Australian Energy Regulator

NSW Electricity Distribution Revenue Reset

AER Draft Decision

A response

by

The Energy Markets Reform Forum

February 2009

Assistance in preparing this submission by the Energy Markets Reform Forum was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.

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The content and conclusions reached are the work of the EMRF and its consultants.

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Executive Summary

The Energy Markets Reform Forum (EMRF) is especially concerned with the AER's draft decision which largely provides the New South Wales electricity distribution (and transmission) businesses with the costs sought in their applications.

The resultant increases in network charges, especially those of Energy Australia, clearly defy any logic against the background of a deteriorating business and economic outlook in the State, and hence a worsening electricity demand growth outlook.

An effective 10% per annum price increase or a 50% price increase in five years in Energy Australia's network costs cannot be justified, as the AER must re-address its underlying assumptions concerning the NSW economy and the cost escalators relating to wages and other input costs, such as materials and equipment.

The current capex and opex claims lack credibility. The EMRF provides its analysis in support of this view and makes suggestions for AER controls over the planned capex programs:

- Move some of the capex to contingent projects such that the DB must demonstrate to the AER that the need for the capex is real before the capex is included in the revenue stream.
- Carryout an annual assessment of actual capex and allowing only the actual capex to be included in the following year revenue. This will have the added benefit of preventing back ending of capex programs
- Build in a claw back mechanism to recover the unearned revenue from capex underspends
- Carry out an annual assessment of all capex to ensure that the capex is efficient. This will assist in preventing capex programs which were initiated on the basis they are efficient at the estimated costs but when actual costs show there will be an over run they can be terminated before inefficient capex is incurred.
- There is a relationship between opex and capex in that opex includes for the capital raisings necessary. If the capex program is less than allowed, the costs of debt and equity raisings should be discounted for the amount of capital (debt and equity) not raised.

As for opex claims, the EMRF is concerned with the analysis undertaken by the AER's consultants and also by the AER.

- For Wilson Cook to determine that the year 4 opex performance of the NSW DBs is at benchmark performance already and therefore

acceptable as a basis for future opex is severely in doubt. In fact a review of all the benchmarking used by Wilson Cook tends to show the NSW DBs are using opex significantly higher than the composite and other various benchmarks would indicate.

- The EMRF considers that the AER has not carried out a significantly detailed analysis of the current opex levels by assessing whether the 4th year benchmarks have been driven to best practice levels. In fact, the Wilson Cook analysis indicates that the NSW DBs probably have not achieved best practice efficient levels based on the 4th year costs.

The EMRF considers that unless the AER rebalances its draft decision and takes into account the devastating economic conditions prevailing in the economic and business environment and outlook in NSW, it would have failed in providing efficient and effective regulation. Credibility in the regulatory process would be lost.

1. Introduction

1.1. The Energy Markets Reform Forum (EMRF)

The Energy Markets Reform Forum (EMRF) is a forum representing large energy consumers in New South Wales. The EMRF is an affiliate of the Major Energy Users Inc (MEU), which comprises some 30 major energy using companies in NSW, Victoria, SA, WA, NT, Tasmania and Queensland. EMRF member companies – from the steel, aluminium, paper and pulp, cement and the mining explosives industries – are major manufacturers in the State and are significant employers, especially in many regional centres.

The EMRF provided its views on the applications from the NSW electricity distribution businesses (DBs) late last year and presented its initial views of the AER draft decision before Christmas at the AER public forum. The EMRF welcomes the opportunity to provide its detailed comments on the AER draft decision.

The companies represented by the EMRF (and their suppliers) have identified that they have an interest in the **cost, reliability, quality and long term sustainability** of the electricity supply needed for their businesses, suppliers and employees. In particular, they see that the energy networks services are an essential element in the electricity supply chain and therefore are very keen to provide their input to the AER review and reset of allowed revenues for these businesses.

1.2 An overview of the AER draft decision

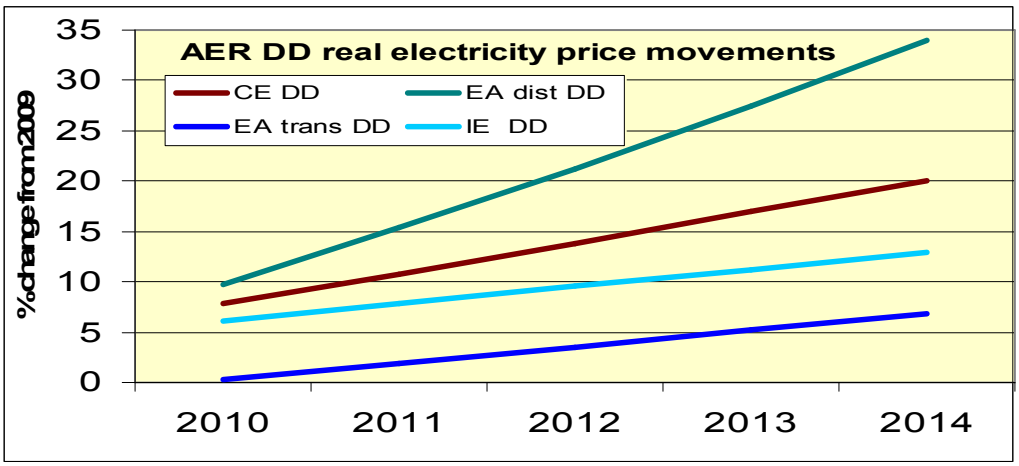
As was observed by the EMRF in its response to the DB applications, they had all taken to heart the fact that the new Rules encouraged investment and as a result they all considered a major investment program should be instituted. The AER draft decision has effectively condoned this ambit claim by the businesses.

In addition to allowing almost all of the requested massive capital sought, the AER has even failed to use the DBs' own historic benchmarking of opex needs, and allowed the businesses to implement a significant step increase in operating expenses.

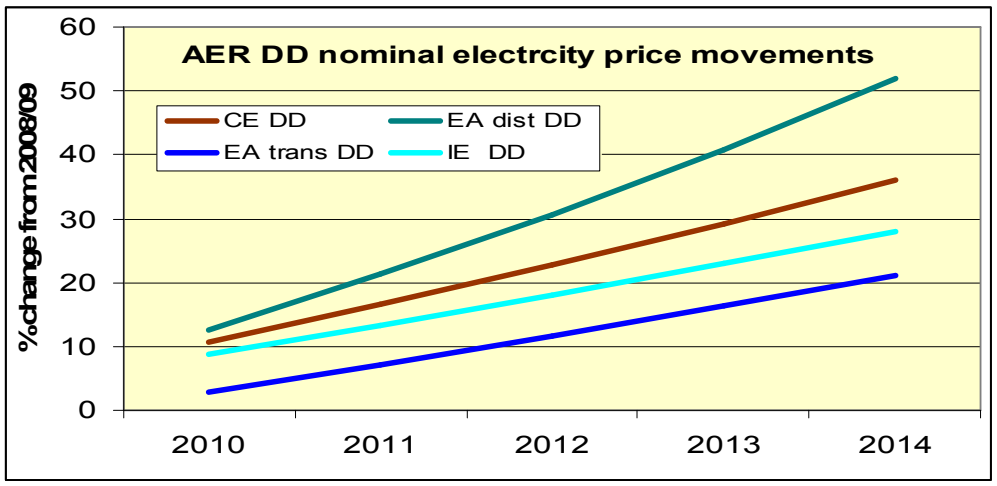
The increases in capex and opex were supposedly justified on significant growth in electricity demand, yet the movements in economic growth in Australia and particularly NSW since the middle of last year have all evaporated and the next few years will see either very low growth or recessionary conditions, and hence, little or no growth in electricity demand. To assume a high growth path for the NSW economy as do the draft decision and the applications, is simply wrong.

In addition to the expected demand growth, the DBs all pointed to the need to replace ageing assets. The AER draft decision has assumed that this is a key element within the reset yet analysis of the applications and the AER consultant's reports highlight that 40-60% of the total capex budget is directed at growth projects, whilst a relatively smaller proportion is for replacement. The EMRF further considers that replacement projects should have the impact of reducing opex, but even the modest asset replacement programs proposed by the DBs have not resulted in the AER reducing opex to the extent expected, as the AER is even proposing an increase in opex overall.

As a result, the outworkings of the AER draft decision will mean a massive impost on NSW electricity consumers. The AER draft decision provides its own view as to the expected increases in the "real" cost of electricity for the small consumer in its table 16.9 which is shown graphically as follows:-



When inflation is added at the rate assumed by the AER, the cost of electricity to small consumers as a result of the AER draft decision will increase in nominal terms as graphically shown below:



This shows that under the AER draft decision, made in the face of a rapidly deteriorating NSW economy, a small consumer in EnergyAustralia area will see a price increase of effectively 10% pa for the next 5 years just to cover the cost of distribution increases!

1.3 Consumers' ability to pay

That the AER blithely accepts these increases as an outworking of its "bottom up" approach highlights the disconnect between what is reasonable for consumers to pay and what the businesses would like to receive.

The arguments given for the massive increases are:-

- There is significant growth expected in demand
- Government has increased standards of performance
- The investment allowed historically under government direction, and later under IPART assessments was inadequate
- There is a need for replacement due to ageing assets
- Increased costs have recently occurred due to competition for, and scarcity of, labour and materials

In most cases, the recent massive reversal in the Australian and the NSW economy puts the lie to these arguments for increases in network expenditures, and these are addressed in more detail in the following sections. However, the issue of government constraining previous capital investments requires comment here.

It has been consistently asserted that government processes prevented adequate investment in electricity networks whilst networks were under direct government control. It must be recognised that governments (whether state or local) had the need to balance delivery of the service with the funds available. The dramatic increase in electrification of NSW occurred in the period of post world war 1. Thus for 75 years governments had the responsibility to balance the competing needs of security of supply with the reasonableness of the prices consumers have to pay. For some 10 years, IPART has had this responsibility and the AER just recently has been given this responsibility.

If government approaches were so fundamentally wrong in the past (in that they did not provide the funding the DBs see as necessary and who are now so critical of previous government limitations), how is it that the quality and security of supply was largely so well provided in the past? It also raises the fundamental question that the DBs now find it more difficult to maintain historic performance standards which were achieved under a regime that they consider was inadequately funded.

Effectively, what the DBs experienced under government control were the very limitations general industry sees from its Boards of Directors – that funding for capital works must be constrained to a level that the market allows, rather than to what the practitioners (or engineers) would **like** to have. Nothing focuses the mind better than when it is being constrained to address the critical few issues.

That the NSW DBs are critical of the constraints IPART applied to their capital expenditure aspirations serves a poignant reminder to the AER that it also has to be careful with consumers' money. It is blatantly unacceptable for the AER to allow the DBs, effectively, unfettered capital and operational allowances which consumers must pay. **For electricity bills to be allowed to rise by 50% over the next five years due primarily to increased network charges is clearly unacceptable and totally at odds with the current and expected economic climate.**

The AER needs to take into consideration the reasonableness of the prices consumers have to pay for what the DBs are stating are essential costs, especially for a service which is essential to all NSW consumers. But as electricity usage is essentially price inelastic, there is limited ability to modify demand. The very large price increases, however, have the potential to cause **large consumers** to reduce production (which is already occurring in light of the poor, business outlook) or even relocate, coming on top of the worsening economic climate.. Should this occur, there would be a significant loss of demand for electricity. This in turn would result in significant spare capacity in the network, but as the Rules do not punish a DB for building or having surplus capacity, the costs will be carried by a fewer number of consumers, potentially causing more consumers from using the network.

Thus the AER must have regard to the reasonableness of the prices consumers have to pay as an essential element of its assessment. Allowing largely unfettered price rises which result in loss of usage has minimal impact on the DB, but a significant impact on the consumers continuing to use the service.

1.4 The impact of the global financial reversal

The world economy is experiencing a severe shock (with significant widespread negative growth) and is undergoing a deep and long term adjustment process. It is already clear that Australia is not immune and government actions are already in place in attempts to ameliorate the impacts on the Australian economy.

Many OECD countries are already in recession (including the US) and Australia is expected to dip into negative growth in 2009. There is universal agreement amongst economists, government and business leaders that the Australian economy is in dire straits. Many Australian businesses have

already initiated actions to provide their own response to the current economic climate[1]. Such responses are widely reported and include deep staffing cuts, reducing operating expenditure, cancelling and/or indefinite deferring of expansion and investment plans, and reducing inventory. Capacity utilisation by industry generally is at historically high levels and is set to fall dramatically.

All of these actions in response to the economic climate will dramatically reduce the demand for electricity over the next 3 to 4 years. What is as significant, is that the many small and medium size businesses that go out of business under the current depressed economic and business environment will not return, thereby fundamentally reducing the underlying growth in demand and consumption of electricity. Moreover, investment plans that are shelved or deferred by large companies may never ever be implemented.

The latest National Australia Bank's business survey shows that the Australian business environment is at its worst since the 1990 recession and will deteriorate even more in the next few months. The bank expects the Australian economy to fall into recession, and decline by 0.25% in 2009 and then rising by 1% in 2010. The AER needs to factor into its forecasts of demand the likely outcomes of such recessionary impacts, by using comparable data from other recessionary periods.

Against this backdrop of a very significant collapse in economic activity and a very weak outlook over the next 3 to 4 years, , the AER's draft decision in allowing the NSW electricity DBs to massively increase their network charges based largely on ambit claims and out of date and invalid assumptions, is grossly wrong.

1.5 Summary

It is clear that in its draft decision, the AER has not had regard for

- The recent and savage down turn in the economy
- The resultant and continuing reduction in demand and consumption of electricity from consumers as they adjust to the lower economic climate
- The clear likelihood that demand forecasts are hugely optimistic

[1] Major industrial users in NSW have already announced substantial cut-backs in production, announced deferment or cancellation of investment projects, and warned of further cutbacks in production and in jobs as the economic and business outlook continue to worsen. Major companies that have made announcements include Rio, BHP Billiton, OneSteel, etc. For example, OneSteel has just announced a further 150,000 tonnes of production cuts from its electric arc furnaces at Laverton and Sydney, on top of a 300,000 tonne reduction announced in January 2009. Annual production will be down to about 850,000 tonnes, down from 1.3 million tonnes.

- The expected increases in costs claimed by the DBs are no longer correct
- The greater difficulty consumers are likely to have in paying the increased charges as the reduction in demand will mean unit costs rising higher than might be the case
- The likelihood that governments in the past did apply a realistic approach to constraining the claims for increased costs from the DBs, and that even with these constraints, the service provided was adequate for the needs

Unless the AER takes the above into account to mitigate the otherwise very substantial cost increases claimed, we consider that it would have failed as an efficient and effective regulator.

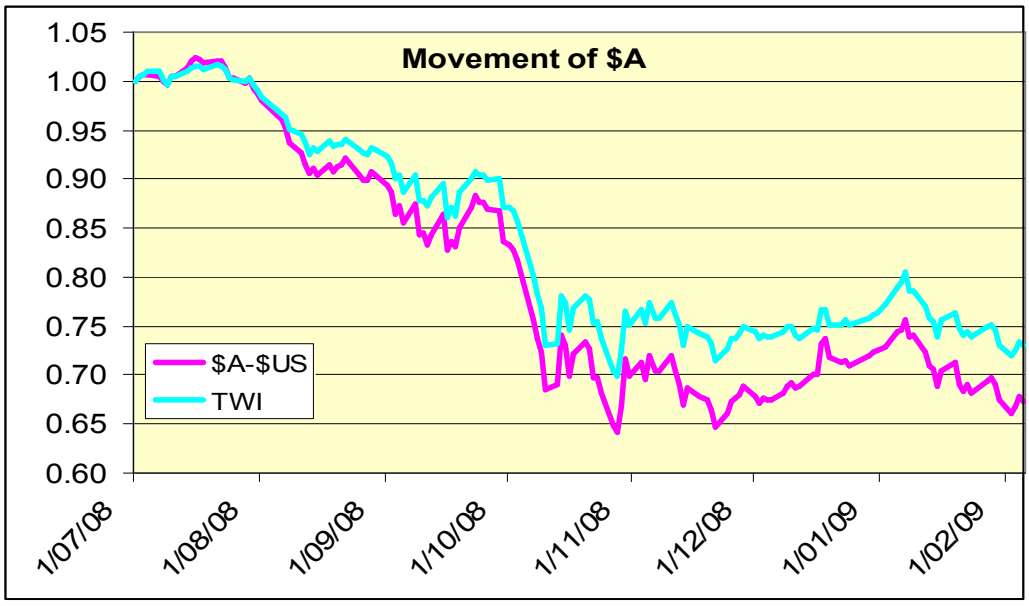
2. Demand and consumption forecasts

The forecasts for demand and consumption growth are very important elements in a price cap revenue reset review. As the EMRF advised in its response to the applications, understating consumption allows the DB to set higher unit rates leading to higher revenue as consumption exceeds forecasts and effectively "gaming" the regulator. Overstating growth in demand allows the DB to justify increases in capex and to a lesser extent, opex.

Because of the sensitivities of tariffs and capex to these forecasts, the EMRF had recommended the AER commission independent assessments of the forecasts provided by the DBs. The AER advises that it had commissioned independent advisers (MMA) to identify likely forecast scenarios. These independent assessments have resulted in a number of changes being made to the forecasts provided by the DBs, but the assessments also supported some of the forecasts provided.

Unfortunately, the forecasts and the subsequent assessments were carried out prior to the extent of the global economic downturn becoming apparent. Forecasts made in the middle of 2008 are now wildly optimistic and those made at the start of Q4 2008 are demonstrably out-of-date.

It is recognised that much of the growth in electricity use has been driven by low cost imported electrical equipment, especially low cost refrigerative air conditioners. The loss in buying power of the $A has been massive over the last seven months, and particularly since the forecasts were provided by MMA to the AER.



Source: RBA

The impact of the loss in buying power by some 30-35% due to currency movements will have a major impact, as will the general loss of consumer buying power resulting from the economic downturn. The impact of this loss of buying power will be to reduce the incidence of new electrically driven equipment, especially residential air conditioners which are one of the large drivers of demand growth.

Other exogenous impacts have also become clearer over time, such as the carbon reduction schemes (emissions trading and the expanded mandated renewable energy targets). A number of businesses have advised that the introduction of carbon reduction programs would have the potential to put them out of business. For example, Nyrstar has publicly advised it will vacate Australia (ie close its smelters) if the cost of carbon mitigation exceeds $40/T.

Most businesses have advised that their capital programs will be scaled back and in many cases deferred indefinitely. Additionally, many businesses have reduced production and laid off many staff and contractors as a result of lower demand for their products and the prices expected for them. A direct outworking of such reductions in production must provide major downward pressures on demand and consumption growth forecasts.

New facilities have also been significantly scaled back. For example, CitiBank forecasts are showing strong negative signs:-

- Non-residential buildings approvals fell in 4 of the last 5 months of 2008
- Falls in residential building approvals are much larger than expected seeing an additional reduction of 5.4% against already scaled back market forecasts
- Household wealth destruction is unprecedented (as shares and house values fall) which in turn is driving an increase in savings and reduced spending.

The expected reductions in demand resulting from such exogenous sources reflecting the economic downturn must be factored into the forecasts by the AER. The considered view and the experience of large energy consuming businesses relayed in this submission need to be carefully considered by the AER as part of its review.

In particular, capital programs proposed by the DBs must be reassessed in terms of the impact such large reversals of previously accepted growth forecasts will cause.

3. Capex and Opex cost inflators

In their applications the DBs forecast that a significant element of the increases they claimed in their capex and opex allowances was due to the costs for labour and materials exceeding the general inflation rate as represented by the consumer price index. In previous reviews, the AER had allowed capex and opex to be increased to allow for this supposed effect.

In its response to the DB applications, the EMRF pointed out that such an increase is not warranted but the AER draft decision has allowed for these real cost escalations.

> "The underlying objective of real cost escalations was to take account of the commodities boom and skills shortages in the engineering field in Australia. In light of these external factors, it was considered that cost escalation at CPI no longer reasonably reflected a realistic expectation of the movement in some of the equipment and labour costs faced by electricity network service providers (NSPs)." (DD page 530)

The above statement is, of course, now wildly out of date and is incorrect, given the extent and depth of the economic downturn now being seen.

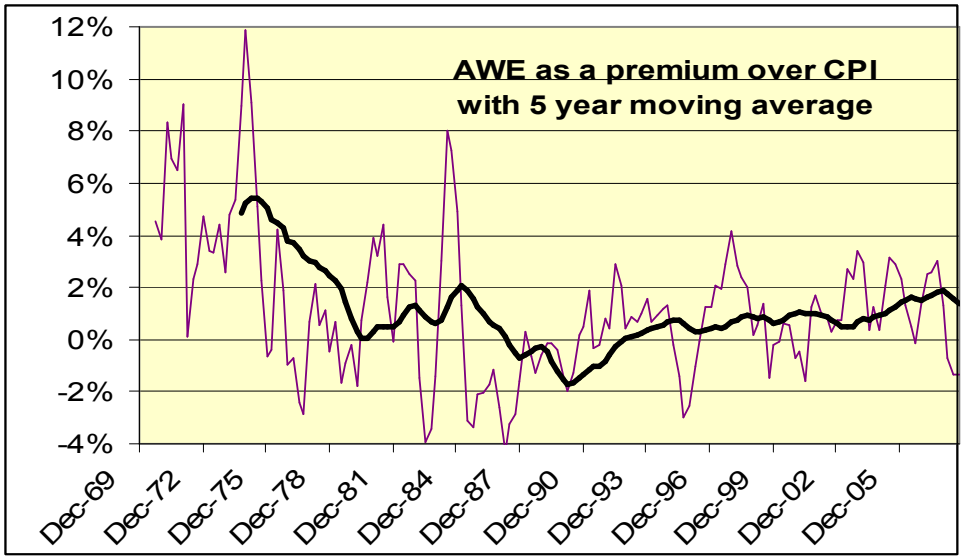
The EMRF has also pointed out that the premiums for specific labour and materials used by the DBs and the AER have already been allowed for in the base capex and opex allowances, and by applying these "real cost escalators" to the whole amount of the capex and opex is effectively double counting. The explanation provided by the AER still does not recognise that the unique escalators used have varied from the long term average relativity. It is only where there is a move from the long term average relativity that the AER argument might be supported. The EMRF views the AER approach just embeds an unnecessary premium into the allowances.

3.1 Labour cost escalators

It is accepted that the costs for labour increase at a faster rate than the CPI over the long term. Effectively, the difference is the improvement in productivity of Australian labour. Over the past 50 years average weekly earnings has exceeded CPI by some 120 basis points and in recent times by even more.

The premium is not a constant value and moves almost on a quarter by quarter basis, but the five year moving average shows this premium average

is positive for most of the time, and positive in its long term average. The following graph shows this clearly.



Source: ABS indexes G2 and G6

The purpose for providing this data is to demonstrate that the AER should not just increase allowances for opex and capex by the "real" increases in sectoral labour rates but to discount the base productivity (ie premium of wages over inflation) from any increases that sectoral labour rates might be indicating.

Analysis of the data indicates that there is a negative premium (a discount) between inflation and average weekly earnings at times of recession such as after the 1975, 1987and early 2000s periods where wages growth was less than CPI. The latest data for 2008 shows that wages are increasing at a lesser rate than inflation, indicating that the current premium is negative. Already pressure on wages growth has been reduced due to the current economic conditions and outlook, indicating that for the duration of the period of very low or possibly negative economic growth, wages will remain at a discount to CPI.

The AER should take into consideration the current economic climate more fully in its analysis of wage cost escalation.

Notwithstanding that the data used by the AER for its draft decision is factually now out of date and not reflective of the expected economic conditions, the AER has also made a fundamental error in making allowance for the whole "real" premium of wages growth.

The AER DD has assumed that EGW rates (assessed prior to the recent announcements of widespread labour shedding) show a real average premium of some 3.0 as shown in table N.5 in the draft decision.

Table N.5: AER's conclusion on NSW EGW real labour growth rates (per cent)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	Average
AER's EGW labour	−1.4 (CE) 1.4 (EA) 1.5 (IE)	2.8	3.9	3.4	3.0	2.8	2.1	3.0

Source: CEG, NSW electricity businesses, p. 8; Econtech, p. 10.
Note: The AER derived the real growth rates for 2007–08 using the actual CPI for 2007–08 of 4.5 per cent.
The average is calculated for 2009–10 to 2013–14.

In fact this premium, if correct, should be discounted by the long term average of wages over inflation, of 120 basis points, and only 180 basis points should be included in any assessment of labour cost escalation for EGW labour.

In the case of general labour, the AER DD has assumed that general labour shows only an average premium above CPI of 78 bass points above CPI, and shows this in table N8.

Table N.8: AER's conclusion on real general wage growth (per cent)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	Average
AER	0.6	1.0	1.1	0.7	0.7	0.8	0.6	0.8

Source: Econtech, *Labour cost growth forecasts*, p. 25.

As this premium is less than the long term average, the AER should discount general labour costs by 42 basis points as the long term average is 120 basis point of premium.

Overall, the AER assessments are predominantly derived from assessments made using data from early to mid 2008 and before. These assessments are reflective of a strongly burgeoning economy. As is now known the Australian economy has nose-dived from Q3 2008, is now practically in recession, and there is little likelihood of a return to the 2001-2008 economic growth pattern for some years. The draft decision has not factored in the extent of the economic downturn.

Analysis made in February 2009 shows that the AER draft decision assumptions and forecasts for wages growth is unlikely to apply as the economy is already implementing large staff redundancies. This indicates that rather than wages growth exceeding CPI (ie real increases) the AER should be factoring in real reductions in these escalators and applying a discount for labour escalation based on the current economic cycle.

In its labour cost forecasts, AER consultant, Econtech, based its expected real wages growth on an average Australian "real" GDP growth expectation for the next five years (ie 09/10 to 13/14) of 3.2% pa. It forecast "real" GDP growth for 08/09 of 2.2%

There is no doubt that the GDP growth for Australia will be less than 2.2%, and Treasury is already factoring in lower GDP expectations, and banks are factoring recessionary times.

Econtech shows that the "real" GDP growth for the period 02/03 to 06/07 averaged 3.2% so the expectation on which it based its assumptions for labour cost growth reflect that growth experienced in the past five to six years. This is certainly not an expectation widely held now.

Based on the current economic conditions Econtech's assumptions must be viewed with extreme caution, and therefore to base labour cost escalation based on the Econtech assessment is not reflective of current expectations.

3.2 Land cost escalators

The AER has built into its escalators, a real increase of 4.1% for the entire five year regulatory period.

The market is showing that land prices (especially residential land in NSW) are at best static if not actually falling, and with increasing office vacancies the value of commercial land is also falling. This is a result of the current economic conditions.

For the AER to factor into its allowances for the DBs, a strong increase in land values is patently out-of-step with the current actual market conditions.

3.3 Material cost escalators

The AER has provided a detailed analysis of its view on future materials prices. But unfortunately these were made before the global recession set in. Comparing these materials prices to actual movements over the past months shows that the impact of the global economy reversal has demonstrated the AER assumptions need significant revision.

Table N.12: AER's conclusions on real copper and aluminium cost escalators (per cent)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
Copper	–6.3	–13.5	0.3	1.4	–5.6	–6.3	–7.0
Aluminium	–6.3	–7.0	7.5	9.3	–0.8	–1.3	–1.6

In fact, copper and aluminium prices have fallen already in 08/09 by some 60% since the start of the year

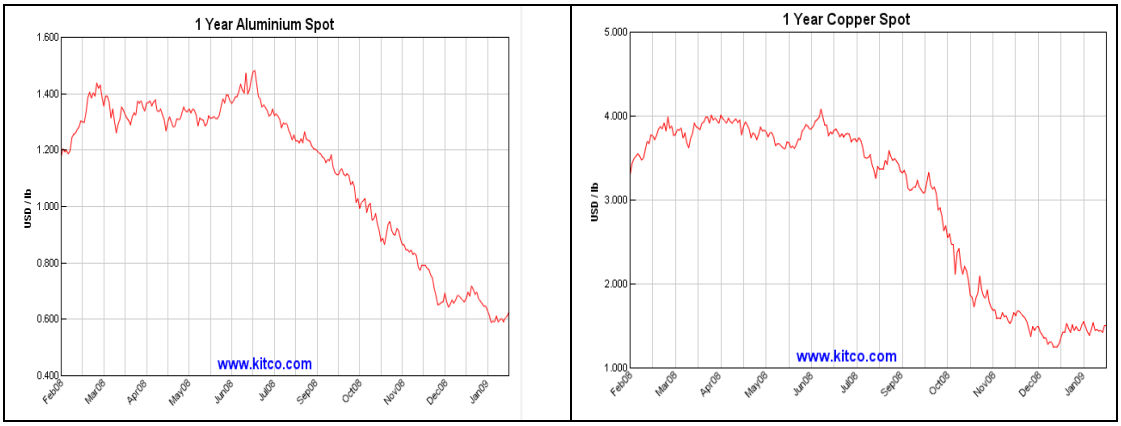


Table 15: AER's conclusion on real fabricated steel escalators (per cent)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
AER	45.4	3.4	–1.7	–2.4	–2.5	–3.0	–3.4

Rather than a 3.4% increase in steel we have seen steel prices fall by some 65%.

Table N.17: AER's conclusion on real crude oil (per cent)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
AER	43.5	–13.4	1.5	1.7	0.1	–0.6	–0.1

Crude oil prices have fallen 70% rather than 13.4% forecast by the AER for 2008/09

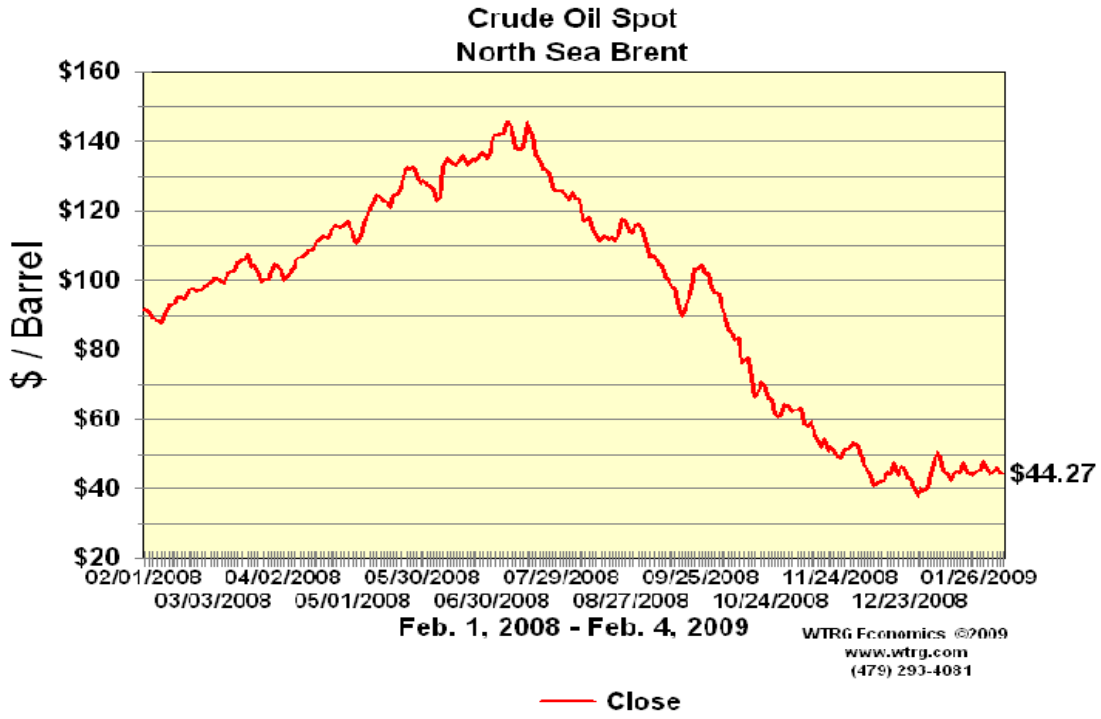
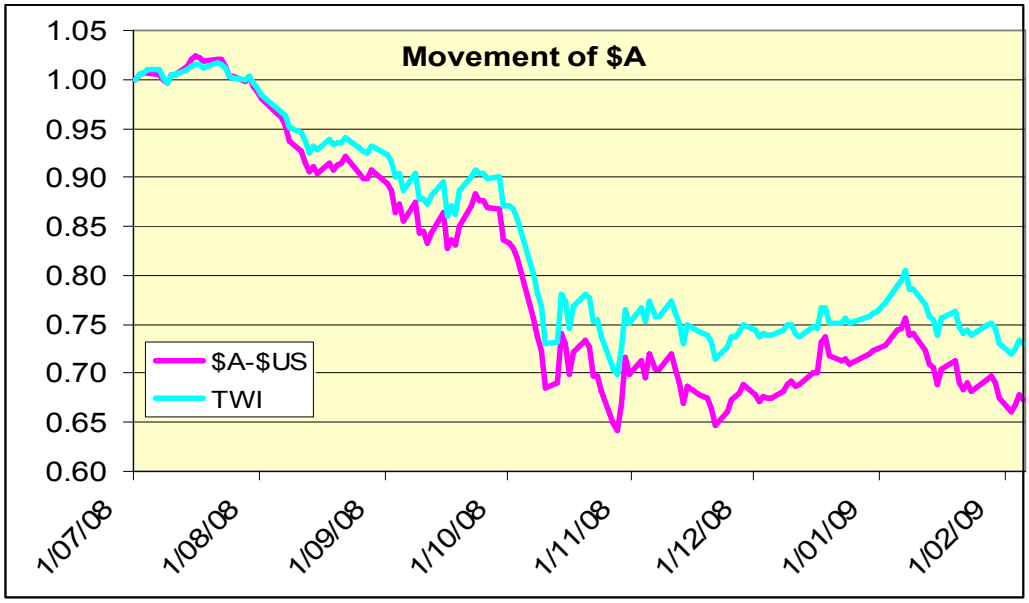


Table N.20: AER's conclusion on AUD/USD exchange rate forecast, as at 1 July

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
AUD per USD	0.85	0.96	0.88	0.84	0.82	0.80	0.79

Source: Econtech, *Australian National State and Industry Outlook*, 22 June 2008, p. 110.

The exchange rate for the $A rather than sitting at $US 0.80-0.96 has fallen by 30% to less than $US 0.70



Source: RBA

The assumptions made by the AER in setting material price escalators are grossly out of date when the actual impact of the world economy (including the Australian economy) on materials and prices are assessed.

3.4 Summary

Overall the AER draft decision is forecasting real increases from 07/08 levels in labour and materials for the next five years. On the basis of what has occurred in that last six months this assessment is not supported by the data.

Most OECD countries are in recession now and the US is projected to experience a deep and long lasting recession. Australia just missed negative growth in Q3/08 due to strong farm output and Q4/08 is forecast to be negative, implying a recession is probable. The NSW economy, which has lagged behind most of the other States in economic performance, is likely to continue to weaken. Its recent mini-budget was, contrary to sound economic policy practice (as demonstrated in the various global stimulus packages seen), even counter-cyclical (expenditure cuts and tax increases), thereby further weakening the prospective outlook for the State economy. Under such an overhang of poor economic factors, business conditions in the State are likely to remain depressed for some time, and hence the demand and consumption of electricity is likely to remain static at best - and certainly not show the growth seen over the past five years. With unemployment rising, investment plans deferred, and historically low capacity utilisation, residential and industrial demand and consumption of electricity could possibly fall.

Projects all over the world are being deferred (some indefinitely) and capital projects in Australia being similarly impacted. The effect of this, combined with overall lower demand, means there will be increasing manufacturing capacity for plant and equipment needed by the networks. As a result prices for new plant needed by the DBs will fall dramatically as manufacturers seek to fill empty manufacturing "slots" caused by cancellations, and competition will be fierce for any work as manufacturers and construction companies fight for sufficient work to maintain viability

The benchmarking approach for opex and capex is based on actual performance by the DBs in the 2007/08 year. At that time, and for a short period thereafter, costs for materials and labour did rise. But since mid 2008, all relevant material, land and labour prices have plummeted. The exchange rate has likewise plummeted. What is concerning is that there is no certainty that the markets have "bottomed" even now. The Australian share market has continued to fall since last November, albeit at a much slower rate, indicating that it has not reached its nadir.

Rather than applying cost escalator inflators to the forecasts for labour and materials, the market is showing that deflators are appropriate. The AER has indicated that when a deflationary cycle applies they will apply such deflators as a symmetrical approach to applying inflators. This approach has been foreshadowed by the AER

> **"It was also communicated by the AER at the time of allowing real cost escalations that the regime should symmetrically allow for real cost decreases. This was to allow endusers to receive the benefit of real cost reductions as well as facing the cost of real increases." (DD page 530)**

The market is now indicating that the economy has turned and there is now a need for this symmetry to be implemented.

The AER needs to reassess the factors it has used as part of the draft decision which support the DB claims for increased allowances for escalation of costs for opex and capex based on what are now totally and obviously discredited assumptions made by the DBs, the AER and its consultants.

4. Total Ex-Ante Capital Allowance

The DBs (and TransGrid) have sought to provide justifications for the significant increase in capex proposals as being due to:

- Growth, especially peak demand growth
- Reliability obligations, as part of licence conditions
- Asset renewal, as a result of ageing asset profiles.

The EMRF agrees that these are reasonable aspects to consider as part of a capital program. By and large, the AER engineering consultant (Wilson Cook) has basically concurred with the DBs about the extent of their capex programs and the AER draft decision effectively supports this view.

The approach by the consultant and then by the AER concentrates on the assumption that the DB requests are valid, and then attempts to assess whether there are aspects where the capex requested might be considered to be excessive. This approach is referred to as a “bottom-up” approach. Experienced senior business practitioners are all to aware that a bottom-up approach to capex (and opex) claims by subordinates can be difficult to refute and as a result the maximum allowances are commonly set on a top down approach which looks at the business limits on cash available for capital investment.

What is absent from the DB applications and also from the AER draft decision is the imperative constraint as to whether the market can absorb the costs that will result from such a program. As noted in section 1.3 above, in previous times governments would balance the desires of the electricity industry it owned with its assessment of whether there was reasonableness in the prices consumers are to pay. Typically, if the DBs are to be believed, consistently governments would scale back desired investment based to al level where it considered it had the ability to raise the cash needed for such programs and the ability of the consumers to pay for the work.

In its assessment, Wilson Cook has only assessed whether the capex can be justified (which it confirms it can be, on both a needs basis and a cost basis), and has not assessed whether there is an ability to raise the cash needed for the works, and whether it is reasonable for consumers to pay such costs.

The EMRF does not doubt that a case can easily be made for the capex requested. The main question the EMRF has, is whether the amount requested is economically efficient (ie whether it is needed now or could be deferred) and whether there is the capacity to pay for the investment, given the marked economic downturn and the associated potential reduction in

electricity demand and consumption by both business and residential customers.

Economic efficiency in relation to investment and as interpreted by the AER and its consultants has concentrated on whether the capex requested can be justified in terms of the capital management objectives of the applicant. This is just one side of an assessment as, in fact, investment economic efficiency requires more than this. Overall, an economic efficient approach requires an assessment as to whether the intention to invest can be matched with a high expectation of receiving a return which provides a better outcome than investing elsewhere or even not investing.

In the context of a regulated monopoly, the expected return for an investment is set by the regulator and where the monopoly service is essentially inelastic with respect to price, the regulator has to identify whether the benefits received by the consumers are reflected in the costs it will cause to be imposed on the consumers. This balancing in relation to electricity distribution needs the investment to return to consumers improved or maintained service standards at a price which consumers can pay.

The AER draft decision makes little attempt to address this second element of economic efficiency in relation to delivery of improved service and whether the consumer should pay for this improvement in service against the background of a weakening economy and reductions in demand and consumption of electricity. It has merely assessed whether the requests by the DBs are justifiable.

4.1 Benchmarking

The capex requested by the DBs appears to be excessive when compared to various benchmarks, and as the AER and its consultant have effectively accepted the requests for capex these benchmarks are equally appropriate to the draft decision.

For example there are quite differences between the IPART allowance, the actually incurred capex and the AER draft decision in respect to capex/RAB

Capex/RAB	CE	EA dist	IE
IPART adj (relative to RAB 2004)	64%	63%	73%
Actual (relative to RAB 2004)	87%	80%	78%
AER DD (relative to RAB 2009)	93%	99%	79%

What this benchmark shows is that relative to what the DBs actually spent, capex in the current period is still lower than the allowance the AER DD will provide, and that the AER allowances are significantly higher than those

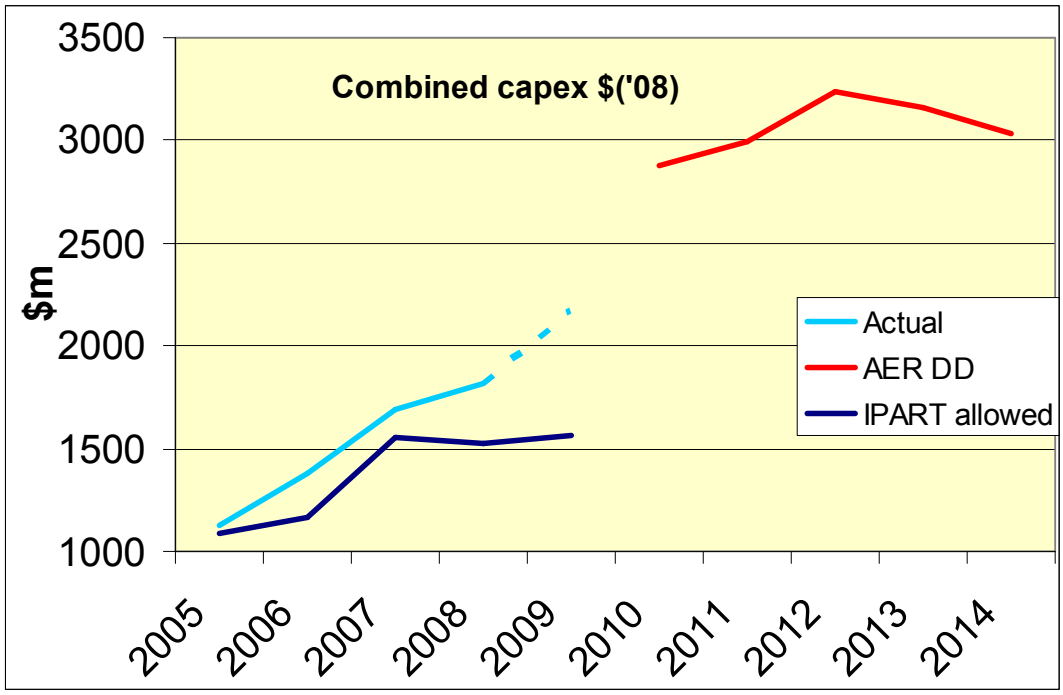
allowed by IPART even after adjustment for allowing the pass through of additional capex.

The Wilson Cook reports show that all three of the DBs exceeded their capex allowance granted by IPART including the pass through amounts. Tellingly, of the additional capital expenditure incurred by the DBs above the allowances provided by IPART, it is assumed that nearly 50% of the overrun will occur in the last year (08/09) of the period and some 25% of the total over-run was incurred in the second last year (07/08) of the period.

Implications that could be drawn from this analysis are that the DBs only incurred significant additional capex very late in the current period when:-

- The over-run was heavily impacted by the higher costs incurred as the economy commenced to "over-heat"
- The DBs were assured that the actual over-run would be included in their recalculated RAB after the transition Rules were developed to ensure any capex over-run would effectively be incorporated in the RAB and that there would be no optimisation review of the capex, and
- The over-run would be used as part of setting the benchmark for claims for new capex allowances.

Even allowing for the 4th year of a period to be used as a benchmark, the AER DD accepts there will be a significant step change in the capex allowance, as shown on the following chart.



The average annual capex allowed by IPART/ACCC was $1378m, and the actual average was some 20% higher at $1635m. The AER DD has set a new high for average combined capex of $3061m pa , some 90% higher than the average capex for the current period and 122% higher than IPART/ACCC

Accepting the DBs have set their own benchmark for capex at the 4th year rate of $1813m pa, the AER DD allows an increase of 70% more than the DBs actually used in the benchmark year.

Benchmarking indicates that the AER has provided a new capex allowance well in excess of reasonable levels.

4.2 Service standards

The regulatory bargain posits that consumers will get a service standard commensurate with the cost of the service provision. The DBs, the AER consultant and the AER DD all opine that the DBs need additional capex to provide for the growth in demand and to meet service standards set by the government. Particularly, the DBs have commented that the improving standards required by government warrant significant capex for their achievement.

In its DD the AER provides the requirements for service in terms of SAID and SAIFI and the DB performance in relation to these.

Table 7.4 NSW DRP licence conditions – average reliability standards- SAIDI minutes per customer, by feeder type

	2005–06	2006–07	2007–08	2008–09	2009–10	From 2010–11	Actual performance 2006–07
EnergyAustralia							
CBD	60	57	54	51	48	45	13
Urban	90	88	86	84	82	80	78
Short-rural	400	380	360	340	320	300	290
Long rural	900	860	820	780	740	700	1093
Integral Energy							
Urban	90	88	86	84	82	80	66
Short-rural	300	300	300	300	300	300	175
Long rural	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Country Energy							
Urban	140	137	134	131	128	125	114
Short-rural	340	332	324	316	308	300	239
Long rural	750	740	730	720	710	700	497

Source: NSW DRP licence conditions; DNSP annual reports.

Table7.5 DRP licence conditions – average reliability standards- SAIFI interruptions per customer, by feeder type

	2005–06	2006–07	2007–08	2008–09	2009–10	From 2010–11	Actual performance 2006–07
EnergyAustralia							
CBD	0.35	0.34	0.33	0.32	0.31	0.30	0.17
Urban	1.30	1.28	1.26	1.24	1.22	1.20	0.96
Short-rural	4.40	4.20	3.90	3.70	3.40	3.20	2.76
Long rural	8.50	8.00	7.50	7.00	6.50	6.00	5.64
Integral Energy							
Urban	1.30	1.28	1.26	1.24	1.22	1.20	0.90
Short-rural	2.80	2.80	2.80	2.80	2.80	2.80	2.00
Long rural	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Country Energy							
Urban	2.00	1.96	1.92	1.88	1.84	1.80	1.36
Short-rural	3.30	3.24	3.18	3.12	3.06	3.00	2.47
Long rural	5.00	4.90	4.80	4.70	4.60	4.50	3.82

Source: NSW DRP licence conditions; DNSP annual reports.

Every DB readily achieves the government set benchmarks in their performance in 06/07 when the capex allowances started to exceed the

IPART/ACCC allowances for capex. In fact, the achievements exceeded the requirements set for 10/11. The only category not to be exceeded was EA long rural feeder SAIDI performance.

The fact that the service standard performance to date has exceeded requirements raises the question as to whether capex in addition to that included in the current capex allowances is necessary to achieve the licence levels set by the government. A supplementary issue is whether non-achievement of the service standards will result in a penalty anyway. In the absence of financial penalties (such as the AER decision not to apply despite recommendations from consumers) it is unlikely that the government can impose significant sanctions on DBs (they have never done so yet!) that fail to meet the licence conditions. This removes much of the risk faced by the DBs.

4.3 General observations on capex

As noted in section 2 above as to whether the growth forecasts used to justify the capex are now likely. The EMRF is of the view that growth is likely to be much lower than forecast as a result of the economic downturn. If the expected growth is much lower than forecast much of the capex targeted to address growth becomes unnecessary. The current rate of capital investment already includes for a growth rate in demand comparable to the forecast growth rate, implying that the current usage of capex (even that in the 4th year) should be able to address the forecast growth rates. The fact that the forecast growth rates are likely to be lower than forecast, raises the concern that consumers are being expected to build into the networks significant surplus capacity.

Performance against service standards already shows significant outperformance. This raises the question as to why so much capex is required to meet the enhanced performance standards set by government when the DBs are already exceeding those set for 10/11.

Self benchmarking has been identified as a strong regulatory tool for assessing capex and opex. Already the capex allowances include for significant allowances for replacement of assets at the end of their useful lives. The capex programs include for an even greater rate of replacement raising the concern that assets still used and useful are being retired purely because the DBs will no longer receive a return on them as they have been fully depreciated. In this regard Wilson Cook makes it very clear that they have not assessed this aspect in anyway[2]:-

> "The following matters were excluded from consideration in our work or were not undertaken:

[2] Wilson Cook main report pages 15, 16

- physical inspection of the assets;

We did not carry out an audit of any DNSP's accounts, asset register, data, expenditure, processes or any item or activity or take any action that might be considered to have constituted an audit but relied instead solely on the submissions received from the DNSPs and the representations made in response to our enquiries."

They note that they have assumed that[3]:

"(h) The physical condition of the network is understood to be commensurate with age."

There has been no clear attempt at all (other than accept the blandishments of the DBs) to identify if some of the capex proposed could realistically be deferred. Deferment of capex provides a distinct benefit to consumers and what they are required to pay.

The AER observes in its draft decision that (pages 149-150)

"The AER notes that the NSW DNSPs have explored options to defer and appropriately time its investments in light of the risk of resource constraints. EnergyAustralia noted that it has deferred $50 million of network investment through demand management. It also noted that its capex has ramped up over the current regulatory control period at a rate of between $150 and $200 million per year, and it has considered targeted increases of $200 million per year in planning its capex proposal, which forced it to consider deferrals, demand management and bearing higher risk of asset failure.

The AER acknowledges the point made by the NSW DNSPs that the increase in value of the programs between the current and next regulatory control periods reflects, to a material extent, increases in the real cost of inputs. For example, EnergyAustralia attributes approximately 10 per cent of the increase in capex between the current and next regulatory control periods to real price increases."

It appears that the AER has taken such assurances at face value, as has Wilson Cook. Wilson Cook confirms this when it makes the observation in relation to EA transmission (Vol 2 page 25):-

"Because of the integrated nature of the capital investment programme, it would not have been possible to suggest the deferral or modification of component parts of the plans without requiring that the entire programme be reviewed. We did not consider that that was appropriate for this high level study…"

[3] Wilson Cook volume 2 [EA} page 3

> These comparisons indicate that the NSW DNSPs are capable of delivering significant increases in capex, including expenditure in excess of the regulatory allowances. To date, access to finance has not been a constraint on the NSW DNSPs ability to undertake capital works beyond their regulatory allowance. However, instability in world financial markets and concerns about debt levels may prove to be a constraint going forward.

4.4 The capacity to implement the capex programs

After pointing out that the DBs have all introduced significant expansion of their capex programs, the AER notes (pages 150-151

> "The strategies proposed by the NSW DNSPs appear reasonable as noted by Wilson Cook. However the AER does have some concerns that the NSW DNSPs will be concurrently seeking resources and using overlapping delivery strategies, including with TransGrid and other Australian DNSPs and TNSPs. This is addressed, to some extent, by an expectation that the Australian and global economies are entering a period of reduced activity which will see a decline in demand for resources and materials.
>
> Given the very high concurrent level of investment proposed for the NSW distribution (and transmission) electricity networks, the AER will carefully monitor the expenditures of the NSW DNSPs on an annual basis and through its annual regulatory reports will publish information on the actual capex spent by each of the NSW DNSPs, including any under or over spends if they occur."

Such an observation provides scant comfort to consumers as when the AER approves an ex ante amount of capex, this is locked in and despite any DB under-running its capex program, consumers pay for the capital not expended in accordance with the capex program.

The AER is proposing to allow the DBs to expend over $17billion dollars in the next 5 years. The AER has identified (and then dismissed) the concern that with the capex programs already approved by the AER, adding the NSW DB capex programs has the potential create competition between all electricity transport businesses for the limited resources (financial, material and labour). The impending recession is expected to ameliorate scarcity for labour and materials but the issue of financial resources is made worse by the recession. The risk for consumers is that if the funds are not available for the capex programs, the ex ante approach to capital still allows the DBs to benefit from not accessing the capital.

The risk of the DBs not getting the funds required for the capex programs is high. In its mini-budget, the NSW government has already indicated it will:-

- limit borrowings of its entities to protect its AAA credit rating

- defer allocation of some $850m in funds sought by its utilities for capex
- increase contributions from the DBs (preventing the DBs providing their share of equity contributions)
- impose levies to pay for government commitments for clean coal technology and energy efficiency outcomes

The government finance corporations (such as T-Corp in NSW) are being limited in their ability to borrow. Australian banks have had to be supported by the Federal government to protect their borrowings and overseas banks have indicated they will be reducing lending in Australia. As a result of these constraints, bank lending has been tightened.

Overall there is a limited amount of cash available for utilities to borrow, and refinance their existing borrowings. It still is to be assessed whether the attractiveness of guaranteed cash flows from electricity transport businesses will be adequate to overcome the credit squeeze that currently is being applied by lenders.

Against this back drop of a credit squeeze and NSW government financial requirements, the AER has blithely accepted that the capex programs proposed should be supported. From the point of the DBs the credit squeeze provides them with a perfect excuse to limit their capex programs in the future, but still retain the commercial benefit from receiving a return on the capital not provided.

It has already been seen that the performance in meeting service standards is not at risk, because there is no real penalty due to non achievement, and the DBs will accrue a financial wind fall if they are unable to implement their capex programs due to the ex ante nature of the approved capital and the automatic roll in of actual capex at the next reset.

It is incumbent on the AER to be assured that the capex requirements and the necessary roll over of current debt can be actually achieved. In the absence of such an assessment the AER is likely to be granting the DBs significant unearned income.

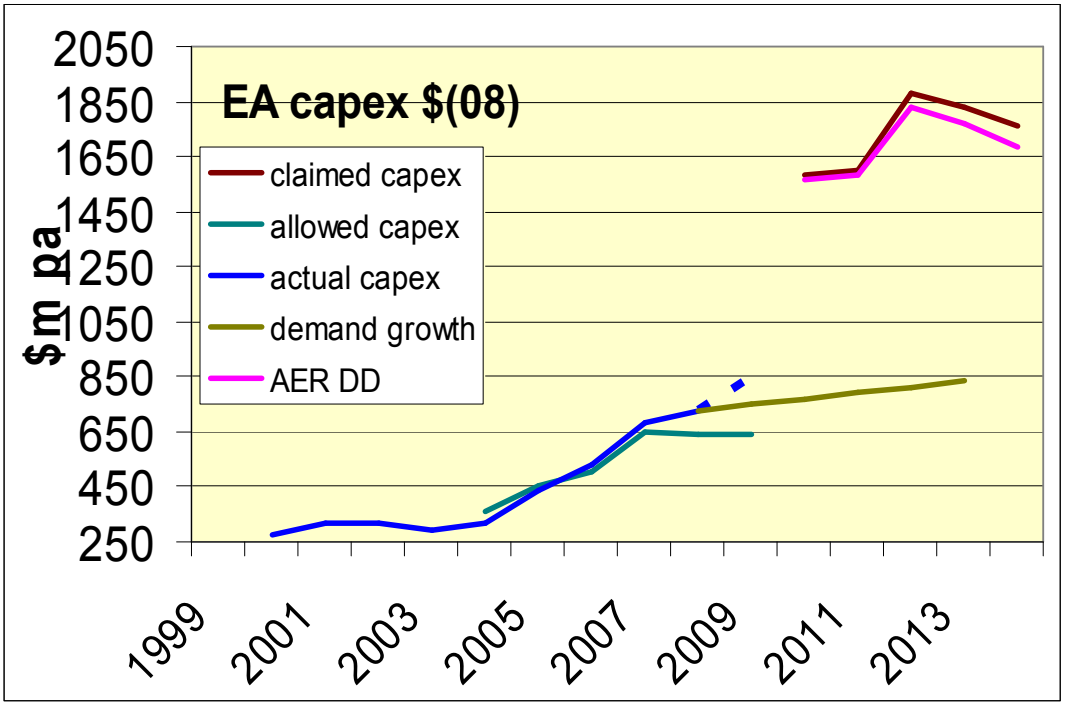
This issue leaves the AER in an invidious position. On the one hand it considers there is a reasonable case to grant the DBs the capex requirements based on a bottom up assessment. A top down assessment implies that the DB requests are grossly overstated based on their capex performance for the 4^{th} year requirements and even on the extrapolated 5^{th} year indications.

The risks to consumers arising from the Rules are significant, as the AER's discretion is limited. The risks are not only that capex programs would be so inflated by the incentives determined by the AEMC Rules, but also the

Regulatory Asset Base would be inflated by regulatory gaming. The risks that the expected explosion in capex and the RAB would extend beyond the forthcoming regulatory period are very real and very significant. Against this background, the AER and its consultants would need to rigorously examine ex-ante capex and contingent capex projects with the view to limiting the scope for gaming to inflate the capex program and RAB over the next two regulatory periods.

4.5 EnergyAustralia

The AER (after a very modest downward adjustment) has effectively concurred with EA that its capex program (which is double its current program) is economically efficient and must be accepted.



What the AER has failed to do is to assess whether the program is efficient and whether the program is necessary within the time frame. Whilst in the long term the EMRF does accept that the work EA has included in its program is probably necessary, the EMRF queries whether it is essential that all this work is needed to be carried out in the next five years, and not over a longer period.

As noted above the EMRF has a major concern that with EA targeting such a large program it will compete not only with the other DBs for resources thereby increasing costs, but whether the actual capital with be available for it to implement the program.

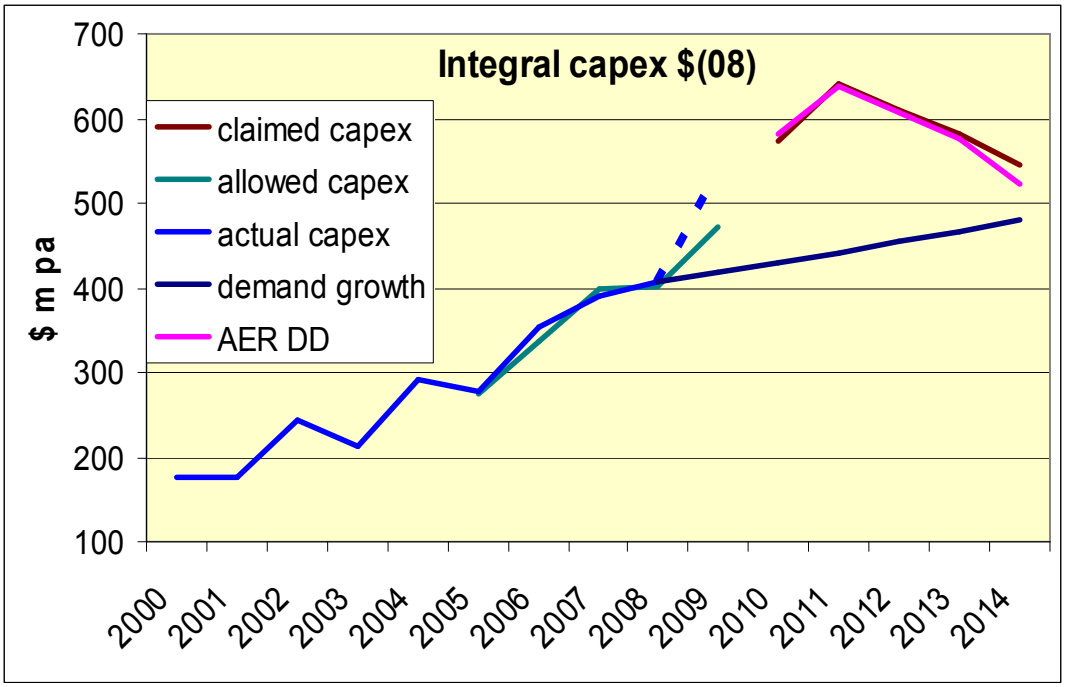
It is quite clear that there is not sufficient growth in demand to warrant the massive increase in capex, but despite this the major proportion of the capex is dedicated to accommodate the growth in demand.

Reliability is defined as the third largest capex aspect (after augmentation and replacement) yet the overall performance of EA in relation to its service standards shows that its historic performance with lower levels of "reliability capex" shows that the amount of capex might not be efficient, yet this aspect is not addressed by the AER.

The EMRF accepts that assets which are not performing require replacement but notes that neither the AER nor Wilson Cook has carried out an independent survey to assess whether used and useful assets are being replaced just because they have been fully depreciated. Replacement of fully depreciated assets still able to perform their functions reliably, should not be automatic, yet this has not been addressed as part of the reset review.

4.6 Integral Energy

Integral capex program is shown as follows in relation to past capex.



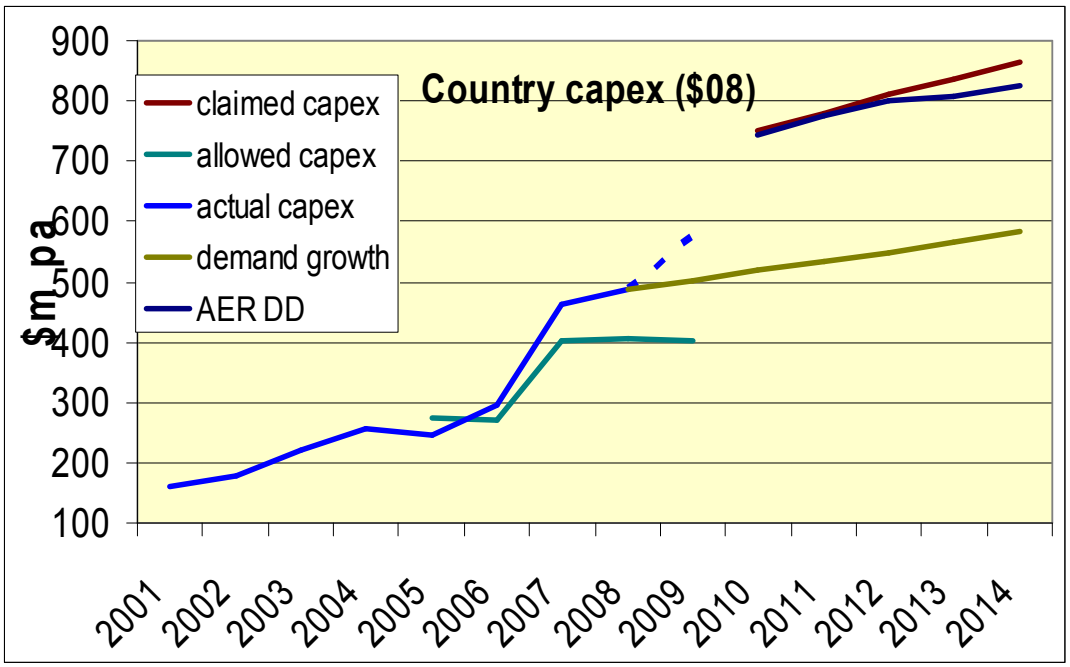
Integral has not sought, relatively, as much capex as EA. Despite this IE will still be seeking funds for their capex program in competition with EA and CE. Many of the issues raised as part of the commentary on EA above apply equally but to a lesser extent to IE.

Of most concern to EMRF is that the bulk of the IE capex (see AER DD table 7.5) is dedicated to augmentation, yet the growth of the IE demand does not appear to warrant such a massive injection. In particular, the expected growth (after the world economic shock has fully impacted) will be a lower increase in demand than during the current period, yet the amount of funds IE intends to dedicate to augmentation is nearly twice the capex expended for augmentation in the current period. This indicates a disconnect between the direct experience (which creates the benchmark) in the current period, to the future.

Overall, the EMRF retains a concern that the IE program does not reflect reality based on the growth in the current period. The AER must reassess the growth forecasts and adjust the forecast capex allowance to reflect the demand for investment in relation to actual growth patterns and how IE addressed these in the past.

4.7 Country Energy

Country Energy capex program is shown as follows in relation to past capex.



CE is proposing to maintain its replacement program at levels similar to those in the current period. The main increases in the need for capex are for augmentation and reliability.

As with IE, the EMRF has difficulty in accepting that with the same growth pattern being forecast as occurred in the current period, there is the need for such a large capex program by CE. The same disconnect seems to apply.

CE is also significantly increasing its capex related to reliability, yet the current allowances have been more than adequate to manage even the reliability levels required to apply in 2010. Again, as with the capex for augmentation, there seems to be a disconnect between the service levels already being achieved and the need for capex to further enhance them.

4.8 Early retirement of assets

The EMRF raised the concern that assets were being retired before they are no longer used and useful. The EMRF pointed out that a DB is incentivised to do this as once fully depreciated on an economic basis, the DB no longer receives a return on them. If the assets are replaced the DB is allowed to earn a return on the replacement value.

The AER has not addressed this issue and its whole approach (where its engineering consultant only looks at the information provided to it in the DB's office) is one of accepting assurances from the DB about what has actually occurred with regard to its assets.

The EMRF seeks advice from AER as to how the AER can ensure that used and useful assets are retained in service and not replaced unnecessarily.

4.9 Summary

The EMRF is of the view that the capex programs sought by the DBs are excessive, both in scope and value. There is no doubt that the capex allowances should be reduced to recognise that the escalations built into the forecasts are very unlikely to eventuate.

The impact of this massive capex program has resulted in a large increase in the costs consumers will have to pay, and there is real doubt as to whether the capex to be invested will provide a benefit to consumers. The AER has the responsibility to ensure that allowed capex is economically efficient and if the capex does not return a benefit to consumers then it cannot be classed as efficient.

Historically, consumers have seen allowed capex programs to be manipulated in a way that earns the DB a commercial benefit not contemplated by the regulator – back ending the capex program (ie underspending in early years and overspending in later years) provides such a commercial benefit. If the DBs do not spend all of the capex allowance then they still retain the commercial benefit of underspending.

The EMRF has raised as an issue that with all the capex approved in other determinations, the NSW DBs (in addition to having an excessive capex program, will find it difficult to achieve the allowed capital wisely and efficiently due to competition for resources, including the essential funds required from debt and equity needs.

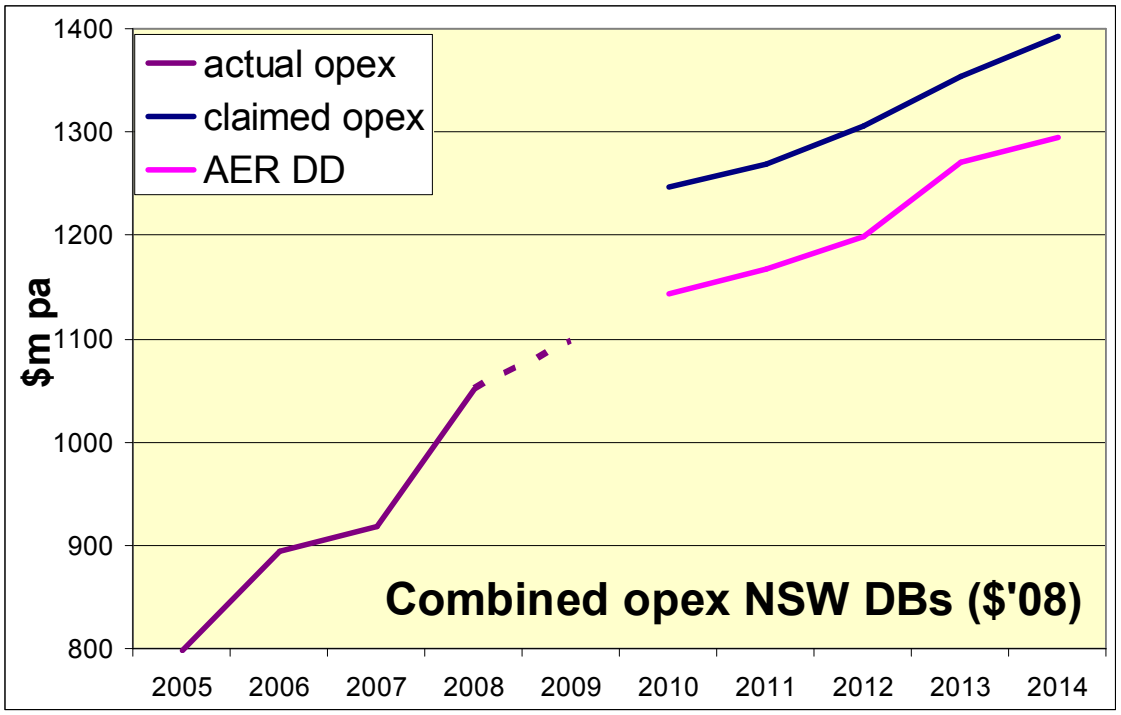
With these concerns the AER must develop a method of ensuring that it's approved capex is efficient and that it does not include for allowances (on which a return is included in the allowed revenue) which might not be achieved. The EMRF suggests that the AER impose on the DBs some controls to ensure that the failure to achieve the capex programs does not result in unearned income for the DBs. Some suggested approaches to avoid this occurring are:-

- Move some of the capex to contingent projects such that the DB must demonstrate to the AER that the need for the capex is real before the capex is included in the revenue stream.
- Carryout an annual assessment of actual capex and allowing only the actual capex to be included in the following year revenue. This will have the added benefit of preventing back ending of capex programs
- Build in a claw back mechanism to recover the unearned revenue from capex underspends
- Carry out an annual assessment of all capex to ensure that the capex is efficient. This will assist in preventing capex programs which were initiated on the basis they are efficient at the estimated costs but when actual costs show there will be an over run they can be terminated before inefficient capex is incurred.
- There is a relationship between opex and capex in that opex includes for the capital raisings necessary. If the capex program is less than allowed, the costs of debt and equity raisings should be discounted for the amount of capital (debt and equity) not raised.

As the EMRF commented at the AER public forum - the world has already punished those investing unwisely, so why should the networks be given virtually all the capex they request without the substantial discipline needed in the post sub-prime financial crisis world of today?

4. Forecast Operating Expenditure

The AER has assessed the applications from the DBs for opex. It has decided that there are grounds for increasing the allowed opex from current levels and has determined that overall the opex allowance from the year 4 benchmark should be increased significantly, and that there should be significant future increases as well.



The AER analysis assumes that the year 4 data is efficient, but as noted in section 5.1 below the comparative date developed by Wilson Cook implies that this is not the case.

The AER has effectively discounted the DB claims by some 6-9% in their approved allowance, but allowed average increase above the year 4 benchmark of 15%. What this overlooks is that already the DB opex is significantly above benchmark as demonstrated by the data provided by Wilson Cook.

5.1 Analysis of the underlying data

In its response to the applications from the DBs the EMRF observed that, with such a significant increase in capex both in the current period and in the next period, the DBs (especially EA) should be required to provide much larger efficiency savings in:

- Capex/opex trade-offs (i.e. larger opex savings)

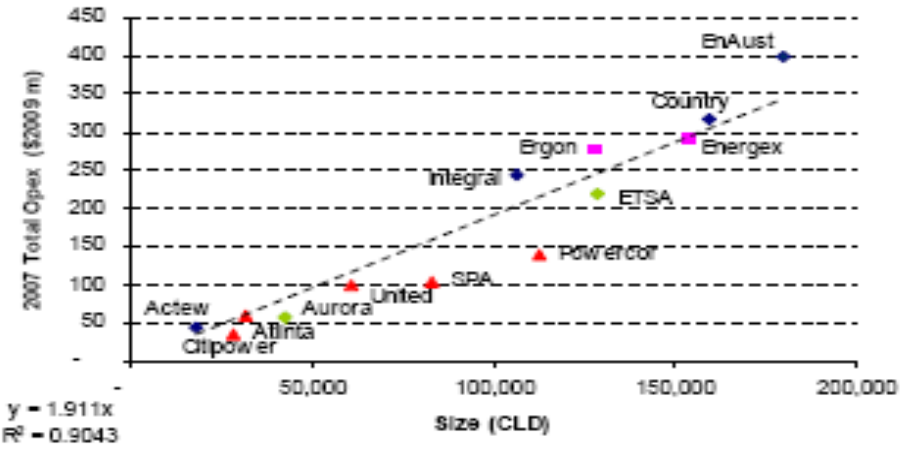
- Larger productivity savings than the 2% applied by the ACCC in the current regulatory period (new and more capital assets)
- Savings from maintenance programs no longer required on replaced assets.

In the report from Wilson Cook and reiterated by the AER, there is a view that very modest opex savings will be achieved from these sources and that the growth of the networks will require increased opex, justifying much of the opex increases claimed by the DBs. The EMRF considers this approach lacks justification and raises a core doubt about the entire purpose of incentive regulation, which is to drive the DBs to the most efficient levels of opex (and capex). Instead what is being seen is a decision which allows the DBs to consistently increase revenue, and opex in particular (very much akin to an automatic cost plus approach).

The ESCoV approached incentive regulation quite differently to the approach taken by the AER. In their most recent review of electricity distribution, they decided that the year 4 opex **was** the benchmark, and the DBs had to justify in considerable detail what changes had occurred which justifies an increase above the year 4 benchmark. The Wilson Cook analysis determines that the year 4 benchmark for the NSW DBs lies above the average using the an unproven approach of “composite size”

Against this benchmark they developed a correlation.

Figure 3.1: Comparative Analysis of Opex vs. Size



There are three fundamental issues that arise from the Wilson Cook analysis:-

- To what extent is the composite measure applicable when there is such large diversity between the different DBs and to what extent are the weightings realistic or even applicable

- The chart shows that the line of best fit for all the DBs still has the NSW DBs above the line by showing a 15-25% premium on the opex. Notwithstanding this data based on the NSW and Queensland DBs and to a lesser extent the SA DB have not been subject to the stringent service standards measurement and rigorous benchmarking that the Victorian DBs and to a lesser extent the Tasmanian DB have undergone. This implies that the line of best fit is not in fact a line which demonstrates an indication of best performance.
- The lines of best fit drawn incorporate the opex of the NSW DBs. This then biases the line of best fit, particularly considering that the NSW DBs provide the bulk of the measures at the higher end of the graph. Eliminating the influence of the three NSW DBs dramatically reduces the slope of the line of best fit and shows the NSW DB opex performance includes a further 15% premium compared to all the other DBs.

For Wilson Cook to determine that the year 4 opex performance of the NSW DBs is at benchmark performance already and therefore acceptable as a basis for future opex is severely in doubt. In fact a review of all the benchmarking used by Wilson Cook tends to show the NSW DBs are using opex significantly higher than the composite and other various benchmarks would indicate.

The NSW DBs have not been heavily impacted to the same extent as the Victorian DBs have in regard to benchmarking and incentive regulation, and as a result there is a concern that the NSW DBs have not been driven towards best practice as well as they might have. Further, on the basis of the work by Wilson Cook, this new information tends to support the EMRF view as to whether it can be assumed that the NSW DBs are operating at best practice levels.

Wilson Cook discounted the inclusion of the forecast premium for escalation but even after this the residual data still indicates that the forecast are significantly higher than benchmark performance of all other DBs.

5.2 Why should the opex increase above the self set year 4 benchmark?

It has not been demonstrated that under the current conditions the overall opex should be increased. The reasons for increasing opex are:-

- There is an increase/decrease in cost as a result of the relative movement of input costs (labour, materials, finance) against the long term average.
- There is additional hardware as a result of increased demand, consumption and/or customers
- There are increased costs to comply with new regulations

- There is increased line length into areas not previously served

Against these parameters it is clear that the escalating costs claimed by the DBs are no longer applicable (see section 3 above).

The actual growth of demand is modest (perhaps 3% pa) and the increase in numbers of new customers is also less than the average increase in demand. The EMRF would point out that opex does not necessarily increase with demand unless additional plant is installed. For example, an increase in demand might require the replacement of a transformer bay with one of increased capacity. The amount of hardware remains the same but with larger capacity. As a result the ability to serve increased demand is provided but there is no increase in opex.

Additionally, the EMRF knows from the experience of members that the reduction in opex resulting from replacement of equipment with new has a significant downward pressure on opex. As a Rule of Thumb, EMRF members would expect capital investment to recover the savings on opex within 3-4 years. If these savings are not forecast then the investment is not condoned. For the DBs and Wilson Cook to consider that at best a 1% reduction in opex would come from the massive investment programs instituted is not economically efficient – and economic efficiency is what the AER must strive to ensure is the basis of their approvals of capex and opex.

Opex does not increase proportionally with demand, consumption or numbers of consumers. There are many aspects of opex that are fixed and do not relate to these parameters. For example, the costs controlling the network are essentially fixed and the computer systems mange the increased numbers of plant items without the need to increase staffing.

The DBs have all indicated that the increasing service levels are causing an increase in costs. This is difficult to accept as the DBs are already out performing the service levels set for the next period. It is accepted that some of the levels of reliability (eg N-1 to N-2 reliability) are being demanded by government. Not all consumers benefit from this increase in reliability but those that get this increase often get this at the same cost as those consumers who do not benefit.

For example, there is a drive to increase the reliability of supply to the CBD. Consumers in the CBD pay the same as those external to the CBD. This implies that consumers external to the CBD are being required to subsidise the enhanced reliability granted to CBD users. The Rules allow for users seeking enhanced performance (such as reliability) are permitted to have this but they must pay the costs associated with the increase in service standards under NER clause 6.6.6(c). Thus if higher standards of supply are provided for some consumers then they must pay for them. Such increases in supply levels are above the standard supply levels and the consumers

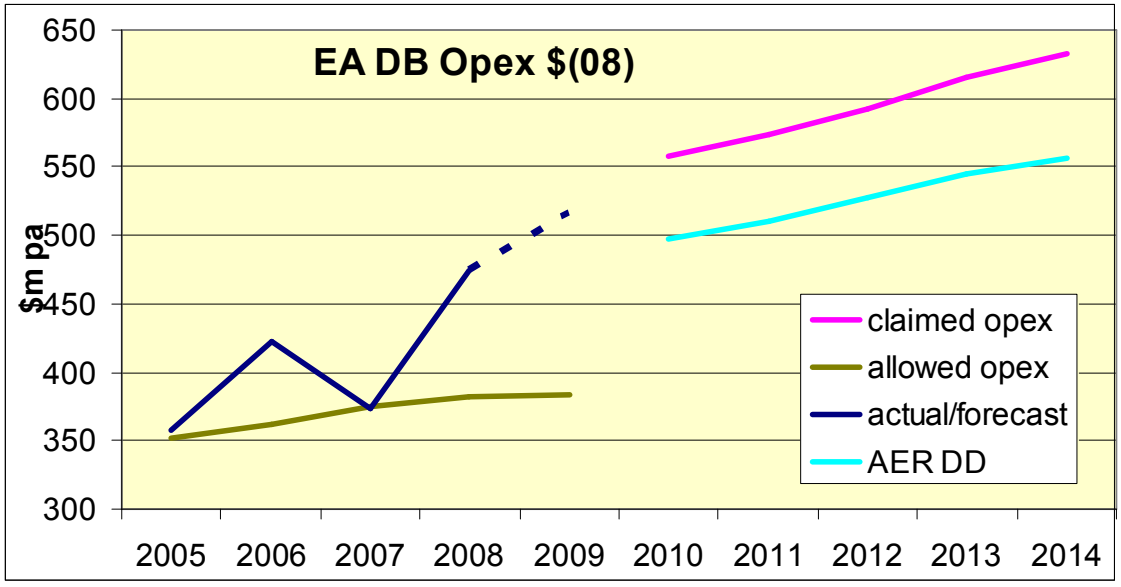
receiving them pay for these under negotiated services, not as part of the direct control services provided.

In relation to other standards, the DBs are providing a service standard in excess of the standards to apply from 2010/11. It seems bizarre that consumers should pay more for service standards that they are already receiving as part of the regulatory bargain.

The final reason for increased opex is that there is an extension of the network. An extension is different to an augmentation. An augmentation may be the increasing of capacity of existing assets but an extension increases the reach of the network beyond its existing boundaries. The EMRF would agree that an extension of the network does increase opex, probably at a rate nearly in proportion to the extension. However a review of the Wilson Cook report and the AER DD do not identify that they have considered extensions to the network as a separate and identifiable subset of augmentation. In the absence of such review, the EMRF is of the view that the amount of extension work does not provide a substantiation for the large step increase in the opex claimed.

5.3 EnergyAustralia

The following chart shows the historic IPART allowed and actual opex, along with the claimed controllable opex and the AER DD. This chart has been extended to include EA opex for the entire current period.



Sources: ACCC and IPART decisions 2004, EA application, AER DD

The EMRF notes that EA was able to manage its opex needs for its network on an average of some $430m pa with a 4th year opex of $470m. It is concerning that the EA opex shows such wild swings year on year indicating

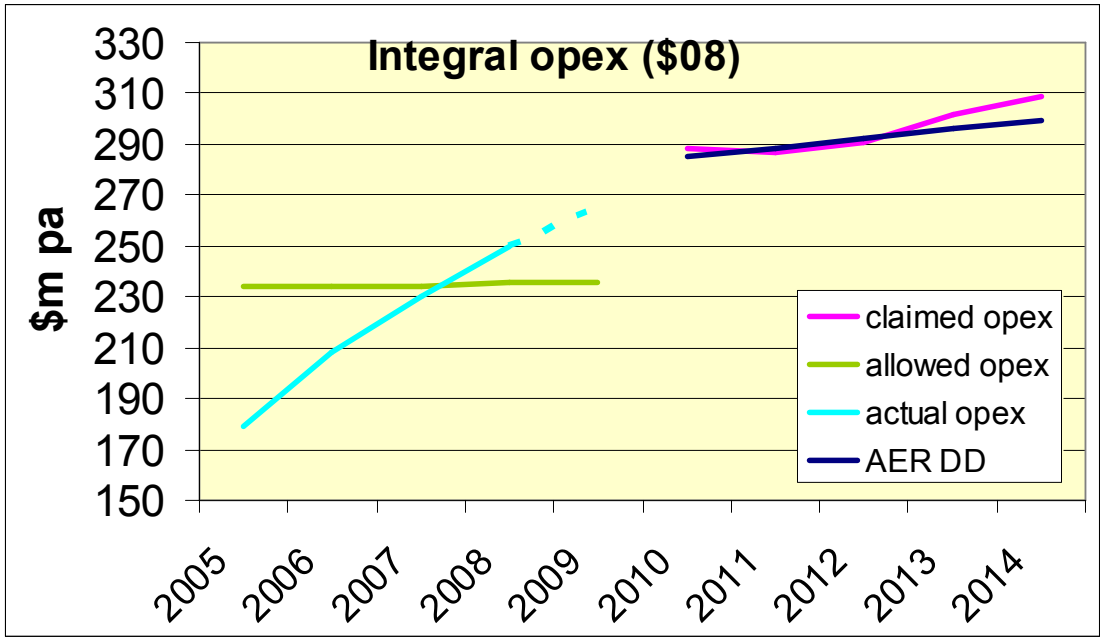
that EA has not managed its opex well. The IPART allowance was based on the EA claims in 2004 which indicates EA has not been able to assess its own needs well.

Whilst the AER DD has pegged the starting opex for the next period at some 5% above the benchmark year, the opex rises to be nearly 20% (at a rate of some 3% real per annum) above the benchmark year by the end of the period. There is no clear reason why the opex should grow at such a rate over the next period, especially as there has been so much capex in the current period and even more planned for the next period. When this capex is assessed against a very modest growth in demand it is inconceivable how the AER DD can accept such a large increase in opex during the next period.

When compared to the growth rate in opex claimed by and allowed for Integral (which faces similar constraints to EA) there appears to be significant inconsistencies between the two. EMRF is of the view that there should not be any real growth rate in opex over the next period, and that efficiencies should result in a negative real growth rate in opex.

5.4 Integral Energy

The following chart shows the historic IPART allowed and actual opex, along with the claimed controllable opex and the AER DD allowed opex. Effectively the AER has accepted the IE claim for opex.



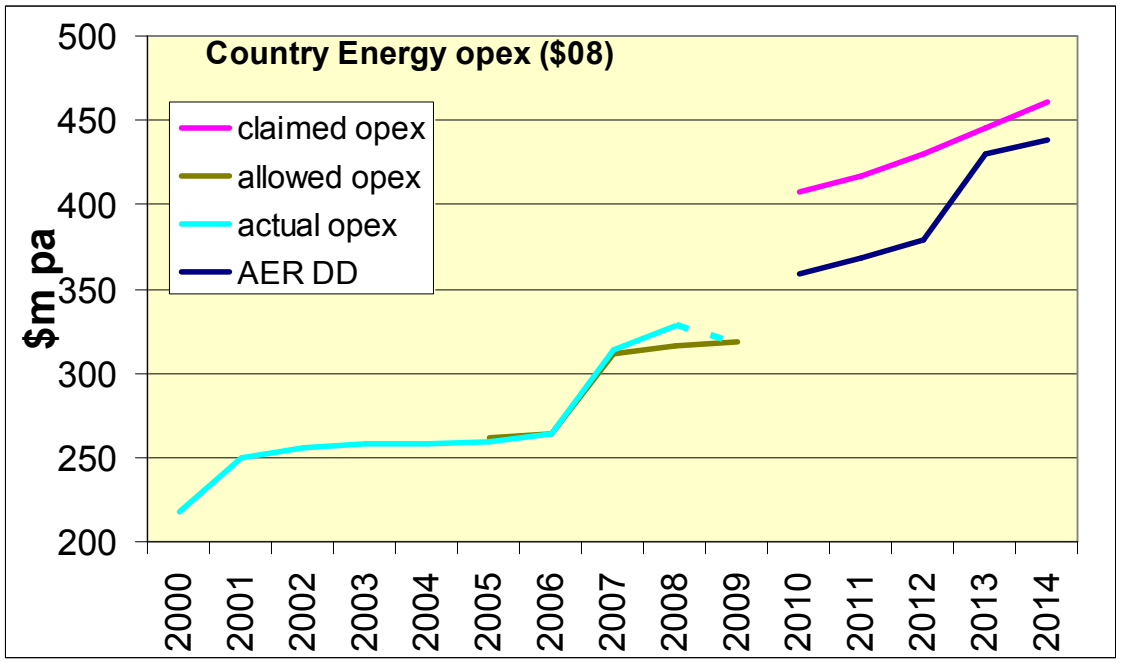
Sources: IPART decision 2004, IE application, AER DD

As with EA the AER has allowed unsubstantiated changes to underpin a step change of 16% between the opex in the benchmark year and the start of the next period. In addition, the Wilson Cook benchmarking study shows IE does not have its opex at a level which is best practice which inflates the AER DD allowance even further above the opex that should be allowed based on best practice.

In contrast to the allowed opex for EA, the growth in opex over the next period is a modest 1% real pa, and the rate of change is more reflective of what would be expected, although as noted in section 5.3 negative real growth in opex should be expected based on a sound understanding of the capex impact and the need for continuing improved efficiency.

5.5 Country Energy

The following chart shows the historic IPART allowed and actual opex, along with the claimed controllable opex and the opex allowed in the AER DD.



Sources: CE application, IPART decisions, AER DD

The step change into the 4th and 5th years relates to the AER decision not to allow deferred opex to be included in the allowance for the first three years of the next period. If this had been allowed then the AER would have effectively allowed the claimed opex by CE which would have been a 25% step increase in opex from the benchmark year. It must be noted that the AER has effectively permitted this large step increase to apply to year 4 and 5, creating a disconnect between the opex allowances between the beginning and end of the next period.

If the costs are not allowed for years 1-3, then there can be no logical basis to allow the costs for years 4 and 5, but by disallowing the carry through of the deferred opex for the earlier part of the period, implicitly the AER has allowed it for the last two years. This is illogical because there is no effective justification for a step increase in opex between years 3 and 4 of the next period. The EMRF is at a loss to understand why the AER has effectively disallowed the cost for a part of the period, and not for all of it.

As with the AER DD allowances for EA and IE, there is no justification for real cost escalation to apply for the opex allowance. If the disallowance of the deferred opex is removed, the AER DD allowance for CE opex shows an increase of 2% pa. This compares with 1% real for IE and 3% real for EA exhibiting no consistency between the three DBs.

The EMRF considers that the real growth of opex over the next period should be negative.

5.6 overall assessment of opex

Wilson Cook has derived a benchmarking approach to assess the reasonableness of the opex claims. Unfortunately, this benchmarking approach has indicated some limitations. Notwithstanding these, the benchmarking shows that the NSW DBs have opex levels consistently higher than the bulk of their comparators. Despite this, Wilson Cook has advised the AER the claimed opex levels are considered to be in keeping with others!

The AER has taken the advice of Wilson Cook, but has discounted the opex claimed in most instances but for differing reasons. However, the AER has not followed the lead provided by the ESCoV which insisted on the DBs providing detailed reasons for any step change which could justify an increase in opex above the 4th year actual opex levels. The AER has been influenced by the Wilson Cook approach of “composite size” as a benchmark rather than using the actual benchmarks set by the DBs themselves.

The EMRF considers that the AER has not carried out a significantly detailed analysis of the current opex levels by assessing whether the 4th year benchmarks have been driven to best practice levels. In fact, the Wilson Cook analysis indicates that the NSW DBs probably have not achieved best practice efficient levels based on the 4th year costs.

The AER then has not insisted that the 4th year benchmark levels become the basis with all step changes being fully and individually substantiated.

Wilson Cook has already demonstrated that the 4th year benchmark opex is higher than comparable networks, so using the 4th year benchmark provides the DBs with an inflated starting point, which the AER then allows to rise significantly for later years.

As a result the AER DD provides the NSW DBs with more opex than is needed to provide the services required by consumers

6. Service Performance Targets

The AER has decided that it will not implement a service performance incentive scheme for the coming period. The reason given is that the DBs do not have data collected in a form sufficient to implement the scheme.

The AER has determined that it devotes the next five years to acquiring adequate data in a suitable format so that a scheme can be implemented in 2014.

This is clearly intolerable from the view point of consumers. Consumers have already seen that many of the measures on which service performance can be measured are already in place. The government has implemented service performance measures for a considerable period so it is amazing that the regulator considers a commercial basis for such a scheme cannot be implemented at this time.

In section 7 of the draft decision, the AER provides a detailed listing of the main service performance requirements for the DBs set by the NSW government. The EMRF cannot understand why the AER cannot use these as the basis for a service performance incentive program. As the EMRF points out in section 4.2 above, the DBs have consistently outperformed the service standards set for 2010/11. On this basis the DBs would be granted a bonus!

Table 7.4 NSW DRP licence conditions – average reliability standards- SAIDI minutes per customer, by feeder type

	2005–06	2006–07	2007–08	2008–09	2009–10	From 2010–11	Actual performance 2006–07
EnergyAustralia							
CBD	60	57	54	51	48	45	13
Urban	90	88	86	84	82	80	78
Short-rural	400	380	360	340	320	300	290
Long rural	900	860	820	780	740	700	1093
Integral Energy							
Urban	90	88	86	84	82	80	66
Short-rural	300	300	300	300	300	300	175
Long rural	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Country Energy							
Urban	140	137	134	131	128	125	114
Short-rural	340	332	324	316	308	300	239
Long rural	750	740	730	720	710	700	497

Source: NSW DRP licence conditions; DNSP annual reports.

Table7.5 DRP licence conditions – average reliability standards- SAIFI interruptions per customer, by feeder type

	2005–06	2006–07	2007–08	2008–09	2009–10	From 2010–11	Actual performance 2006–07
EnergyAustralia							
CBD	0.35	0.34	0.33	0.32	0.31	0.30	0.17
Urban	1.30	1.28	1.26	1.24	1.22	1.20	0.96
Short-rural	4.40	4.20	3.90	3.70	3.40	3.20	2.76
Long rural	8.50	8.00	7.50	7.00	6.50	6.00	5.64
Integral Energy							
Urban	1.30	1.28	1.26	1.24	1.22	1.20	0.90
Short-rural	2.80	2.80	2.80	2.80	2.80	2.80	2.00
Long rural	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Country Energy							
Urban	2.00	1.96	1.92	1.88	1.84	1.80	1.36
Short-rural	3.30	3.24	3.18	3.12	3.06	3.00	2.47
Long rural	5.00	4.90	4.80	4.70	4.60	4.50	3.82

Source: NSW DRP licence conditions; DNSP annual reports.

To allow the DBs a massive amount of capex and increased opex, much of which the DBs state is to improve service performance, without imposing some incentive on performance appears to consumers to be totally contradictory.

As it stands the only sanction the DBs face for non achievement of reasonable performance as established by the NSW government, is the risk the government will remove the DB licence – a very hollow threat indeed.

The AER has failed NSW consumers by not implementing a service standard performance scheme based on the current service standards.