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1. Background

The National Electricity Rules (the rules) require the AER to make a constituent decision on whether to accept, or reject and substitute, the forecast capital expenditure (capex) and forecast operating expenditure (opex) that Essential Energy sets out in its building block proposal for standard control services. To enable the AER to make its constituent decision, Essential Energy’s building block proposal must include the total forecast capex and forecast opex for the relevant regulatory control period which the Distribution Network Service Provider considers is required in order to achieve the capital and operating expenditure objectives.

Schedule 6.1.1 and Schedule 6.1.2 of the Rules require a DNSP’s building block proposal to contain information and matters relating to capital expenditure and operating expenditure respectively. The purpose of this document is to meet the requirements of Schedule 6.1.1(4) and (5) relating to forecast capital expenditure, and Schedule 6.1.2 (5) and (6) relating to operating expenditure by identifying the key assumptions that underlie the capital and operating expenditure forecasts. The certification of the reasonableness of the key assumptions by the directors of Essential Energy is contained within and Appendix A to this document - Directors’ certification of key assumptions.

The term ‘key assumption’ is not a defined term in the Rules. Accordingly, we reviewed previous regulatory proposals submitted by DNSPs and regulatory determinations of the AER. Our review process indicated that there was a diverse range of approaches used to identify key assumptions. Our view is that a ‘key assumption’ could be best defined as a small number of high level assumptions relating to facts or circumstances, the truth or correctness of which underpins or is highly material to the expenditure forecasts.

Based on this reasoning, we have identified the following assumptions which we consider are highly material to our expenditure forecasts.

<table>
<thead>
<tr>
<th>Key assumption</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key assumption 1</td>
<td>The Legal Entity, Ownership and Organisational Structure are those in place at the time forecasts are finalised.</td>
</tr>
<tr>
<td>Key assumption 2</td>
<td>The capital program has been prepared on the basis of amendments to the NSW Design Reliability and Planning Licence Conditions that will come into effect on 1 July 2014.</td>
</tr>
<tr>
<td>Key assumption 3</td>
<td>Capex programs have been developed using a strategic management framework that prioritises expenditures for maintaining a safe, reliable and sustainable network.</td>
</tr>
<tr>
<td>Key assumption 4</td>
<td>Growth capital expenditure forecasts are derived from the spatial demand and customer connection forecasts included in the regulatory proposal.</td>
</tr>
<tr>
<td>Key assumption 5</td>
<td>Forecast labour cost escalation has been set consistent with our Enterprise Bargaining Agreement (EBA) for the period in which the EBA applies. For the period subsequent to the expiry of the EBA, we have set forecast labour cost escalation consistent with the advice provided by an expert independent consultant “Independent Economics”.</td>
</tr>
<tr>
<td>Key assumption 6</td>
<td>The opex year 2012/13 has been adopted as the efficient base year for deriving a forecast of recurrent opex.</td>
</tr>
<tr>
<td>Key assumption 7</td>
<td>Essential Energy has engaged with stakeholders in developing its regulatory proposal in accordance with the stakeholder engagement process outlined in the National Electricity Rules.</td>
</tr>
</tbody>
</table>

In the following sections, we identify why we consider the assumption is material to our forecast capex and/or opex. We also set out why the assumption is reasonable, with reference to the material that comprises our regulatory proposal.
2. Key assumption 1 – Legal Entity and Ownership

This is a key assumption as it provides clarity that capex and opex have been prepared based on current ownership and legal structure and do not incorporate any impacts associated with a potential change of ownership. We consider that this is a reasonable assumption basis given that there has been no formal announcement by the current owner that a sale of the company will proceed in the 2014-19 period.

Our current structure has also been important in providing strategic input into the objectives that have underscored the development of our capex and opex proposals. For instance, under industry reform there has been a greater focus on customer affordability through efficiency programs introduced across the three NSW DNSPs. These have been instrumental in deriving efficiencies that have been incorporated our forecast capex and opex, and which have enabled us to meet our objectives of customer affordability while maintaining safety and reliability of the network. We consider that the level of efficiencies we have achieved are reasonable in our circumstances, as they have been based on a functional review of the costs we incur in providing services.

Further information on our organisational structure under industry reform can be found in Section 1 of Attachment 1.1 – “Delivering Efficiencies for our Customers”, together with information which demonstrates that the level of efficiencies underpinning the capex and opex forecasts are reasonable in our circumstances.

3. Key assumption 2 – Amendments to NSW reliability licence conditions

This is a key assumption underpinning our forecasts of capacity and reliability compliance capex. On 13 January 2014 we received a letter from the Minister for Energy and Resources which notified of a variation to the existing Design and Reliability Performance Licence Conditions imposed by the Minister on the under the Electricity Supply Act 1995. The amendment will remove Schedule 1 of those conditions relating to design criteria. The remaining conditions in Schedules 2 and 3 are now termed the Reliability and Performance conditions. The amended licence conditions come into effect from 1 July 2014, and we consider it is reasonable to conclude that they will be in place for the entirety of the 2014-19 regulatory control period.

The amendment to the licence to conditions by the removal of Schedule 1 of means that Essential Energy does not have specified design criteria for when to invest in the security of the network. This has impacted our proposed forecast capex for the 2014-19 period as it has provided opportunities to defer capacity investment where we determine a prudent level of risks could be tolerated. We have used a high level methodology to identify the cost savings we think will be attributable to the removal of Schedule 1 of the Licence Conditions. The resultant forecast is reasonable given that there are only limited opportunities to prudently reduce capex without deteriorating reliability, and that spot loads rather than organic growth are driving capacity investment.

We note that Schedule 2 and 3 (which relate to average and individual feeder reliability) are consistent with the licence conditions in place for the 2009-14 period. The proposed capex in our Reliability Compliance plan sets out the required investments to comply with Schedule 2 and 3 of the amended licence conditions.

Further information on how the changes to licence conditions have impacted our forecast capex is contained in Section 5 of the regulatory proposal. The letter from the relevant Minister and the amended licence conditions are contained in the supporting document, “Reliability and Performance Licence Conditions for DNSP, Minister for Energy, commencing 1 July 2014”.

4. Key assumption 3 – Strategic management framework including prioritisation

We consider that this is a key assumption as the framework has resulted in a significant reduction to Essential Energy’s forecast capex. A key aspect of our forecasting method was to apply the outcomes of a prioritisation process that was centrally coordinated across the three NSW DNSPs.

The objective of the process was to identify prudent opportunities to defer or avoid capital expenditure based on an assessment of relative risk such that we could minimize our requirement for investment funding and better meet
our goal of customer affordability. The prioritisation process was conducted in parallel with Essential Energy’s planning processes. The key components of the prioritisation process were:

> At several points in the development of the expenditure plans, Essential Energy identified a full suite of projects and programs that would comprise the proposed expenditure portfolio. This was at a granular level involving hundreds of individual line items.

> Each project or program was assigned a risk ranking, based on a consistent methodology for assessing risk. The consistent application of a single approach by each of the NNSW businesses allowed us to objectively rank projects across the three NSW DNSPs in a consistent way.

> A process of feedback and iteration refined the plans and risk assessments as the expenditure forecasts were refined with multiple passes through the risk prioritisation tool.

> A board level review of the overall risk profile and the relationship between risk and different scenarios of expenditure identified the prudent level of capital investment which forms the basis of our expenditure forecast.

We consider that the outcome of prioritisation was reasonable, in that it reflected a prudent assessment of risks to achieve our objective of customer affordability. In this respect, the reasonableness can be demonstrated by the method used to rank relative risks of the program. This enabled us to prudently select programs that could be efficiently deferred.

Further information on our strategic framework to incorporate prioritisation of the program can be found in Section 5 of our regulatory proposal document, and in Section 4 of the Attachment 1.1 - “Delivering Efficiencies for our Customers”.

5. Key assumption 4 – Demand and customer connection forecasts

This is a key assumption underpinning our capacity related capex including our Distribution Growth Strategy, relevant Asset Management Plans and Investment Cases. Peak demand forecasts set out the expected increase in peak demand on locations of our network, while customer connections record the increase in the number of residential and non-residential customers on our network.

In respect of the reasonableness of peak demand forecasts, we note that in developing our capex forecasts for the 2014-19 period, we have applied our methodology using most recent available historic data. Similarly customer connections has relied on historical estimates, and take into account evidence on changes from historical levels due to well accepted drivers of connections such as economic activity and construction data.

Further information on our demand forecast methodology and outcomes can be found in Section 5 of our regulatory proposal document. Further information on customer connections can be found in Section 5 of our regulatory proposal document.

6. Key assumption 5 – Forecasts of labour escalation

This assumption is material to the forecasts of undertaking capital works and operating activities in the 2014-19 period. Real cost escalation refers to the movement in the price of labour relative to the Consumer Price index. A positive value denotes that the price of labour is expected to increase above CPI. The impact of the value of real cost escalation enables us to estimate the likely cost of undertaking capital works or an opex activity in the year that the work is undertaken.

In deriving a value of real cost escalation for labour escalation, we have applied our most recent Enterprise Bargaining Agreement (EBA) for the period that it operates. We consider that the EBA is the most reasonable forecast to use as it provides a specific and accurate estimate of Essential Energy’s future labour costs, based on strong negotiation between Essential Energy and its staff. We note that the AER has approved the duration of an EBA as a basis for determining real cost escalation when making regulatory determinations, which further demonstrates the reasonableness of this assumption.

For the period after the EBA has expired, Essential Energy has adopted the forecast of labour escalation advised by Independent Economics. To ensure that the changes in labour costs appropriately reflect the skills required and
the market factors driving the demand and supply of labour, Independent Economics had provided expected changes in labour costs for the utilities sector. We have used the utilities sector real labour cost increase to forecast the likely labour costs we would need to undertake activities that require engineering and electrical technical skills which are essential in undertaking work on our electrical system and assets. For non-engineering related labour costs, we considered that labour cost changes in the general labour sector best reflect the efficient labour costs in the forthcoming regulatory control period.

We consider that our approach to adopt the values advised by Independent Economics is reasonable for the following reasons:

> Independent Economics is an expert economic firm with the expertise to provide a reliable forecast, taking into account our industry.

> The method used by Independent Economics has been the approach the AER has used in recent regulatory determinations.

Further information on our labour cost escalation is in Sections 5 and 6 of our regulatory proposal document. The advice provided by Independent Economics is contained in the Attachment, “Independent economics - Labour escalation for NSW DNSPs”. The inputs used for real cost escalation is in Attachment 5.7.

7. Key assumption 6 – Using 2012-13 as opex base year

This assumption is only relevant to our proposed forecast opex. The bulk of Essential Energy’s forecast opex is derived using the base year approach under which the actual operating expenditure of the regulatory year 2012-13 is used as the opening starting point upon which ‘change factors’ are applied to derive the future opex requirements for the 2014-19 period.

The base year method is commonly used by the DNSPs and is the AER’s preferred method to derive estimates of forecast opex. It is a reasonable method as the majority of our costs are largely recurrent. The 2012-13 base year is the last year of actual capex and is therefore the most current estimate of providing standard control services that are of a recurring nature. This current actual cost is then adjusted to account for future changes in Essential Energy’s circumstances, operating environment, regulatory obligations and changes in demand and cost inputs in arriving at a forecast opex. This is to ensure that all known factors affecting Essential Energy’s future opex requirements are appropriately accounted for.

We note that the manner in which we have used 2012-13 data as a basis for forecasting is also fit for purpose and reasonable in our circumstances. Further information on why our approach to deriving forecast opex, including the manner in which we have applied 2012-13 data can be found in section 6 of our regulatory proposal document.

8. Key assumption 7 – Engaging with customers

Our engagement activities have influenced the development of our opex and capex proposals. The findings of our customer engagement activities support the key objectives of our regulatory proposal and resultant expenditure forecasts, and demonstrate that our proposals are reasonable in the context of giving effect to the views of our customers:

> Reliability – Customers were generally satisfied with the reliability of their service, in fact, many felt it had improved over recent years. There was little willingness to pay more for a higher level of reliability. Our proposal has sought to maintain the reliability performance standards of our licence conditions, and has not sought funding for additional reliability.

> Affordability – a significant number of our customers had seen increases in their electricity bills over the past few years. Customers understood the need to spend money to maintain the electricity network. However, there was a clear preference that if prices needed to increase, they should do so in a steady manner over a number of years rather than a one-off “bill shock”. Our capex proposal has sought all available opportunities to prudently defer expenditure and incorporate efficiencies. Our opex program ensures our opex profile remains relatively flat over the 2014-19 period which will provide a solid platform for ensuring price stability for the 2019-2024 period. Further information on how the program has taken into account price pressures of the proposal can be found in Section 5 of our regulatory proposal.
Safety – Customers expected that electricity was supplied in a safe manner and believed that this should be taken into account when constructing and operating the network. In this respect, our replacement program continues to remove assets that deteriorate the safety of services we currently provide and our maintenance opex program is aimed at ensuring the network is safe.

Chapter 2 of our regulatory proposal provides further information on our customer engagement activities. The Attachment 2.1 – “Stakeholder Engagement Framework”, Attachment 2.2 - “IPSOS customer research report” and Attachment 2.2 – “How customer engagement informed our proposal” show the activities we undertook in engaging customers on a range of issues including reliability, price, construction and design standards, metering technology, demand management and energy efficiency, support for vulnerable households, and communication and engagement. The attachments also show the findings of our customers in these areas.
Certification under clauses S6.1.1(5) and S6.1.2(6) of the National Electricity Rules

The undersigned Chairman of Essential Energy certifies that:

In accordance with schedule 6.1.1(5) of the National Electricity Rules, the key assumptions that underlie the capital expenditure forecast as set out in the regulatory proposal are reasonable.

In accordance with schedule 6.1.1(6) of the National Electricity Rules, the key assumptions that underlie the operating expenditure forecast as set out in the regulatory proposal are reasonable.

Signed in accordance with a resolution of directors.

Roger Massy-Greene
Chairman

28/5/14
Dated