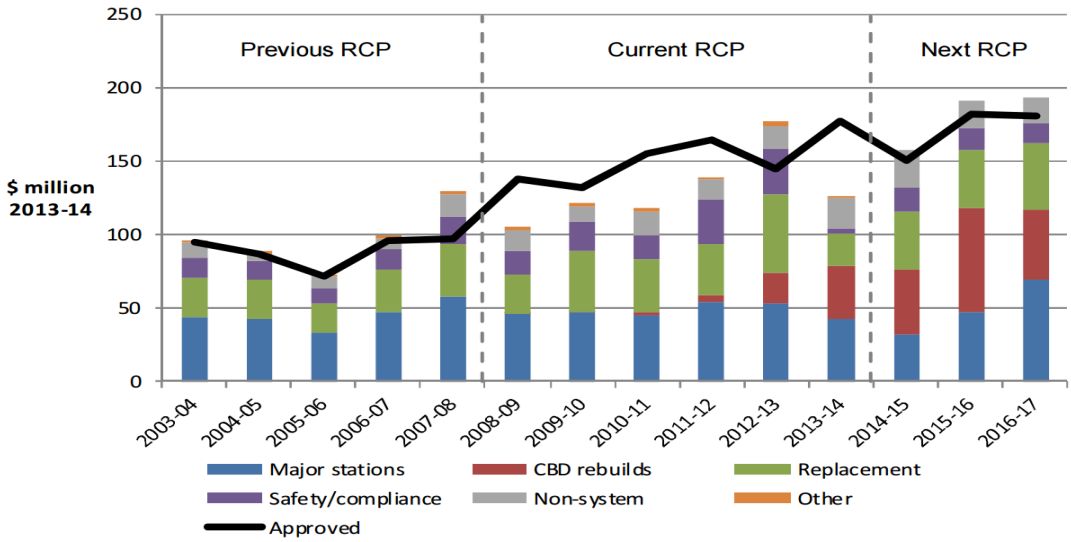
The EUCV considers that longer term historic capex is a better guide as to the needs for capex over the next period.

2.4 Change in Key planning assumptions

As noted above, the EUCV acknowledges that this claim of capex comes at a time of reduced demand in the network. The EUCV does not accept AusNet's claim that a reduction in capex as a result of falling demand will result in a lower level of reliability for consumers. This claim is preposterous. A decline in demand on services will only serve to put less pressure on equipment and services, and therefore increase reliability. Indeed, as noted by AusNet, capex allowances over the past reset period peaked in 2012-13, largely due to Richmond Terminal Station Rebuild (RTS). It is the view of the EUCV that this capital investment, and others within the past reset period inclusive of their capex allowances, should have increased reliability within the network and mitigate AusNet claims that falling demand will influence reliability.

AusNet has supported their claims of a 'maintain' case for their revenue proposal supported by an argument utilising the AEMO Value of Customer Reliability (VCR). AusNet has decided to use the 'lower' 2014 VCR estimate, stating that their consumers would rather see lower energy prices, and as a result, lower reliability within the network. Whilst consumers do want (and probably most need) lower electricity prices, the EUCV does not accept the argument that lower prices have to be accompanied by lower reliability.

Chart 2.5 SP AusNet's actual and forecast capex



Source: AER Final Decision: SP AusNet (transmission) 2014-17

The above graph highlights a breakdown of capex allowed for the past 3 reset periods. Of significance is to note the vast majority of capex allowed for replacements and major stations. Indeed, the EUCV notes that during the 2008 – 12 period, the AER provided a higher allowance than was sought by AusNet for the redevelopment of the RTS, and despite this there was still an overspend during 2012, although that was the only overspend for the entire 6-year period. The EUCV ask the question: what benefits have consumers seen from these allowances? The EUCV finds the position of AusNet that they are satisfied to justify a decrease in reliability given capex has not been sought in some areas as unacceptable.

The EUCV argues, again, that the significant increases in capex over the years should justify, at a minimum, an increase in base line reliability of the network. It is quite evident that this is a tactic of AusNet to maintain their ability to increase costs to consumers without having to increase the quality of service provision. The EUCV finds this unacceptable. This issue is discussed further in the 'Emerging Energy Market Trends' section, below.

AusNet have proposed to adjust their VCR targets, as they have argued:

> *"While the adjustment has resulted in a lower threshold for one of the sub-parameters (the number of events greater than 0.05 system minutes) than that applied in the current period, AusNet Services considers that the adjusted target (3) is warranted in light of the magnitude of the expected decline in reliability as a result of the VCR reduction."*

It has been suggested that the recent change to the Value of Customer Reliability (VCR) developed by AEMO, will impact on the reliability provided by the network as it will result in deferments of augmentation and replacement projects. EUCV agrees that this will be a natural outcome as VCR is a core element used in the probabilistic calculation of the need for capex. Over the very long term, a lower VCR will possibly impact network reliability but not in the short to medium term as assets already built have lives that extend over many regulatory periods.

Equally, EUCV considers that the impact of changing VCR will be minimal in the short term as the bulk of assets providing the reliability were implemented under the higher values of VCR used in the past, along with deterministic reliability settings used before probabilistic tools were used. So overall, reliability across the network should be maintained because the decisions for historic investments which comprise the vast majority of the network assets were made using higher standards. As the STPIS reflects historic performance, the impact of the slight deferrals in new investments that will now apply through the use of a lower VCR will change over time to reflect the outcomes of using a lower VCR.

2.4.1 IT capex

EUCV is very concerned that AusNet considers that the IT capex used in the current period (or even the previous period) provides an argument to continue such projects at the same level of expenditure as in the past. EUCV notes that AusNet has overspent the allowance for IT over the current and previous periods and considers that this trend should not continue for the next period.

The EUCV considers that at some point the previous IT capex should be sufficient for the needs of the TNSP. It seems that all NSPs want to replace their IT systems each regulatory period implying that they

need replacement every 5 years. At what point does the regulator consider that what is in place and operating the network adequately need to be replaced with the newest model?

The amounts of capital that consumers are providing to allow NSPs to have the latest in information technology is staggering when seen across all NSPs.

The EUCV considers that the current AusNet IT system is working adequately and does not need to be replaced in the next period.

2.5 Emerging Energy Market Trends

Section 2.2 of AusNet's proposal outlines how they plan to manage emerging market trends, and the effect these have on the capex sought. More broadly, AusNet have claimed that their plan will focus on the deferral of long lived assets and seek to adopt opex solutions to as an "alternative to additional network investment"[11]. AusNet makes claim that these solutions are as a result of trends in network utilisation, improved storage technologies and increase in distribution generation.

The EUCV would like to highlight, more specifically, some key concerns with the capex sought by AusNet under this position.

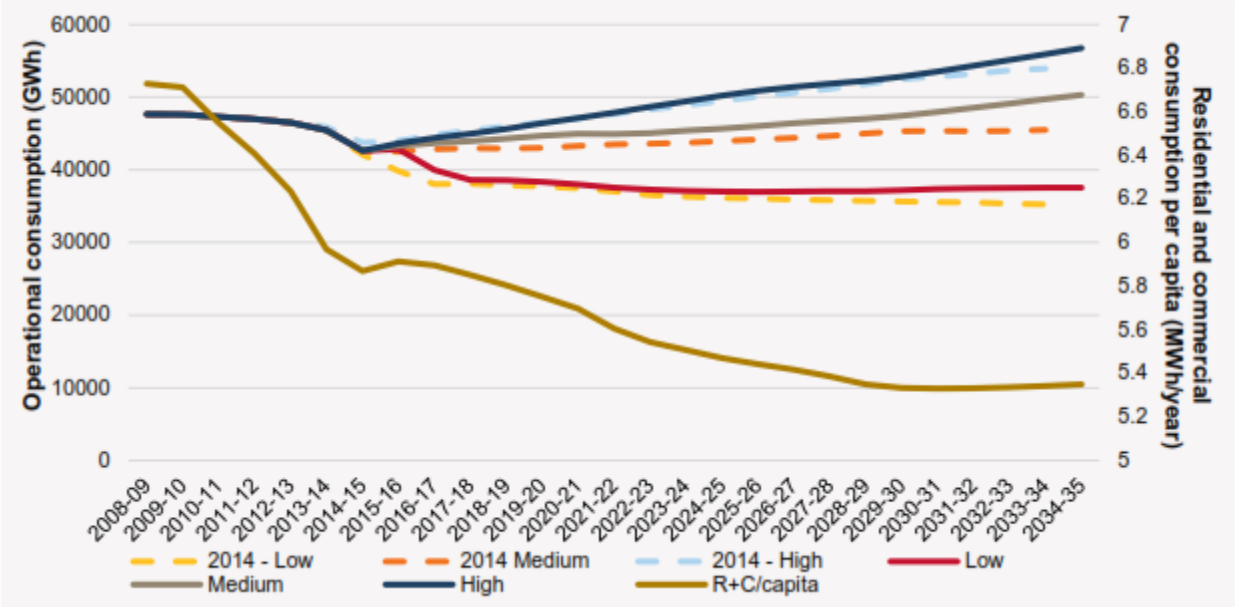
AusNet argue that the relationship between GDP growth and growth in electricity consumption is not as strong as it has been historically. As representatives of large commercial users, the EUCV agrees with this position as EUCV members and other large energy consumers have had to find means to offset the massive increases seen in the provision of electricity services in order to maintain their competitiveness in their markets.

The pressures placed on transmission networks as a result in the decline in manufacturing and pressures on industry more broadly are a result of ever increasing costs by the monopoly network services. However, the EUCV would like to highlight that the Bureau of Resources and Energy Economics (BREE) notes that in Victoria, energy consumption growth is considered to be modest, as opposed to other states.[12] The concerns in declines in energy consumption that have been implied by AusNet are overstated as, according to the BREE, such declines only apply for the South Australia and Tasmania whose growth rates are forecasted to be lower.

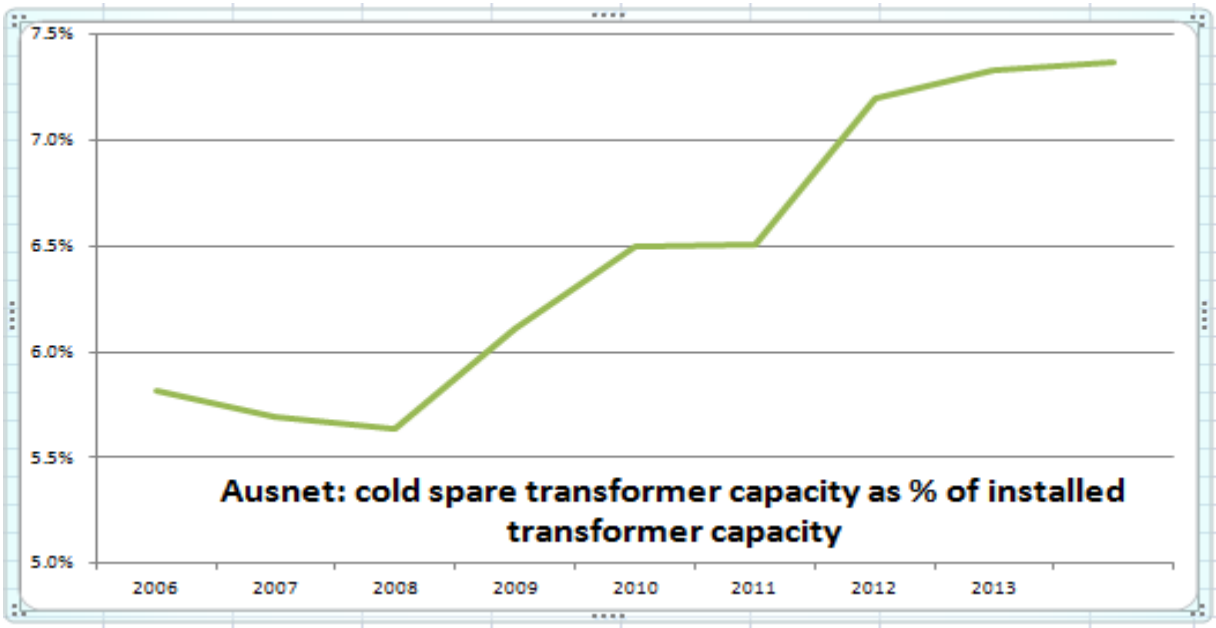
Whilst, again, the EUCV notes that there are indeed challenges in the reduction in energy growth that must be considered by TNSP's when seeking capex, the EUCV is of the view that it must remain state specific. The use of generalist industry views to justify a position in unacceptable and views must reflect appropriately the market in which the TNSP operates. We do not argue that growth is stagnating; rather, that growth is still expected in the market, and is not in decline in Victoria. This view is supported by AEMO forecasts where it considers that after a significant fall in consumption, AEMO in its 2015 NEFR considers that Victorian electricity consumption will show a small increase as the following chart shows

[11] Page 29 – AusNet: Revenue Proposal
[12] Bureau of Energy and Economics - Australian Energy Projections to 2049 - 50

Chart 2.6 Comparison of Low, Medium and High Forecasts in Victoria



EUCV also notes from the AusNet economic benchmarking RIN, that despite there not being an increase in peak demand since 2009, AusNet has increased its transformer capacity by some 5% and at the same time increased its spare (unused) transformer capacity as shown in the following chart.



Graph 1.5 Cold Spare Transformer Capacity

Source: AusNet benchmarking RIN, EUCV analysis

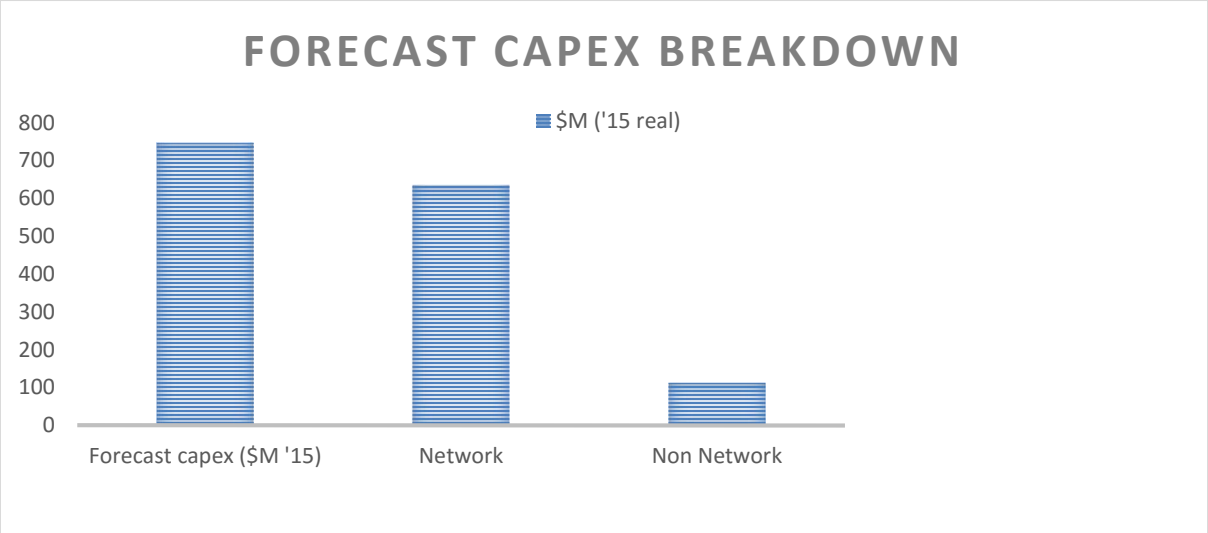
The EUCV views one central argument outlined within this section to be counterintuitive. AusNet claims the need to mitigate changes in market trends in network utilisation within the capex it is seeking. Equally, AusNet claims some of these changes are in the growth in the network and network utilisation, amongst others. However, what we have seen, despite a staggered reduction in capex sought for this the remaining three years of the next period, is a historical pattern of continued increases in capex over the last 3 reset periods.

Looking past the significant capex reduction in the later years of the 2017/22 period, what we note is that capex remains as high as the average of the six years of the 2007-13 period during which time we note a significant under run occurred. How is it, then, that AusNet is claiming a capex of this amount whilst at the same time claiming a reduction in capital works in deferring projects and seeking opex solutions to mitigate these losses for the current period?

Whilst we welcome the reductions in the capex sought by AusNet and agree that, overall, the forecast capex for 2017-22 is, on average 8% lower per annum than actual and expected capex in the 2014-17 regulatory period, if we inspect this issue in closer detail, we see a concerning trend.

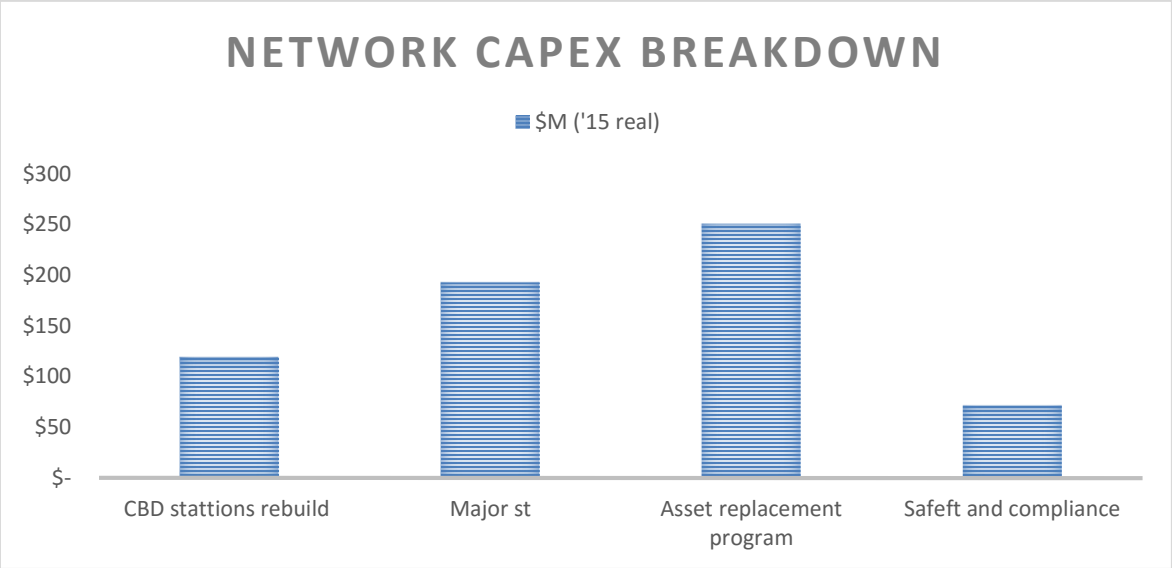
AusNet highlight that a significant proportion of their forecast capex for this regulatory period will be expended within network expenditure, as highlighted in Chart 2.7

Chart 2.7 Forecast Capex Breakdown



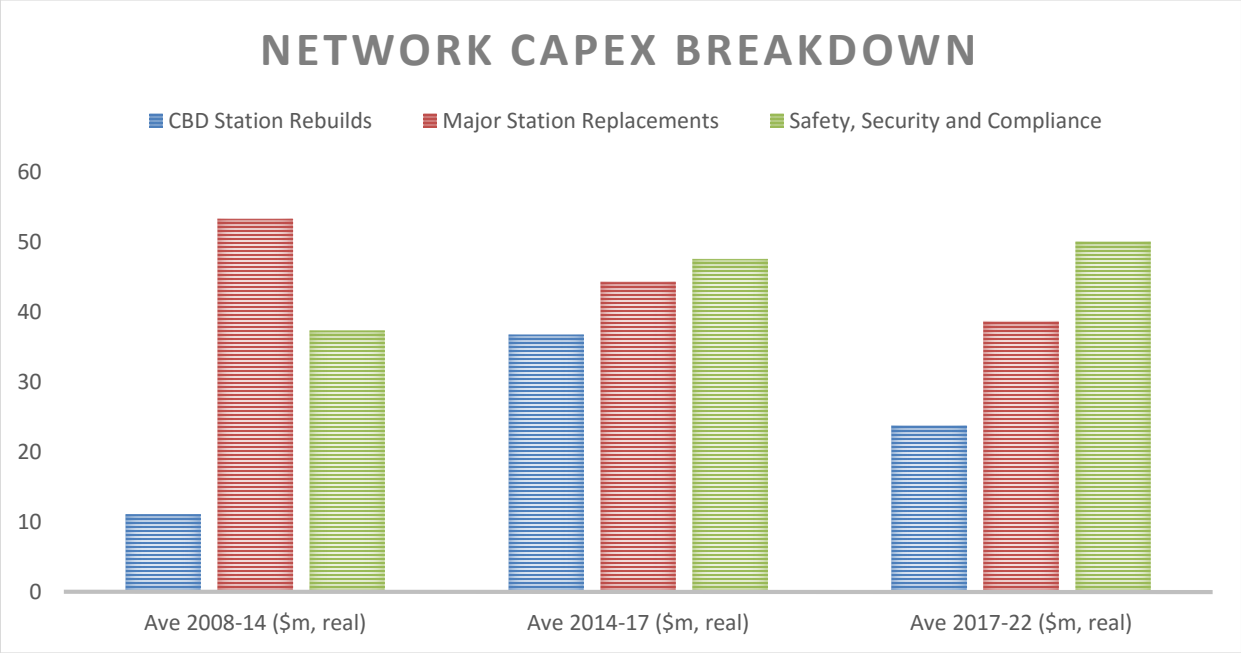
Of which, these networks costs are comprised of the below:

Chart 2.8 Network Capex Breakdown



At a cursory glance these figures do not appear all that alarming However, when you undertake a historical analysis focusing on these key areas, the EUCV notes a concerning trend.

Chart 2.9 Network Capex Breakdown – Trend Analysis



Specifically, the cost for asset replacement averages $36m (notional) pa in 2008/14 period, $40m pa in 2014/17 period (notional), yet for 2017/22 period, the replacement program averages $50m pa. EUCV sees that replacement of assets is a recurrent cost and is of the view that repex can be benchmarked on a clear trend basis and repex should be relatively constant.

Do you consider that AusNet Services has adequately considered customer views in developing its capex proposal[13]?

The EUCV welcomes the opportunity to provide direct feedback to the AER's question above. Moreover, the EUCV has significant concerns in the manner in which AusNet has justified some of the capex through their consumer engagement program. Some of the concerns relate directly to the method in which AusNet undertook their consumer engagement program, and the limited results it generated. These are discussed at length in section 4 of this report.

However, more specifically, whilst we appreciate the challenges associated with having limited space with the Stakeholder Forums to discuss all matters relating to forecasted capex, we note that only one major station project was discussed – the Western Melbourne Terminal Station. Indeed, capex for this project was allowed under the previous reset period. Therefore, we note of the four major station project which add to the 85% of the forecasted capex claimed, not one of them was mentioned within the stakeholder forums.

Table 2.2 AusNet Stakeholder Forum

Stakeholder forum	1	2	3
Topics discussed	An introduction to AusNet Services	Stakeholder engagement update	Emerging Market Trends
	Benchmarking performance;	Value of Customer Reliability (presented by AEMO);	Overview of the Revenue Proposal – outlining the building blocks, the impact of stakeholder feedback and documentation which will be claimed as confidential.
	Responding to changes in the Value of Customer Reliability and forecast demand	**• West Melbourne Terminal Station – project update**	
	Approach to stakeholder engagement;	The latest forecasts of revenue, price and expenditure	

[13] AER: Issues Paper – Capital Expenditure

	An introduction to accelerated depreciation.	Consultation on key issues: price vs reliability and accelerated depreciation.
	Initial operating expenditure step changes;	

The EUCV accepts that AusNet made resources available and welcomed discussions from stakeholders on individual items. We further note AusNet's position when stating:

> *"The impact on both price and reliability of deferring capital projects was explained at the second stakeholder forum, using Springvale Terminal Station as an example"*[14]

However, it is the view of the EUCV that both of these positions are limited. The EUCV questions what depth of discussion was provided in this setting, and the impact it would have on consumers. This is significant as it is noted that 85% of forecasted capex is made of network charges, equating to $634.1M, of which 42% or $266.322M is made of new projects. The EUCV questions the little amount of time spent engaging consumers on these issues, and how they are able to justify consumer support for them.

2.6 Summary

At a high level, the EUCV is concerned that the continuing growth in the RAB (excluding the accelerated depreciation) highlights that there is an excess of capex being allowed and then added to the RAB. In a climate of falling or static consumption and peak demand, it is simply unacceptable to continue to increase the asset base as has occurred for over a decade. That such growth should continue is something that the AER must address as the cost to future consumers will be just too great.

Such a view of the high capex is more poignant when it is considered that AusNet (and its antecedents) in years past, AusNet has delivered the same levels of reliability and performance with much less capex than it is seeking for the 2017/22 period.

In this regard, the EUCV points out that the current high costs for electricity transport are already driving consumers to use the assets less and so reduce their costs. The capex proposal by AusNet continues the trend of higher costs and increasing under-utilisation.

EUCV does not have the information or resources to carry out a bottom up assessment of the various specific projects detailed in the proposal. Equally EUCV accepts that those projects that have been approved and are now being built should be completed - it would be inappropriate to leave these projects uncompleted.

EUCV sees that many of the projects detailed which make up the bulk of the capex are not needed when considering the increase in spare capacity in the AusNet network. The EUCV notes that the AER has, in

[14] Ch. 3 – AusNet: Revenue Proposal – Consumer Engagement

other network reviews, assessed whether the proposals for asset replacements are needed to the extent proposed and whether lower cost alternatives are possible, such as by replacing specific elements in terminal substations rather than a wholesale replacement program. The EUCV notes that the bulk of the AusNet capex program is predominantly to replace existing assets and therefore considers that the AER should commissioning a more detailed engineering assessment of the AusNet capex program to identify if there are lower cost options (such as a lesser scope) than those proposed by AusNet.

EUCV members advise that in the current capital constrained world they have to exist in, their senior management look for the minimums needed for capex and require examination of all options to limit capex, regardless as to whether the lower capex might a less satisfactory engineering solution.

3. Forecast Operating Expenditure

3.1 Overview

The EUCV acknowledges that AusNet Services claim for total Operational and Maintenance Expenditure (opex) for the coming regulatory period of $1,101.7M, which 54% is made up of non-controllable revenue and the remaining 46% consists of controllable opex.

Specifically, EUCV acknowledges that the bulk of the non-controllable opex is for the payment to the Victorian government an easement land tax which replaced the Smelter Reduction Amount levy[15]. In discussions with the ACCC/AER when this tax was introduced, it was made clear that the tax was specific to the Smelter levy replacement and when the government liability to Alcoa which caused this levy no longer applied, the Victorian government would revoke the easement land tax

In this regard, the EUCV seeks for the AER to ensure that the amount included in the non-controllable opex for this easement land tax, is legitimate and reflects the amounts that the government requires to offset its liabilities to Alcoa. Further, the EUCV seeks for the AER to query the Victorian government when the easement land tax might cease.

Other than the easement land tax, costs in the non-controllable opex include self-insurance of $2.7m pa

Table 3.1 Controllable and Non- Controllable Opex

Opex	2017-18	2018-19	2019-20	2020-21	2021-22	Total
Controllable	104.1	99.3	100.8	103.1	104.4	**511.8**
Non-controllable	118.0	118.0	118.0	118.0	118.0	**589.9**
Total	**222.1**	**217.3**	**218.8**	**221.1**	**222.4**	**1,101.7**

Source: AusNet Services

3.2 Controllable Opex

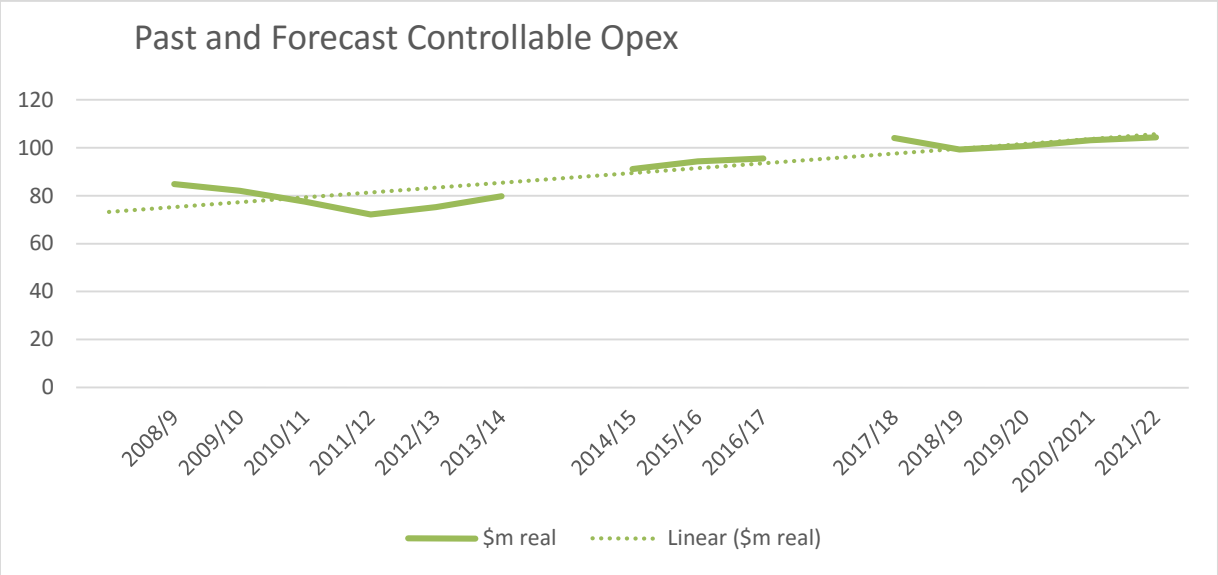
The EUCV notes a claim made by AusNet in their 2013-2017 revenue proposal that

"SP AusNet has delivered efficiency savings during the current regulatory control period, which will flow to consumers during the forthcoming period"[16]

Yet the following chart shows that the 2017/22 opex increased markedly above the 2013/17 opex which was a significant step up from the earlier period opex.

[15] See section 6.7.5 AER draft decision for SP AusNet transmission determination 2008/9 to 2013/14
[16] Page 21 - AusNet: 2014-2017 Regulatory proposal

Chart 3.1 Past and Forecast Opex

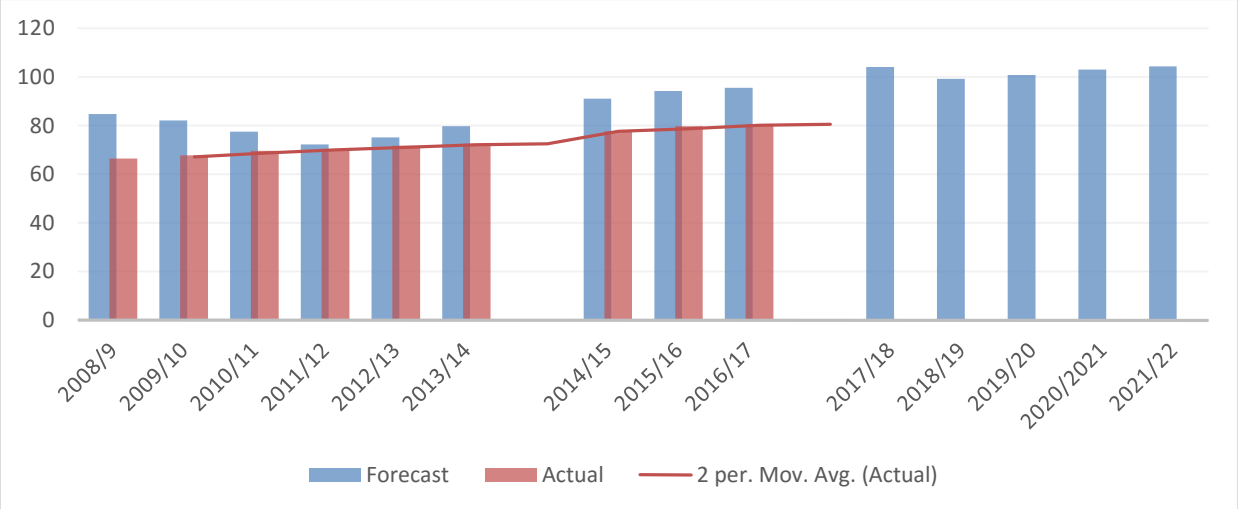


The EUCV asks the question, "where are the savings?" As highlighted in figure 2 above, consumers have not seen these savings reflected within controllable opex for the coming revenue period. Instead, we have noted a continued increase in controllable opex sought by AusNet.

Just as importantly, the EUCV notes a clear statement by the AER in AusNet's previous reset proposal:

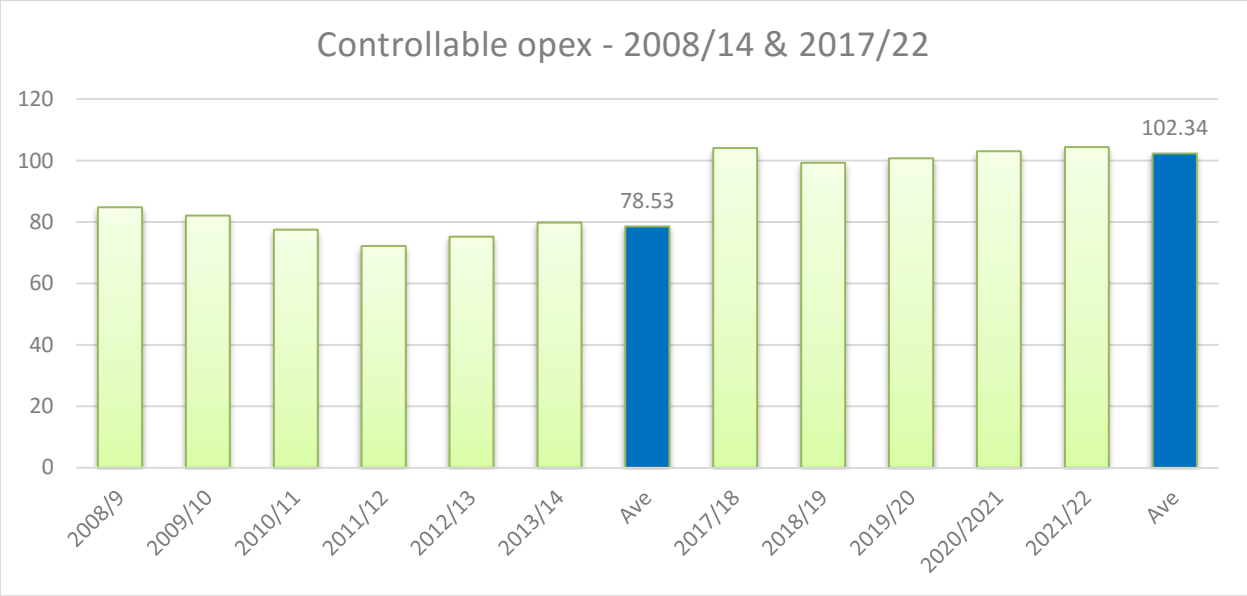
"Over the past 10 years, SP AusNet's controllable opex has been relatively stable from year to year and from regulatory period to regulatory period in real terms. This is what we would expect from an efficient service provider that has undertaken substantial capital expenditure on replacement of aging assets, and proposes to continue to replace aging assets at significant levels"

Chart 3.2 – Controllable Opex - Forecast



However, EUCV analysis highlights that although during the last reset period we did notice a smoothing of controllable opex sought by AusNet, we are noticing a significant increase in controllable opex sought for the coming period. This is despite claims, noted above, that the benefits from the 2014/17 would flow onto consumers. Indeed, we note that since the last 6 year reset period, which should provide the basis for an appropriate comparative analysis for the coming reset period, we have seen an increase the average of controllable opex sought by AusNet of $23.81M or 30.3% between these 2 periods.

Chart 3.3 Controllable Opex – Trend Analysis

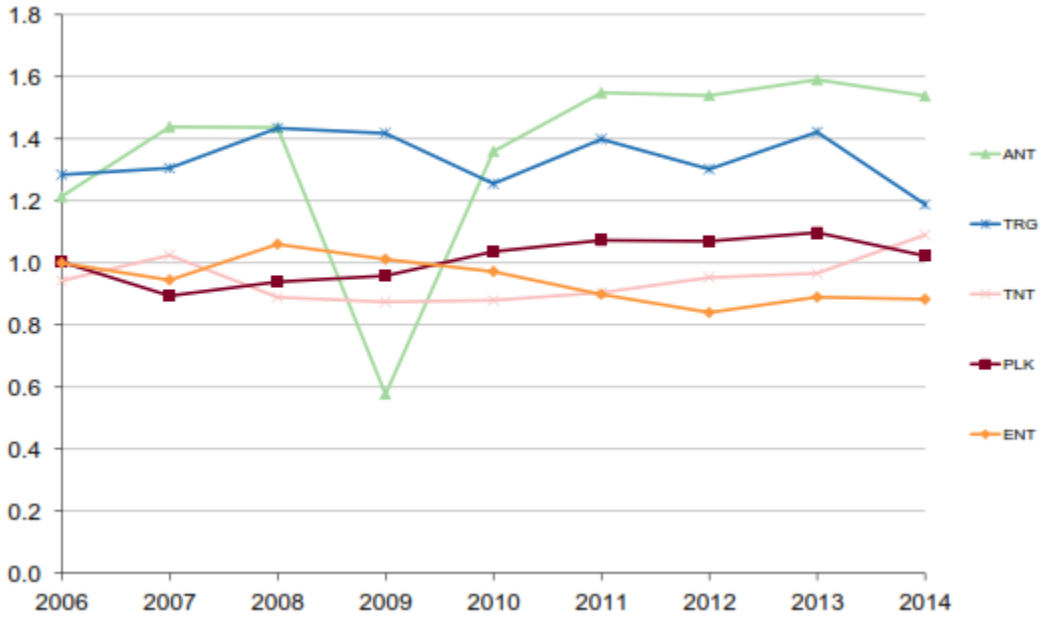


3.3 Benchmarking and base year opex

The EUCV welcomes data provided by AusNet on the Key Partial Performance Indicators and notes their own self-analysis that suggests that they the "lowest or second lowest TNSP in the NEM" [17]. Whilst we are supportive off all TNSPs aiming for the highest opex productivity within the NEM and appreciate AusNet's enthusiasm in this regard, we note that the opex partial factor productivity for 2006-14 assessed by the AER supports that AusNet's opex could be seen as more efficient than the other TNSPs in the NEM[18]. What is important in this assessment is that it only covers opex until 2014 which was the first year of the current period. The following chart shows the comparative assessments of opex PFP for the TNSPs in the NEM.

[17] Page 23 – AusNet: Regulatory Proposal 2017-22
[18] Yet for multilateral total factor productivity, AusNet ranks worst in the NEM implying its capital productivity is really poor

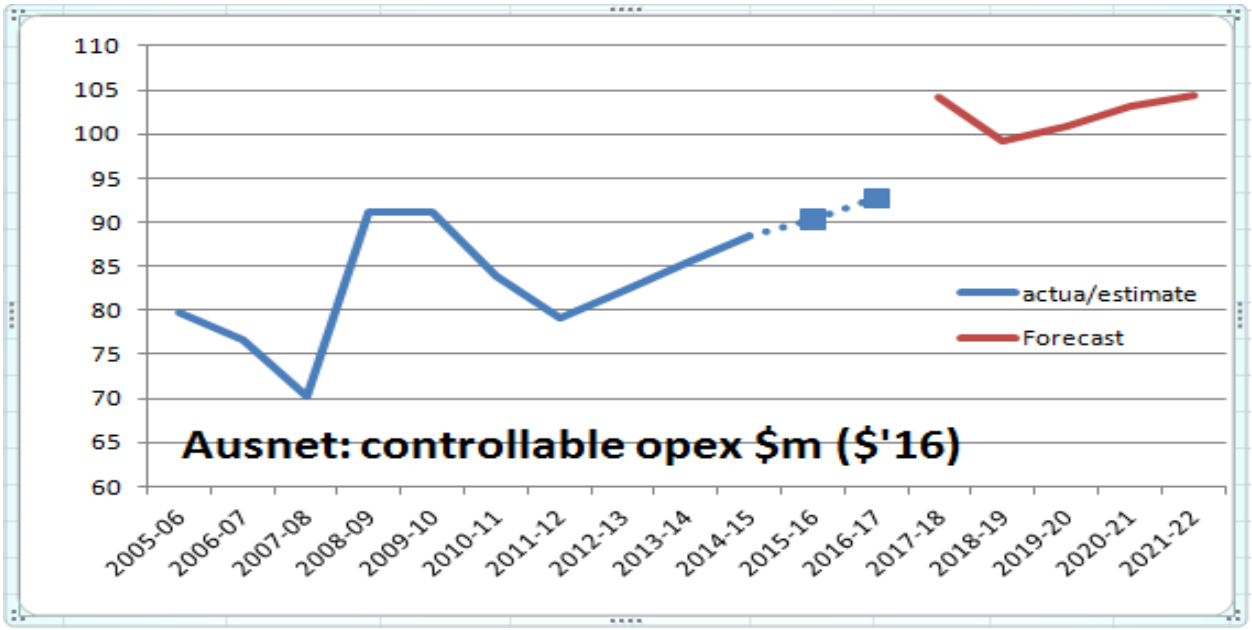
Chart 3.4 Opex Partial Factor Productivity 2006 - 14



It is important to note that the opex PFP relates only up to 2014 so the assessment is based on opex up to this point and does not imply that the current opex is efficient or that the opex forecast for 2017/22 is efficient.

Examination of the opex trends over time is telling. The following chart shows actual and estimated controllable opex to the end of the current period and the forecast controllable opex.

Chart 3.5 – Controllable Opex ($'16)



Source: AusNet RIN data, AusNet proposal, EUCV analysis

Up to the end of the benchmarking study, AusNet opex averaged about $82.8m pa but with significant periods below this level. The opex estimated beyond 2014 shows a considerable increase and that forecast for the next period is significantly higher again.

AusNet table 3.2 in its proposal is telling.

Table 3.2 Average Annual Forecast Controllable Opex ($m, real 2016-17)

Opex component	Annual average opex
Base year opex	83.7
Plus	
Labour escalation	2.6
Output growth	6.7
Step changes	2.7
Group 3 roll in	2.0
Insurance costs	5.8
Less	
Productivity improvements	-1.2
Total	**102.4**

AusNet proposes that its base year of 2014/15 is efficient because

- 2014/15 is the latest year of verified data
- the operating conditions of 2014/5 are representative
- benchmarking reveals 2014/15 achieved stronger opex productivity improvements in 2014/15 than its peers

Of these reasons only the last provides any justification that the base year opex is efficient. However, it is what is included in the base year that is important and what AusNet proposes to add to it to provide its forecasts for the next period.

The proposed base year opex is $83.7m which would appear to be reasonable based on historic opex. To this base year opex, AusNet adds a number of additional costs. The EUCV has not assessed the labour escalation figure (it assumes the AER will apply its usual rigour to analyse this) and the addition of the group three assets opex needs to be verified but the logic of its inclusion seems acceptable.

AusNet provides its view on why it needs to increase the forecast opex through output growth, step changes and insurance costs. AusNet also includes a negative change to the opex through the application of a productivity improvement. EUCV comments as follows on these three issues.

3.4 Insurance

The EUCV notes that until 2014, the cost of insurance ranged between $2.5m to $3.5m in nominal values and saw a massive increase in 2014 to $5m. EUCV questions the cause of this 60% step increase.

However, EUCV points out that the historic opex includes for the cost of insurance (excluding self-insurance) and to increase the forecast opex by $5.8m pa for insurance does not reflect the recognition that the base year opex was reached after excluding only $4.8M for insurance. Further, the longitudinal assessment of opex includes for insurance so there is some concern that the benchmarked opex includes insurance which has subsequently been removed in the assessment of the base year costs.

If on the other hand, AusNet asserts that the benchmark opex used as the base year excludes insurance cost, then the EUCV considers that the base year opex is not efficient and is not representative of the benchmarking used to support the view that the base year is efficient.

3.5 Output growth

AusNet proposes that the output growth for its opex should be based on the AER approach to that used by the AER for the recent TransGrid and TasNetworks transmission reset. The EUCV considers that this is not appropriate as AusNet (unlike the other two TNSPs) is not responsible for augmentation of the network (this is the responsibility of AEMO) and three of the measures used in the output growth are related to augmentation of the network (ratcheted demand, voltage weighted entry/exit points and circuit length).

The EUCV cannot accept that AusNet should be rewarded for increased opex when it does not augment the network and neither should it be rewarded for an increased volume of throughput when it does nothing to provide for this increased throughput.

EUCV notes that AusNet is specifically provided for an increase in opex for the inclusion of the Group 3 assets and to include both this amount and an output growth factor which reflects the growth in the augmentation measures is effectively double counting.

Overall, due to the unique circumstances of the way the Victorian transmission network is operated, the EUCV considers that there should be no adjustment of opex for growth but the inclusion of the opex which is directly associated with the transfer of those growth assets implemented by AEMO into the AusNet asset base (such as the Group 3 assets).

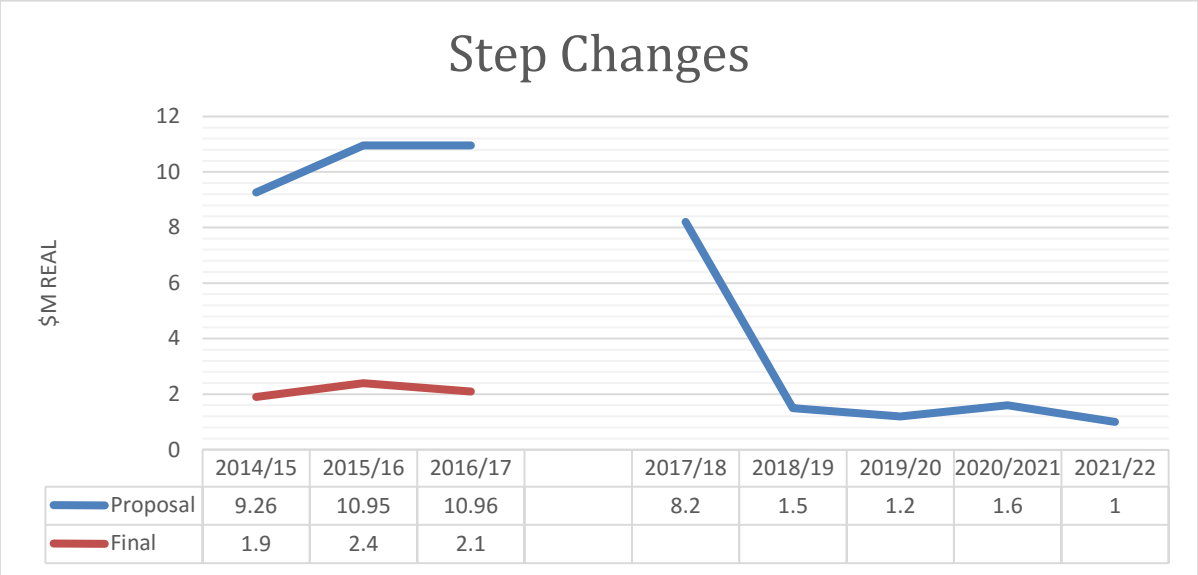
The EUCV is concerned that the addition of the growth factor adjustment is an opportunistic claim for an unnecessary increase in opex.

3.6 Step Changes

The EUCV welcomes AusNet's more prudent forecast (compared the those sought for the 2014/17 period which were mostly rejected by the AER) for Step Changes for the coming reset period. The value of these step changes is shown in the following chart. We also note the AER comment regarding the step changes proposed for 2014/17:

"We found that some of the step changes were not new drivers of expenditure that reasonably reflected the opex criteria and we therefore did not approve them"[19]

Chart 3.6 Revenue sought Step Changes



Despite AusNet taking note of the AER admonition in this regard, we note that AusNet proposes the following as step changes

Table 3.3 Summary pf Forecast Step Changes Opex ($m, real 2016-17)

Step change	2017-18	2018-19	2019-20	2020-21	2021-22	Total
Establishment of IT security team	0.7	0.7	0.7	0.7	0.7	**3.3**
New emergency response arrangements	0.2	0.2	0.2	0.2	0.2	**1.0**
SAIP roll out	0.3	0.3	0.1	0.1	0.1	**0.9**
West Melbourne Terminal Station (WMTS) mobile switchboard*	0.7	0.3	0.3	0.7	0.1	**2.0**
Synchronous condenser decommissioning*	4.3	0.0	0.0	0.0	0.0	**4.3**
Morwell Power Station decommissioning*	1.9	0.0	0.0	0.0	0.0	**1.9**
Total	**8.2**	**1.5**	**1.2**	**1.6**	**1.0**	**13.5**

Source: AusNet Services

* Non-recurrent step change

The EUCV considers that allowable step changes are those that are triggered by a change in Laws or in regulation - they are not expected to encompass activities that are part of the normal operations of the network.

[19] AER – AusNet reset period 2014/17: Final Decision

It is important to note the existing opex already includes for various activities that are recurrent in a global sense, but are unique at the actual point of doing. For example, work on a specific transformer is unique and may only be carried out once every few years, but work on all transformers is a recurrent activity.

Secondly, opex is not a constant each year as the chart above of historic opex attests, but the allowance set for each year is set as a relative constant amount. This means that in any one year, the actual opex will include for activities that are essentially of a type which recurrent but is a "one-off" activity which might increase the opex in that year, but in the following year, another recurrent but "one off" activity is carried out which is considerably less in cost, leading to an under-run of opex in that year.

Bearing these two points in mind, the EUCV sees that all of the activities cited as step changes by AusNet, are not step changes, with the single exception of the new Emergency Management Act (2015).

EUCV notes that some of the activities stated as step changes are not as they are activities that should be included by any TNSP operating with good practices such as IT security and emergency response. What concerns EUCV is that these two activities are already activities that AusNet has already included (or should have included) in the current opex - they are not new - except for additional costs incurred as a result of providing additional resources to comply with the EM Act.

The step change proposed for smart aerial imaging (SAIP) is interesting. AusNet implies that this activity will result in savings in the future through lesser amounts of capex yet there is no evidence that there is a likely return for undertaking this activity. At a high level, EUCV sees that this project might be beneficial to consumers. With this in mind, the EUCV suggests that AusNet could include the project as a NCIPAP project providing it can identify and quantify the potential benefits. EUCV does not consider it a step change as such.

3.7 C-I-C pass through event

The EUCV notes section 12.4.5 of AusNet's proposal, titled Commercial In Confidence (C-I-C). The EUCV is privy to the details of the pass through event and can understand why AusNet has requested this to be a pass through cost.

Equally, the EUCV considers that the proposed pass through event is not one that warrants inclusion as a pass through event as it is a normal operation that any NSP has to undertake on a regular basis.

3.8 Summary

EUCV is very concerned that the opex claimed by AusNet is a significant increase from the opex that has been benchmarked as being efficient. The EUCV considers that AusNet has made a number errors in the development of its forecast opex and the issues raised by EUCV need to be examined in detail.

4. Consumer Engagement

The EUCV supports the AER's best practice Consumer Engagement Principles which provide a basis for all consumer engagement within the revenue reset process. As noted previously, the EUCV and its affiliate the MEU, wholeheartedly support any and all attempts to engage consumers in this revenue reset process.

Table 4.1 Consumer Engagement Principles

Consumer Engagement Principles	
Clear, accurate and timely communication	set timelines and provide info that is simple to understand.
Accessible and inclusive	Engagement is not just undertaken for the submission proposal and is used educate customers to overcome complexity hindering engagement.
Transparent	manage expectations; explain how consumer views will be used; report both positive and negative consumer views.
Measureable	establish KPIs (qualitative and quantitative); measure performance against KPIs; report performance.

In regard to the consumer engagement process as directed by AusNet services, the EUCV would like to state from the outset we acknowledge all efforts for consumer engagement undertaken during this period, and welcome this as a "good step forward". We will continue to support all TNSPs as they continuously improve their efforts into consumer engagement.

However, more specifically, the EUCV notes some concerns within AusNet's current consumer engagement framework. In addition, the EUCV holds serious concerns that many of these initiatives are used by AusNet to justify many areas of capex and opex, when if we dig a little deeper, we note that the process, whilst at a general level looks positive, does not delve into the appropriate depth required to ensure that consumers are being appropriately informed.

4.1 Engagement Activities

AusNet services claim to run community engagement programs for major projects and uses these as a basis for major product community engagement. Within section 3.3.2 of their proposal, they use Richmond Terminal Station (RTS) upgrade as an example of this work. Within this framework, AusNet claim success by offering the following community engagement:

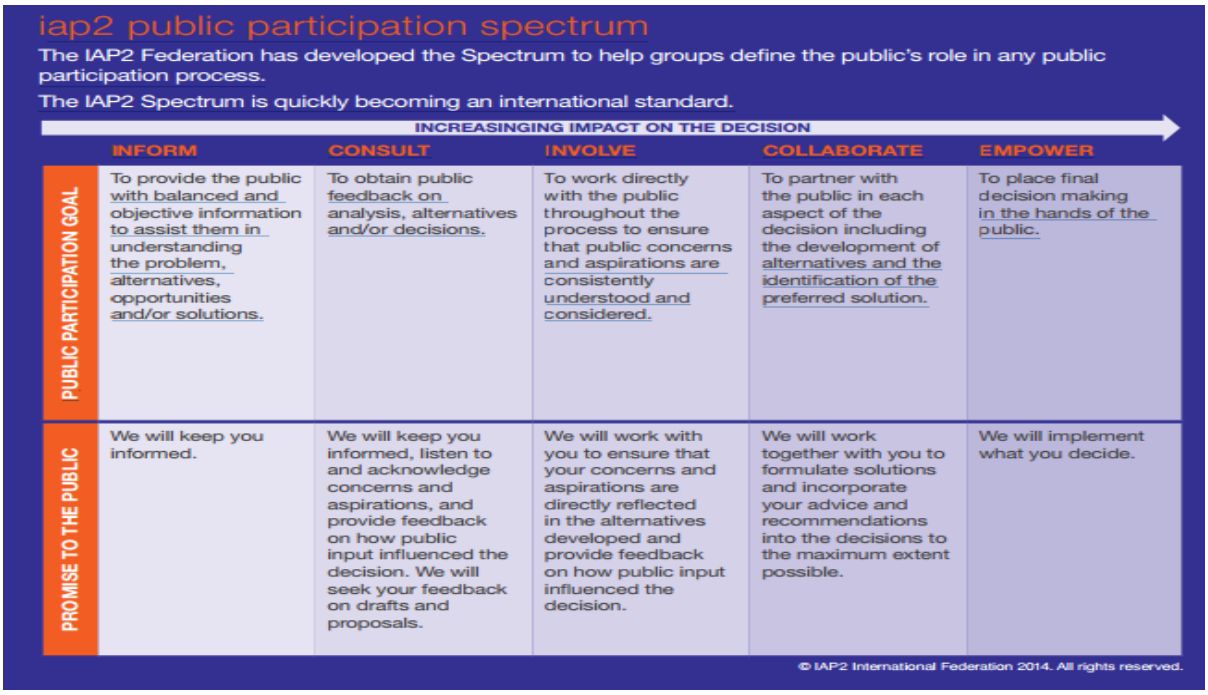
- The use of literature and information to communities and stakeholders impacted
- 1 public information night

AusNet make claims for other engagement activities within this framework, including "Building trust between community and stakeholders" and "ensuring the smoothest possible delivery of work on site"; yet as for direct engagement[20] , we note that has been limited to 2 activities as noted above. The EUCV would also like to highlight that this project is being undertaken close to a local school.

The EUCV highlights that this project comprises of $14.2M of the revenue sought for the 2017-22 period, with the understanding that this project is due for completion in 2018. Some of our primary concerns are:

- ✓ The engagement process for this project seems incredibly limited due to:
  - There was no direct consultation with the local school
  - There was only one public forum
  - Concerns from the submission process were "dealt with" by their community engagement team; however, there was no mention of any changes that came as a result of this feedback
  - There was no mention of quality control within the information made available to stakeholders to ensure they provided information that was unbiased and informative

Figure 4.1 IAP Public Participation Spectrum



Source: International Association of Public Participation 2016

[20] The EUCV also notes that community engagement is not consumer engagement as such. Community engagement addresses concerns that nearby residents might have about a specific activity whereas consumer engagement ultimately impacts of the cost of the service provided.

To explore the above concerns further, the EUCV draws on standards provided by the International Association of Public Participation (IAPP) as highlighted in figure 3.1. According to the IAPP this participation is quickly becoming an international standard for all public participation and we therefore we consider it is a good template to highlight some of our concerns.

We note that, although AusNet have indeed undertaken some of the elements within their consumer engagement process outlined within the table above, we note some key areas that are lacking.

1) **Providing balanced and object information**

As discussed above, the EUCV have concerns over the level and type of information provided to the public regarding major projects e.g. RTS. We acknowledge, however, that the lack of information provided within their revenue proposal does not necessarily imply that all information is of unbiased and fully informative views, yet the EUCV feels it is an important issue to raise in the interests of ensuring consumer views are not swayed. We add that a core element of the transfer of information relies on longitudinal information (i.e. information that allows the reader to compare with similar information applying at an earlier time) being provided. A failure to provide appropriate information can lead to incorrect conclusions.

2) **Partnership with public in relation to decision making and finding proposed solutions.**

We draw your attention to table 2.2 of this report outlining the 3 stakeholder forums that were provided by AusNet as part of their consumer engagement program. We note, with some sadness, that not in one of these forums do we see a section that actively seeks consumer feedback.

It is not uncommon for consumer engagement programs to effectively utilise facilitating activities, such as round table discussions or world café to engage the minds of their participants and draw out new ideas for solutions. Yet, we note the absolute lack of any of these activities and question the structure the forums. Indeed, assessing the structure a little closer, it supports assumptions that these forums were established more to “tell and sell” to the consumer, rather than deliberate with them to find a “preferred" or better solution.

4.2 Consumer input

One significant area of concern is that of the low level of input on key issues relating to the revenue proposal. We note a claim made by AusNet:

“This approach recognised that different stakeholder groups had different preferences regarding topics and level of detail. For example, some topics, such as rate of return and service standards were not addressed in core engagement activities. However, very few stakeholders expressed interest in participating in individual discussions. The low rate of uptake reinforced that the ‘two tier’ engagement approach was appropriate”[21]

AusNet make this claim under section 3.5.5 – Stakeholder Capacity for Involvement. Whilst the EUCV agrees that there are certainly constraints on then ability to effectively engage consumers in these

[21] AusNet: Revenue Reset 2017 - 22

activities, we would argue that, given the resources provided to AusNet to ensure their success, that they have the means to find innovative in the ways to achieve them. Specifically, the EUCV points out that many consumers just don't have the knowledge to provide constructive criticism on many issues and it is incumbent on the seeker of the input to provide sufficient training of participants where the seeker wants useful input.

Additionally, the areas that AusNet are stating they are seeing low levels of consumer engagement, such as Rate of Return and Services Standards, are some of the most important areas that need to be deliberated with consumers. Indeed, we have increased concern about the manner in which AusNet approaches these topics, and the manner in which they approach their consumers. We note from the topics outlined within this reset proposal, and indeed some of the vernacular outlined within it, that they engage their consumers and topics for discussion at a low base. In doing this, it provides a significant advantage for AusNet as they are able to effectively avoid topics that are contentious.

The EUCV notes that during the 2014/17 reset period, the AER supported by their consultant EMCa did not allow for any additional revenue allowance to undertake their consumer engagement programs. We view this as a prudent measure and are relieved that we have not seen AusNet apply for revenue in this coming reset period. However, we further note in section 3.8 of AusNet's proposal that the proposed consumer engagement program going forward through this period is somewhat diminished compared to their attempts throughout the current period. We view this as unacceptable and view the importance of maintaining their current program in its current form a minimum requirement.

4.3 Summary

Whilst AusNet makes claims that imply a robust process has been undertaken, moreover, the EUCV find the attempt of consumer engagement activities by that of AusNet services in the lead up to this reset period, somewhat lacking. We maintain significant concerns over ley areas within this program, including:

- ✓ The quality and objectivity of all information provided to those participating
- ✓ The generality of the topics discussed in the stakeholder forums
- ✓ The lack of identifiable consumer input into major decisions throughout this proposal
- ✓ Low response rate of community participation on key areas of the program, notably, the low response rates within survey's and lack of consumer engagement on the "one on one" meetings sought with consumers
- ✓ The continued use of claims of stakeholder engagement and input to areas of significance within the proposal, despite the lack of evidence to support them.
- ✓ The lack of effective engagement with consumer advocates who are appropriately versed and understand these issues. We view that AusNet are well enough resourced to ensure that specific consumer advocates views are considered

In addition, AusNet Services' revenue proposal also reflects stakeholder preferences by incorporating feedback from the stakeholder engagement program regarding reliability, although this feedback does not have the same statistical significance as the VCR data.

5. Service Performance Targets and incentives

We support AusNet's position on the Service Performance Targets and incentives when they state:

". the AER's intention to apply the full suite of incentives in Victoria, including the new stronger capital efficiency incentive is fully supported (by AusNet)"

The EUCV is however concerned that the STPIS service component is based on the historical performance. What is absent from this assessment is a recognition that the significant repex program proposed by AusNet should result in improved reliability and fewer instances of plant being out of service. By providing the repex to improve performance, consumers are incurring the financing costs for the new equipment and then paying again a bonus for the achievement of the improved service that they effectively have funded. This is a clear example of "double dipping" at consumers' expense.

EUCV notes that AusNet proposes to adjust the service performance targets to reflect the lower VCR. The EUCV does not consider this is appropriate as the impact of the lower VCR is only just beginning and the bulk of the assets have been provided based on a higher value of VCR.

Overall, the EUCV considers that the service component of the STPIS should be implemented in accordance with the guideline and that the repex should be reduced to levels that resulted in their achievement in the 2000-2013 period as the more recent service levels do not reflect the repex used in the past 2-3 years.

With regard to the market impact component, the EUCV considers that the AER guideline should apply in its entirety without any additional exceptions or exclusions.

The EUCV supports the two NCIPAP projects proposed and as noted in section 3 above, the step change proposed for the SAIP project is more appropriate to be added as a NCIPAP project if the benefits deliver a better than 4-year simple payback.

6. Weighted Average Cost of capital, allowed revenue and tariffs

6.1 Rate of Return

The EUCV are supportive the AER guidelines in relation to Weighted Average Cost of Capital, allowed revenue and tariff setting and as such we do not support any deviations proposed from these guidelines by the networks. The EUCV affiliate, the MEU and its other affiliates have provided a great deal of input into providing views on the guidelines at forums and in past submissions and their applications in revenue resets.

Further, despite a view that the guideline is considered to be conservative, the EUCV notes that consumers have accepted the guideline as being equitable and appropriate. We therefore support these views and maintain them as our position in this submission.

The EUCV notes that AusNet has decided to accept parts of the guideline and not other parts - effectively a "cherry picking" exercise. Of significant importance is that AusNet is also persisting (along with many other NSPs) that the AER guideline is wrong and that a multi model approach should be used to develop the return on equity. This issue has been refuted as many times as it has been proposed.

Fundamentally, the EUCV points out that AusNet has not explained how it has developed its weighting of the different models, nor has it provided reasons why its approach better meets the National Electricity Objective or the rate of return objective and principles - basically Ausnet merely tries to use the freedom in the rules to seek a better outcome rather than to demonstrate that the AER guideline does not deliver an outcome that complies with the intent of the rules and NEO.

Even more telling and is absent from the AusNet assessment is any reference to two recent sales of energy network assets - specifically the sale of Envestra (AUSNET itself) and the more recent sale of TransGrid. In both sale processes, the sale price significantly exceeded to RAB by a considerable margin.

EUCV is aware that the sale price of an asset is usually based on the expected revenue derived from the asset over time. As is well recognised, the cash flow form a regulated energy network is primarily driven by the return on capital invested (i.e. the WACC*RAB) and this is consistently in the range of 50-70% of the allowed revenue. With the RAB identified, it is the value of the WACC that drives this major part of the future revenue stream.

Before both sales, the AER guideline for development of the WACC was released so that potential acquirers of the AGN/Envestra and TransGrid assets were fully aware of the intentions of the AER. The sale of Envestra preceded any decision to appeal the AER WACC guideline and the sale of TransGrid occurred before any result was seen from the appeal of the AER WACC decision by the Competition Tribunal. Despite this, the two sales occurred with a significant premium on the RAB paid by the ultimate acquirer of the assets.

EUCV also draws attention to the ASX 200 results for the last 10 years. The performance of the ASX 200 measured over that last decade delivers a total return (accumulation index) of 4.7%. While the EUCV accepts that backward looking indices are not necessarily a predictor of the future, it is important to

note that over this same time period, AusNet was the recipient of a return on equity well in excess of this outturn return

These actual market outcomes provide a very clear indication that not only is the AER guideline on WACC seen as delivering an acceptable return on the investments made, but that there is support for a view that the AER guideline itself is conservative and the acquirers would accept an even lower WACC than comes from the AER guideline.

EUCV sees the arguments provided by AusNet in support of increasing the WACC are a mere regurgitation of the arguments provided in the Better Regulation program but augmented by a desire to be able to access any positive outcome for networks from the appeal to the Competition Tribunal.

EUCV has not been able to identify any new arguments in the AusNet proposal that have not already been put in previous proposals by energy networks and rejected by the AER

Overall, the EUCV is of the view that the AER guideline is not so different from the regulatory approaches used in the past or that the guideline is demonstrably deficient; in fact, the EUCV considers the AER guideline removes risks from AusNet rather than adds them. The AusNet focus is on attempting to prove that its preferred approach meets the requirements of the Rules more so than the AER approach and, by doing so, has concentrated on showing it is entitled to a higher return than that it would get from the AER guideline. What was totally absent from the AusNet arguments is any evidence that the AER draft decision does not deliver an outcome which is efficient, meets the NEO and the RoR objective. The EUCV considers that the empirical evidence from history supports the AER guideline as being more efficient[22] than the approach strongly put by AusNet.

The EUCV considers that the AER has not properly "put to bed" this issue and has allowed the NSPs to continue their debate on the poorness of the AER guideline. The EUCV considers that a failure by the AER to carry out benchmarking of historic outturn financial performance of the energy network firms and compared these to returns seen in the wider market has allowed this debate to continue unresolved. The EUCV considers that a longitudinal study of the financial performance of regulated networks compared to the wider market, after adjusting for the difference in risk profiles, would provide empirical evidence as to the validity (or not) of the claims by the distribution networks about the WACC guideline development and provide the AER with support for its view that the guideline delivers an efficient allowance for the cost of capital

EUCV is very concerned that despite the low cost of capital currently applying, the Ausnet proposal results in a higher notional tariff and the Ausnet view that prices will rise by 10% supports this view. What is concerning is that there has been a fall by some 300 basis points below the long term average for 10 year CGS on which the current rate of return is based. If the AER were to recalculate the revenue (and notional tariffs) based on the long term average bond rate, the EUCV is of the view that the higher cost of capital would result in a significantly higher notional tariff than AusNet is forecasting and the higher cost of capital that will occur when the risk free rate returns to its long term average will impose considerable harm on future consumers.

[22] An efficient outcome would be where there is just enough investment to deliver the services at the required performance level and no more.

The EUCV also notes that the entire issue of rate of return is still with the Australian Competition Tribunal and its decision is key to resolving the arguments that abound between the AER and the NSPs including AusNet.

6.2 Depreciation

The EUCV notes the AusNet proposal to increase the rate of depreciation by two methods

1. To introduce a declining balance depreciation for assets commissioned post 1 April 2017 and
2. Fully depreciate assets that are to be decommissioned in the current and future periods.

The EUCV opposes both of these proposals and points out that increasing depreciation of assets now merely transfers costs from future consumers to current consumers and reduce the potential risk to AusNet in the event that at some time in the future, AusNet shareholders might be exposed to having to absorb the costs of assets that are no longer needed.

6.2.1 Declining balance

A declining balance approach effectively reduces the expected life of new assets. Already the analysis of the different values used in developing depreciation allowances and the actual replacement of assets is significant as a review of the AER inputs to the depreciation schedules and the input to the AER repex models attest. Further increasing the rate of depreciation by a fixed amount as proposed by AusNet, merely exaggerates the difference between the reality of engineering lives and the notional value used for depreciation.

The EUCV accepts that in a competitive environment, a firm can depreciate its assets at whatever rate it wants, although the tax office decides the rate that depreciation can impact on the taxable profits a firm can claim.

AusNet operates within a regulatory framework that allows many benefits such as getting a current return on assets that are valued on a notional replacement cost and being an allowed current return on assets that are underutilised amongst other benefits. It is incompatible to allow one feature of the competitive market to be introduced into a consistent suite of regulatory approaches as this then upsets the balance of the regulatory approach.

6.2.2 Depreciate decommissioned asset

The AER has previously allowed the return of capital for decommissioned assets (and even assets that have failed earlier than planned). Up to recent times, this practice has not resulted in a significant cost to consumers.

As a matter of principle, EUCV has trouble with this approach as in a competitive environment (which regulation is supposed to replicate for monopoly service provision) an asset that is decommissioned for whatever reason is removed from the asset base and any loss taken into account in the profit to shareholders.

The EUCV notes that the current environment in which the networks operate (with low growth rates of peak demand, increased self-generation, and new renewable generation increasing and displacing thermal generation) the amounts of plant which still have unused life is increasing. The outturn of this is that the return of capital for decommissioned plant and under-utilised assets is becoming significant and is starting to impact the costs consumers are having to pay[23].

The EUCV considers that the AER needs to develop a policy on how should decommissioned assets be treated. To replicate the competitive sector, the EUCV considers that the return of capital for assets no longer needed should be carried by network shareholders and not consumers. This is a risk that can only be managed by networks and to impose the responsibility for managing the risk is an incentive for them implement better controls on how they invest in the networks.

6.2.3 Decommissioning of Point Henry

In addition to the above issues, AusNet also implies that, as a pass through event, the decommissioning and removal of the GTS to PTH terminals would also require accelerated depreciation to return the capital remaining on this asset. The EUCV does not, for the same reasons given for the decommissioning of other assets consider that consumers should have to carry these costs.

6.2.4 Conclusions on accelerated depreciation

The EUCV notes that the decision to increase capex (specifically repex) but then seek accelerated depreciation is inconsistent. The EUCV questions why current consumers should incur a greater share of the depreciation allowance for the benefit of future consumers and whether this complies with the NEO.

The EUCV accepts that faster depreciation will benefit the networks as it reduces their risk of their shareholders incurring a write down at some point in the future. More particularly the EUCV comments on the apparent dichotomy that allowing increased depreciation rates effectively offsets the increased capex that is sought[24].

The EUCV highlights that, whilst risk mitigation is a useful business tactic, it is important to consider the long term affects these have on consumers. It is the view of the EUCV that the implementation of increased depreciation will only serve to the benefit of networks, and not that of the consumer. Using accelerated depreciation, assets can be “written down” much faster than implied by their engineering

[23] Implicitly, this is the question who should pay for the assets made redundant by the impact of the "Death Spiral" - consumers or network shareholders?
[24] In a competitive environment a firm facing price pressures would scale back its capex program and would write off redundant assets at shareholder expense. In contrast, the NSPs are seeking to increase capex and write down redundant assets at consumer expense.

lives providing the networks with increased "free cash flow"[25] which can be taken as profit or used to justify new capex prematurely; such capex costs, as we know, are ultimately paid for by the consumer

If the networks face an existential threat (and their own conduct is contributing to this), their demonstrated behaviour can only occur in a sheltered monopoly where revenues are guaranteed. In a competitive market, firms facing such a threat would have to

(a) significantly constrain their capex (within requirements for safety etc.) and
(b) would have to write off their "redundant" (economic redundant) assets from the balance sheet as a cost to its shareholders - something quite the opposite of what the DNSPs are doing.

The AER needs to bring the capex and the depreciation process into a single analysis of efficient investment.

6.3 Revenue proposed and the impact on consumers

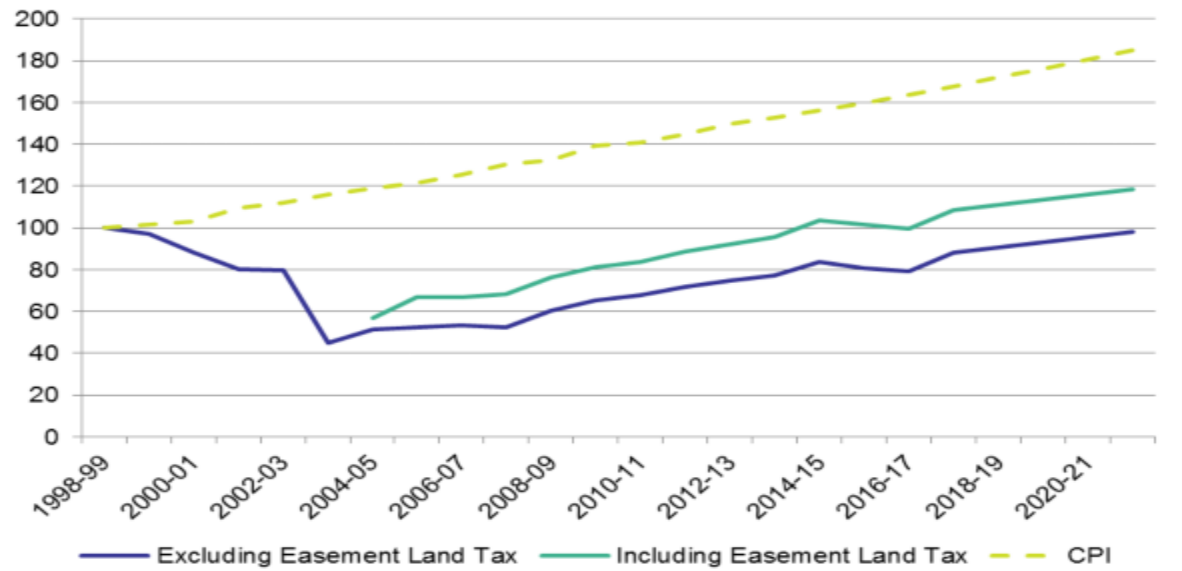
AusNet proposes that the impact of its proposal is to increase prices by 10% above inflation from current levels and then to rise by 0.6% more than inflation for the subsequent four years.

AusNet posits that its costs relative to other TNSPs sets it in the lowest range of costs to provide the transmission services. While this is true, it also is not responsible for growth in the network which is the responsibility of AEMO, so there is some argument that AusNet costs should be lower because its costs do not include all of the costs that the other TNSPs do.

AusNet provides a chart (figure 13.2, below) implying that its notional tariff has tracked inflation since 2004 and that this supports its view that its proposal maintains its place as the lowest cost TNSP. What is concerning is that the current proposal is predicated on a much lower cost of capital than applied at any time prior to the forecast period. If average costs of capital were used, the notional tariff ($/MWh) would be much higher for the forecast period, and well in excess of growth with inflation

[25] Depreciation is a non cash item and therefore the depreciation allowance provides revenue against which there is no cost to the business

Figure 13.2: Historical price path: Victorian transmission (index)



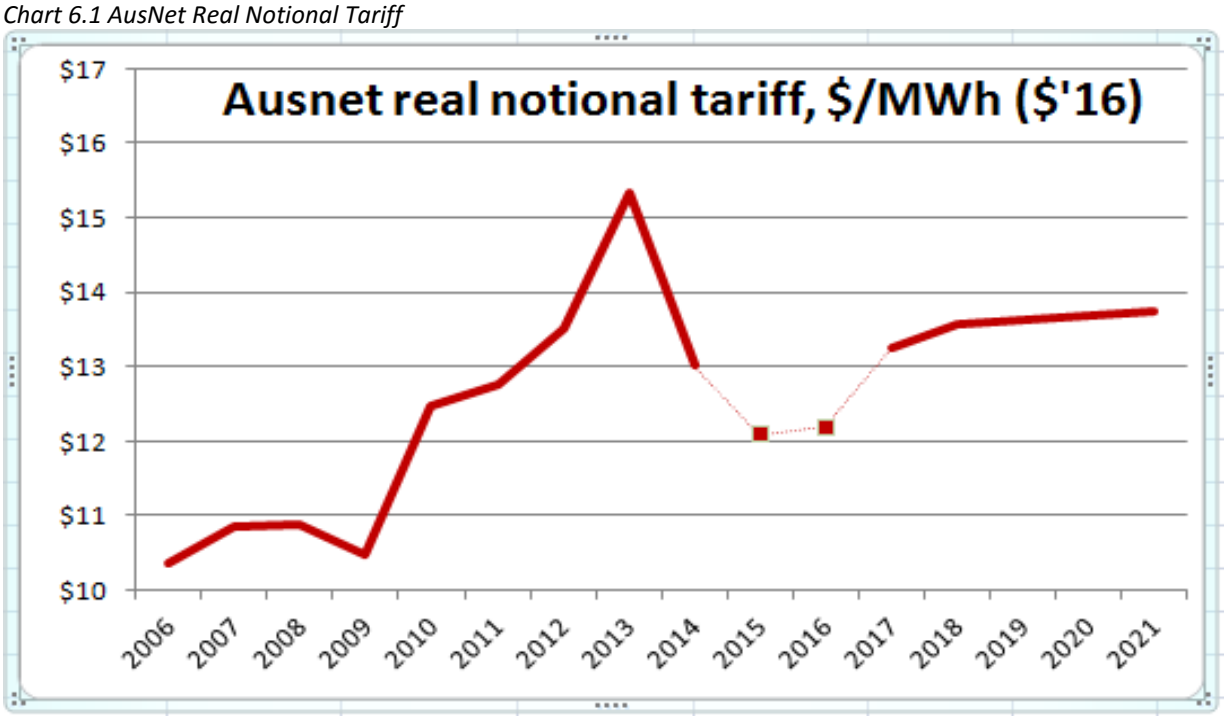
Source: AusNet Services analysis

The EUCV considers that this understates the actual impacts on consumers. EUCV has plotted a notional tariff based on:

- actual Victorian consumption
- calculated future consumption from the 2015 NEFR
- the actual revenues received by AusNet (from their RIN data),
- interpolated the allowed revenues for the "actual data" absent from the RIN data from the AER final decision made in January 2014
- AusNet's smoothed revenue forecast for 2017/21

The EUCV analysis shows a very different picture to future tariffs compared to that shown by AusNet.

Chart 6.1 AusNet Real Notional Tariff



Source: NEM data, AEMO NEFR '15, AER FD 2014, AusNet proposal, EUCV analysis

EUCV reiterates that the forecast notional tariff is based on the current low costs of capital and if average costs of capital were used, the proposal would result in a considerably higher notional tariff. Even so, the EUCV considers that, even with the lower cost of capital, the notional tariff reflects prices applicable during the time when significant capex was allowed due to expected peak demand increases.

6.4 Pass through events

The EUCV identified 6 significant areas of concern within proposed Pass Through Events by AusNet. These being:

1) A terrorism event
2) Insurance cap event
3) Natural disaster event
4) Insurer credit risk event
5) C-I-C event (see comments in section 3.6)
6) Decommissioning GTS to PHT (see comments in section 6.2.3)

The EUCV is concerned that the networks continually seek to reduce their risks and pass these to consumers. In principle, the EUCV does not consider that any of these pass throughs should be allowed as they are not events that firms in the competitive environment can pass through to their customers. Having said that, the EUCV has noted that the AER has allowed the first four pass through events for other TNSPs although the AER has not accepted the detailed wording proposed by the TNSPs and has provided its own wording.

The EUCV accepts that the AER has, due to regulatory consistency, to allow these first four pass through events for AusNet but the EUCV does not accept that any wording other than that established by the AER should apply

The EUCV has provided its views on the other two pass through events in sections above. The EUCV does not consider either of these events should be added to the allowed pass throughs.

7. Forecasts and escalation

The EUCV notes that the AER has developed a series of procedures to implement the adjustments to opex and revenue with time and notes that these are basically mechanical in their application. The EUCV has commented about the approach to opex growth in section 3.3

As AusNet is not responsible for managing growth in peak demand (this is an AEMO function) forecasts for growth in peak demand are academic in relation to this proposal.

The EUCV sees that the AusNet forecasts for consumption have no bearing on the proposal other than to show the tracking of the notional tariff. In this regard, the EUCV considers that AEMO forecasts should be used for this purpose.