



Major Energy Users Inc.

Australian Energy Regulator

NSW Electricity Distribution Revenue Reset

Ausgrid Application for Transition Year 2014/15

A response

by

Major Energy Users Inc

February 2014

Assistance in preparing this submission by the Major Energy Users Inc (MEU) was provided by Headberry Partners Pty Ltd.

This project was part funded by the Consumer Advocacy Panel (www.advocacypanel.com.au) as part of its grants process for consumer advocacy and research projects for the benefit of consumers of electricity and natural gas.

The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission.

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

CONTENTS	Page
Summary	3
1. Introduction	5
2. Ausgrid WACC	13
3. Ausgrid Opex and EBSS	16
4. Ausgrid Capex	20
5. Revenue approach and smoothing	22
6. Service Standards	23
7. Pricing Methodology	24

Summary

The Major Energy Users Inc (MEU) welcomes the opportunity for presenting its views on the application from Ausgrid for a reset of the electricity distribution costs in NSW for the transition year 2014/15.

Ausgrid provides a view that the amalgamation of the three distribution networks has three objectives (page 3):

1. "To continuously improve safety performance for employees, contractors and the public.
2. To maintain the reliability and sustainability of the electricity distribution networks.
3. To strive to contain average increases in our share of customers' electricity bills at or below CPI (consumer price index)."

The first two have determinative outcomes but the third - prices for consumers - is merely aspirational, and whilst Ausgrid just achieves the aspiration for the transition year, it fails for the following years. Ausgrid implies that this is the fault of consumers because they are using less electricity (which drives prices up) but even so, Ausgrid forecast is that its revenue would rise faster than CPI in the 4 subsequent years.

The MEU is very concerned that the revenue for the transition year has been overstated. The MEU notes that this raises two very important issues:

- Community expectations are that there will be a considerable reduction in network revenues to reflect the rule changes that were introduced to achieve this outcome. If consumers do not see these reductions then there will be questions as to why the AER has not used its powers and discretions as they were intended - in the long term interests of consumers
- Even though there is expected to be a "true up" when the full review is carried out, as end user costs for capital are higher than those for regulated networks, an excessive allowance in the transition year will cause harm to end users even after a true up because of this disparity than the benefit that comes from a subsequent true up based on networks' cost of capital

Additionally, the revenue allowance for the transition year needs to reflect the reality that demand and consumption has fallen in recent years and that the revenue allowances in the current period included significant expectations of increasing demands and consumption. This means that the revenue allowance for the current period included amounts that were never needed and that there has been an over-recovery of revenue and investment in assets that was not needed.

To some extent, Ausgrid's application for the transition year does reflect these realities, in that overall capex claims are considerably lower than the capex allowances granted for the current period, and that the claims for the transition year do reflect very slightly lower costs. In contrast to the capex claims, the opex claim represents a significant increase on historical opex. However, even with the relatively static claimed revenue for the transition year there are a number of anomalies where claims have increased significantly above costs that were actually incurred.

Overall, the revenue sought for the transition year reflects a very modest reduction compared to the revenue sought for 2013/14. However, within the lower costs sought for the transition year there are a number of anomalies and the MEU has identified these in the following sections.

The MEU has assessed the WACC, opex and capex claims:

- Ausgrid approach to WACC is not acceptable to the MEU. The approach is a mish-mash of old and new. The MEU considers that, for the transition year, the WACC approach established by the AER for SP Ausnet transmission decision or alternatively the SP Ausgrid gas distribution decision maintains consistency and recognises that more time is needed to develop and implement the detail for the new approach to WACC development. This additional time will be provided when the detailed review is carried out under the new guidelines
- The opex claimed for the transition year appears to be unnecessarily high when considering the actual opex for the base year. However the MEU is concerned about the full benefit of the EBSS reward for under cutting the allowed opex being carried by the transition year. This is not appropriate
- Whilst the capex claim for the transition year appears reasonable, deeper investigation indicates that it is overstated and should be reduced

The current pricing methodology used by Ausgrid has resulted in some considerable anomalies and a loss of equity. It must be assessed in keeping with the basic premise that each user pays its "fair share" and that prices will generally move with the AER approved yearly change in revenue.

1. Introduction

The MEU has addressed this proposal from Ausgrid as setting the revenue allowance purely for the transition year 2014/15. The MEU will therefore focus on the revenue sought for this year to ensure that the allowance reflects an equitable basis.

Whilst the MEU would normally address forecast costs based on the long term performance of Ausgrid, it appreciates for the current purposes that such detail is probably not warranted.

1.1 The scope of this review

There is an overall view that network charges (especially those with government ownership) have risen too much over the past 6-7 years and that the network revenue rules were biased in favour of the networks. Arising from this recognition, the rules on assessing network revenues were changed dramatically to redress what has been determined as over incentivising investment in networks and providing excessive revenues to networks. It was the AER that sought the rule changes that have been implemented to address this imbalance and it is up to the AER to ensure that there is better consumer outcomes by using the discretions now embedded in the rules applying to network revenue setting.

As a result of heavy involvement in the development of the new rules and the guidelines developed by the AER to implement the new rules, consumers have an expectation that the new rules and guidelines will result in significant reductions in network revenues. If this does not occur then all of the effort devoted in the changing of the rules will have been wasted.

Ambit claims (such as provided by Ausgrid) and front loading of costs for the transition year allowance fly in the face of community expectations. The community also expects (as occurs in competitive markets) that declining demand and consumption should result in falling prices as providers struggle to maintain market share yet what is seen in the network claims is that declining demand and consumption results in higher prices. To achieve community expectations of lower prices, requires the networks to reduce their revenues to offset the impact of lower demand and consumption. But this has not occurred!

The transition year revenues will be the first seen by consumers since the new rules were developed so the AER decisions on the transition year allowances will be seen as a test of the efficacy of the new rules and how well the AER will use its new powers.

The AER has traditionally allowed the networks to "smooth" the prices over the regulatory period and considers that "truing up" any over payment in the transition year can be achieved with lower prices in the subsequent years. In

the current environment where large electricity using firms are reducing and even ceasing operations, such a true up is of little benefit.

Over the coming year, Ausgrid is to provide the AER with a detailed application detailing its claim for a revenue stream to apply for the entire five year period 2014/15 to 2018/19. This revenue stream will be assessed under the new electricity rules and the recently published AER guidelines.

The MEU recognises that the AER decision regarding this transition year application from Ausgrid will only provide a "place setter" amount of revenue for the transition year. When the AER releases its decision on the detailed application by Ausgrid for the entire 5 year regulatory period, the AER will adjust the revenues for the last 4 years to reflect any over/under allowance made for the transition year.

In theory this might be considered to mean that there is little need to get the allowance for the transition year to be as close as possible to being correct. The MEU considers that just as much care needs to be devoted to getting the allowance for the transition "right" as would apply under any other regulatory decision. This approach is based on equity. It is inequitable for users of the services in later years to be liable for errors in revenue setting for the transition year.

Whilst the setting of the transition revenue is a "place setter" subject to a later "truing up" care must be taken to ensure that the transition year revenue is still in keeping with community expectations of overall lessening of network revenues. If the revenue for the transition year is higher than it need be, then end users will incur additional costs which they will have to fund at their cost of capital. Whilst a "true up" will be carried out using the networks WACC, consumers have to fund over payments for the transition year based on the higher WACC that competitive markets achieve. This means that the penalty on consumers if the transition year revenue is set too high will be greater than the benefit from any "truing up" by the AER which is based on networks' WACCs¹.

There is no doubt that users and the services they utilise will be different in the transition year to those in the subsequent years. It would be inequitable to require a temporal cross subsidy between users where the cause is attributable to such a significant change in approach.

In its discussion, Ausgrid opines that consumers want stability in pricing. To an extent this is correct but Ausgrid appears to be pre-empting what the revenue stream will be under the new rules. With such uncertainty as to what the application of the new rules will result in, the MEU disagrees with Ausgrid about price stability being a driver of the forecasts, and considers that the pricing for

¹ The AER has, in the past, used the networks' WACC to smooth the revenue stream but firms in the competitive market have (or should have) higher WACCs than the networks as they face greater risks. For the AER to smooth the transition year revenue will therefore not recompense end users for the additional costs they incur as a result of a higher than needed revenue allowance for the transition years

the transition year should be based on getting the "right" revenue rather than one arbitrarily influenced by unknowns.

The MEU view on price stability recognises that under a revenue cap approach, under/over recovery of revenue in one year needs to be offset in the following year - a process that results in significant price instability.

1.2 Ausgrid past performance

The MEU notes that the regulatory decisions for the past two regulatory periods have massively increased Ausgrid annual revenues: from 2008/09 when Ausgrid was expected to receive ~\$1150m (nominal) annual revenue to ~\$2350m (nominal) in 2013/14. Over the same period inflation has increased by ~14% implying that the increase in Essential's distribution revenue has increased by more than 90% in real terms.

At the same time, the volume of electricity transferred in NSW has fallen in every year since and is currently about 11% less and the peak demand has decreased year except once and is now ~2.5% lower. Overall the quality service provided has not significantly changed. NSW consumers have great difficulty in understanding why the distribution costs have risen by so much in comparison to the service required by consumers.

Ausgrid is proposing that the revenue for the transition year will be much the same as in the last year (2013/14) of the current period. At the same time, the allowance for 2013/14 reflects a massive increase in its revenue over the last five years.

The proposal clearly shows that the revenue allowed for the last period was grossly overstated because Ausgrid used considerably less capex and at least \$5m pa less opex² than they were granted at the last review. To reflect this lower cost than allowed, Ausgrid comments that (page 31)

"Ausgrid has responded to the incentives within the regulatory framework. We have actively reviewed our strategies, policies, business processes and procedures so as to contain our total opex for the 2009-14 period within or below the efficient benchmark set by the AER. We undertook a number of cost saving initiatives to contain our outturn opex over the 2009-14 period with the main features of the cost reduction initiatives including:

- A review of work practices to ensure less overtime is needed to perform core network functions.
- Rationalisation and centralisation of finance, human resources, procurement and business services functions.

² \$5m is what Ausgrid has advised its savings in opex is, but the EBSS carryover implies that Ausgrid probably had much larger savings than this - possibly as high as an average \$20m pa.

- Review of our fleet and procurement policies, processes and procedures to ensure value for money, including joint procurement initiatives with Networks NSW.
- Review of our policies and procedures to eliminate any discretionary expenditure; i.e. spending that is not essential to the running of our business"

Despite this attention to generating savings, it is not apparent in the detailed claim for increased allowances (such as for the WACC development, opex and some elements of capex) that the benefits have been transferred to consumers, and that the outcome for consumers is further increases in revenue against a declining consumption base. The MEU is of the view that there is considerable scope for Ausgrid to reduce its costs and claims for a WACC higher than needed so that consumers can see lower prices.

What is more, Ausgrid is claiming the full benefit of the Efficiency Benefit Sharing Scheme (EBSS) in the forecast revenue for its actual opex being lower than the allowed opex, further offsetting the value of the benefit of the lower revenue.

1.3 Customer and consumer engagement

Ausgrid noted that it has increased its customer and consumer engagement and points to research on customer feedback. As distinct for the feedback received by TransGrid (where a small premium on prices was considered appropriate), Ausgrid received clear and definite advice that prices were too high, and that pricing was the most important element that Ausgrid had to recognise. The MEU would agree that Ausgrid's prices are too high and that this is the most important aspect that has been noted from the customer consultation.

Whilst Ausgrid appears to dissemble a little regarding vulnerable customers; what is clear is that excessively high network prices have also impacted on how to address the needs of vulnerable customers. Accepting that network pricing comprises at least 50% of a small customer's bill, lower pricing by Ausgrid would have a significant impact on the number of customers requiring financial support, and the extent of that support, due to high electricity costs.

What is concerning is that Ausgrid's research also highlighted that customers were getting sufficient information from Ausgrid and they did not expect more communication. When this is combined with the strength of the concern regarding prices, it is clear that Ausgrid has not been able to explain to consumers why they are paying so much for the service

The MEU is pleased that this engagement has occurred but is still concerned that such interaction still consists more of "this is what we have planned" and "the reliability and availability is this and this is that it costs" rather than "how can we provide the service you need which meets your ability to pay".

The MEU is also concerned that consumers are unaware that Ausgrid is proposing to increase its revenue just to provide the same level of service. Ausgrid then notes that it expects electricity consumption to continue to fall which, even with a constant revenue, will result in higher prices. It would be expected that consultation would provide an indication of the future price movements to see if consumers were prepared to accept costs increasing further, or if Ausgrid could take action to prevent this occurring.

Although the MEU is concerned about the detail and approach by Ausgrid, the MEU recognises that the consumer engagement process will, hopefully, improve over time, to the benefit of both consumers and Ausgrid.

1.4 Forecasts of demand and consumption

The amount of energy used within NSW rose from 1999 levels to peak in 2009 but since then consumption has fallen to 2003 levels and the expectation is that consumption will continue to be static or even fall further.

Although the most recent full year peak demand showed an increase on the previous year's much lower demand, this was for a single day and the peak demand for the year 2013/14 so far shows a reduction from the rise seen for 2012/13, to the low peak demand seen in 2011/12 year. The forecast peak demand (10% PoE) is not expected to exceed the highest recorded peak demand in NSW (2009/10) in the next regulatory period, reflecting a general trend in the NEM.

Based on this data, there is little expectation for a need to significantly augment the Ausgrid network in the next 5 years but particularly there will no need to augment the network during the transition year.

At the same time, Ausgrid highlights that the lower consumption seen in recent years has impacts on the revenue recovered under a price cap regime. If consumption continues to decline (as Ausgrid forecasts in figure 11) then there would be concern as to what the price cap approach on Ausgrid's revenue would be. The MEU notes that the AER has determined that the regulatory approach for Ausgrid (and the other two NSW distribution networks) will be based on a revenue cap approach. The MEU agrees that this is a sensible and pragmatic approach to a considerable change from historic trends.

1.5 The materiality of separation of Ausgrid's assets

Currently some 11% of Ausgrid's revenue³ is classified as relating to its transmission assets but the bulk of the revenue (89%) is for its distribution assets. These transmission assets are primarily to provide services for Ausgrid's customers.

³ See Ausgrid table 15

Under the current arrangements, TransGrid is the coordinating transmission service provider in NSW and therefore combines the costs for Ausgrid and Directlink transmission assets into the overall NSW transmission cost, creating complexity and cost for TransGrid and a degree of confusion for consumers. In addition, the regulatory approach differentiates and treats separately Ausgrid's transmission and distribution assets creating complexity and cost for the AER, Ausgrid and stakeholders.

The MEU considers that as the amount of Ausgrid's transmission revenue is such a small part of the Ausgrid revenue and the assets primarily service Ausgrid customers, the MEU questions whether there is any value in continuing to separately classify Ausgrid's assets. The Ausgrid application for the transition year appears to incorporate combined costs for both elements.

The MEU notes that Transend (the transmission service provider in Tasmania) has assets that are generally classified as distribution assets, yet there is no attempt to regulate Transend distribution assets separately to its transmission assets. The MEU considers that a similar pragmatism should be applied to Ausgrid assets.

1.6 The helicopter view of the Ausgrid proposal

Ausgrid highlights that its allowed maximum revenue will fall only marginally from 2013/14 for the transition year and then increase through the next regulatory period. The MEU finds that this is anomalous when considering that Ausgrid did not use its allowed capex and allowed opex in the current period. Ausgrid proposes to reduce its overall capex but increase its opex considerably despite under-running its opex allowance in the current period.

A point of concern for the MEU is that pass through of the EBSS benefit from under-running opex in the current period adds nearly 5% to the revenue for the transition year. This is a significant impost which reflects the extent of the gaming carried out by Ausgrid at the last revenue reset.

Ausgrid forecasts that revenues in the subsequent years of the next period will see a rise in revenue and when this is combined with the forecast continued falls in consumption, nominal prices will show a modest rise to the transitional year and thereafter show significant rises for the rest of the next period.

The import of the Ausgrid proposal is that consumers should be pleased with what Ausgrid is proposing. However, as noted in section 1.2 above, Ausgrid costs have risen massively over the past years, despite peak demand and consumption falling significantly in recent years. So when seen in this context, the Ausgrid proposal is a continuation of the current trend, albeit with a degree of "flattening" the historic price rises, despite there being a massive reduction in demand and consumption and little change in the service standards.

1.7 Escalation of costs

As the AER is only to assess the revenue allowance for 2014/15 year under the transition year process, Ausgrid has not provided any support for escalation of opex and capex costs. Yet Ausgrid comments (page 32) that for its capex:

"Ausgrid has applied the following changes in costs to the adjusted base year opex to derive a forecast opex that reasonably reflects the realistic expectation of cost inputs required to achieve the opex objectives:

- Wage increases contained in Ausgrid's enterprise agreement (Ausgrid Agreement 2012) for the duration of its term which ends in December 2014. The agreement allow for an annual wage increase of 2.7% (nominal) offset by savings in other labour costs to achieve an outcome aligned to CPI of 2.5%. This is consistent with the NSW Government Wage Policy and is a good outcome for Ausgrid and for customers, particularly given that the new agreement now enables improved flexibility to outsource some work where this is the most cost effective option, when judged against safety, quality and cost criteria.
- Forecast real cost escalation for external labour derived by Independent Economics - an external consultant engaged by Ausgrid.

Any increases in excess of CPI will however be offset by management initiatives to improve the productivity of Ausgrid's workforce such that we can strive to contain average increases in our share of customers' electricity bills at or below CPI."

There is no detail to indicate to what extent escalation of costs has been included in the transition year costs (or any other year) other than Ausgrid has assumed an inflation rate of 2.53% will apply between 2013/14 and 2014/15.

The MEU is concerned that Ausgrid considers that its enterprise agreement should comprise the basis for wage cost increases. As with other responses to the AER on revenue resets, the MEU sees that using enterprise agreements provides Ausgrid an avenue to pass the costs of wage increases to consumers and allows unions to use this ability to seek higher than reasonable increases. The MEU considers that independent externally calculated wage cost movements (such as those developed by the ABS) must be used for both internal and external wage cost adjustments.

The MEU considers that for the purposes, the transition year assessment should only include for expected inflation and not include for any other escalation, especially as Ausgrid has not provided any indication as to what this "real escalation" on opex and capex might be other than

"...management initiatives to improve productivity to contain...increases ... at or below CPI".

It appears that Ausgrid has increased its revenue to allow for expected cost movements and will retain the benefits of its productivity improvements.

2. Ausgrid WACC and "pass through" of risk

2.1 WACC

In its transition year proposal, Ausgrid seems to propose that the WACC applicable to its transition year should be based on the AER new guideline, albeit somewhat modified. Ausgrid does offer its views on what the new guidelines will achieve (or not) and that the new approach will put a downward bias from the AER's return on equity model - something that Ausgrid does not agree with along with the AER decision to implement transitional arrangements for introducing the new guideline for return on debt⁴.

However, it is clear that the AER has not yet developed in full, the implementation details of the new approach, and neither has Ausgrid. This then raises the issue as to whether the AER should attempt to implement the approach *for the transition year* to WACC development under the new guideline or under the old guideline. The MEU is firmly of the view that *for the transition year only*, the WACC should be based on the methodology and parameters used most recently, such as in the SP Ausnet (SPA) transmission review and released on 31 January 2014 or the SPA gas distribution review released in March 2013.

It is recognised that the new guideline includes for considerable discretion by the AER and for the AER to exercise this discretion in a foreshortened review process could lead to unnecessary concerns and unintended outcomes. As the transition year allowed revenue will be adjusted for any overs/unders later in the regulatory period after the new guideline methodology has been tested within a full review process, it would be equitable to apply the historical approach to setting the WACC for the transition year.

Adopting the recent past approach to setting the WACC for this transition year should be non-controversial and, if anything, favour the regulated firm as the recent rule changes were introduced in order to bring greater balance to regulatory decision making and, in particular, to introduce a realistic methodology for assessing the cost of debt considering that the Competition Tribunal and consumers have been so critical of the AER's previous methodology.

The MEU is most concerned that Ausgrid has elected to approach the setting of the WACC for the transition year based on a variety of inputs reflecting both the old and the new approaches and has done so in a way that results in a higher WACC than might be expected when viewing the current relatively low risk free rate. Ausgrid has also utilised those elements of the old approach which increases the WACC (such as equity beta) and then overlaid elements of the new approach which also increase the WACC (such as a higher market risk

⁴ The MEU agrees with Ausgrid that there is no need for transition arrangements for moving from the "on the day" approach to a trailing average approach and made this point in its submission to the AER on the approach to return on debt.

premium). The MEU also notes that Ausgrid is proposing to use the same WACC for its transmission assets as it does for the distribution assets. For their relative sizes, the MEU questions whether classifying some of Ausgrid's assets as transmission and the bulk of them as distribution would appear to be a necessary distinction.

Ausgrid has offered a range of inputs on which to develop its WACC and these with the most recent decisions on WACC (SP Ausnet electricity transmission decision which is influenced by the 2009 WACC decision) and the most recent decision for distribution (SP Ausnet gas distribution) are shown in the following table:

Parameter	Ausgrid approach			AER on SPA elec trans	AER on SPA gas distrib
	Lower bound	Upper Bound	Proposed		
Risk free rate (nominal)	4.78%	5.17%	4.78%	4.31%	3.14%
Market risk premium	6.5%	6.5%	6.5%	6.5%	6.0%
Equity beta	0.8	0.9	0.8	0.8	0.8
Cost of equity	9.98%	11.02%	9.98%	9.51%	7.94%
Cost of debt - 10 year BBB+ (nominal)	7.55%	7.84%	7.55%	6.79%	6.50%
Expected inflation	2.53%	2.53%	2.53%	2.45%	2.50%
Gearing (D/V)	60%	60%	60%	60%	60%
Gamma	0.25	0.25	0.25	0.65	.25
Corporate tax rate	30%	30%	30%	30%	30%
Vanilla WACC (nominal)	8.52%	9.11%	8.52%	7.87%	7.07%

The MEU considers that the only change the AER should make to their SPA assessments when applying it to Ausgrid is to assess the risk free rate as has been previous practice (and recalculate the WACC based on the risk free rate applying at the time of the final decision) and to decide whether the parameters of MRP should be 6.0 coupled to gamma of 0.25 or MRP of 6.5 coupled to gamma of 0.65. The approach to the cost of debt used for the SPA electricity transmission is the most recent assessment of debt made and this applies equally to all regulated energy networks.

2.2 Pass through events

The use of “pass throughs” is a mechanism for the regulated entity to reduce its risk by passing these onto consumers. Regulators have been inclined to accept this approach as they (rightly) fear that an allowance in the costs to accommodate this risk might be too high reflecting the likelihood of exogenous low probability high impact events.

In the current Rules there are defined elements where the “pass through” of actual costs is permitted. However, it is important to recognise that in a competitive environment, the ability to pass through costs to consumers is not

possible, and firms have to absorb the costs (either through insurance or directly) of any exogenous impact. Because there is the ability to pass through such costs to consumers by regulated NSPs, the AER must recognise that with this transfer of risk there needs to be a compensating reduction in the equity beta to reflect the reduced risk faced by NSPs.

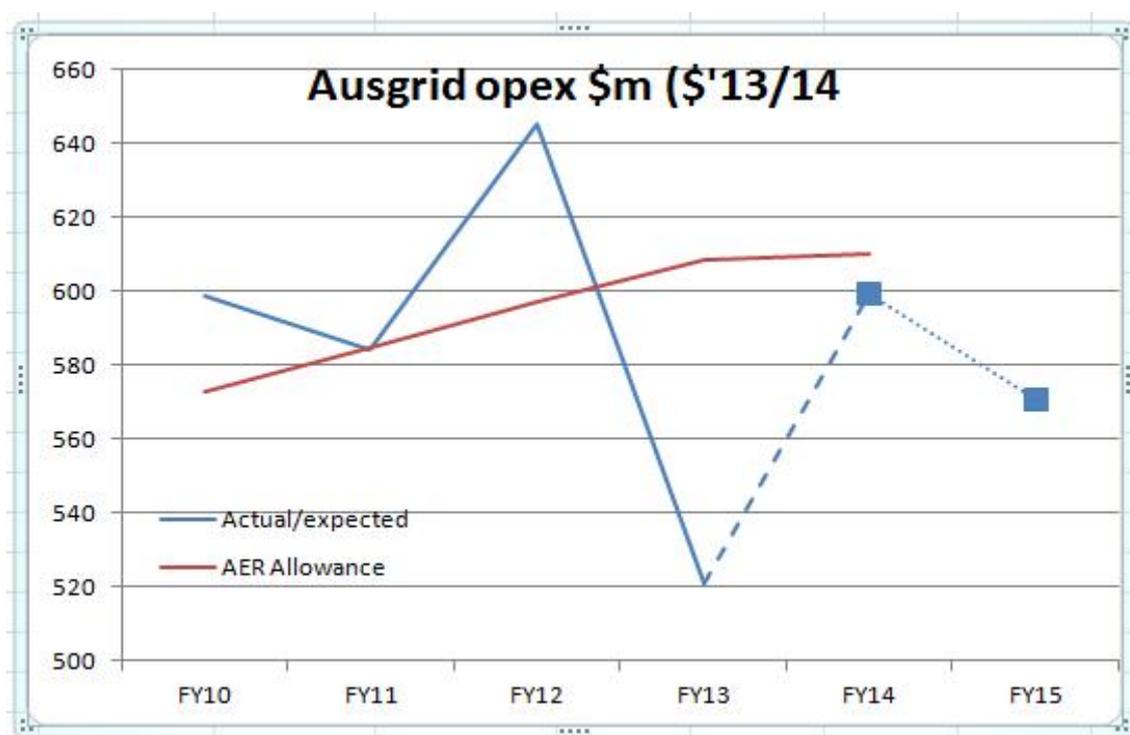
The request by Ausgrid for a pass through provision for the loss of synergy through the sale of its retailing function reflects the AER view that the loss of the function might increase costs. Whilst Ausgrid refers to the AER wording in the draft decision, the wording in the AER's final decision is less clear. The final decision refers to the costs having to be "material" for a pass through to be considered. Ausgrid observes that the earliest that it might have to implement change to the current arrangements would be 27 November 2014, but could well be later, being dependent on actions of the purchaser of the retail function. On this basis, the costs to be incurred in the transition year are unlikely to be significant because of the short period between the setting of the allowed revenue for the entire period and the termination of the transition year.

The revenue allowance for the transition year is a "place holder" allowance which has been developed under a foreshortened regulatory review. This precludes a detailed assessment of the conditions that would constitute a claim for a "pass through" event. As stakeholders will not have the opportunity to review the costs incurred by Ausgrid from the loss of the retail function, no costs for this should be included in the transition year opex.

3. Ausgrid Opex and EBSS

The following chart has been developed from data in the Ausgrid application for the transition year (tables 29 and 30). Tracking the comparable AER allowance for the current period is also provided. However, it is quite apparent that Ausgrid considerably under-ran the opex allowance as the EBSS calculation provides a considerable bonus carry over (Ausgrid appendix F) which implies that Ausgrid achieved an average of nearly \$20m pa saving on its opex.

What is most concerning is that the chart shows a massive 15% increase in opex expected from 2012/13 to 2013/14, with the opex for the transition year being 5% lower than the forecast for 2013/14.



Source: Ausgrid application 2014

Whilst there is some volatility in the actual opex in the current period the overall trend is that opex reduced over first four years of the period and this downward trend is less marked when the high estimated opex for 2013/14 is included. Under the EBSS regime, the opex for the last full year is assumed to be the base for assessing opex into the future. Ausgrid has not used the base year to inform the opex for the transition year.

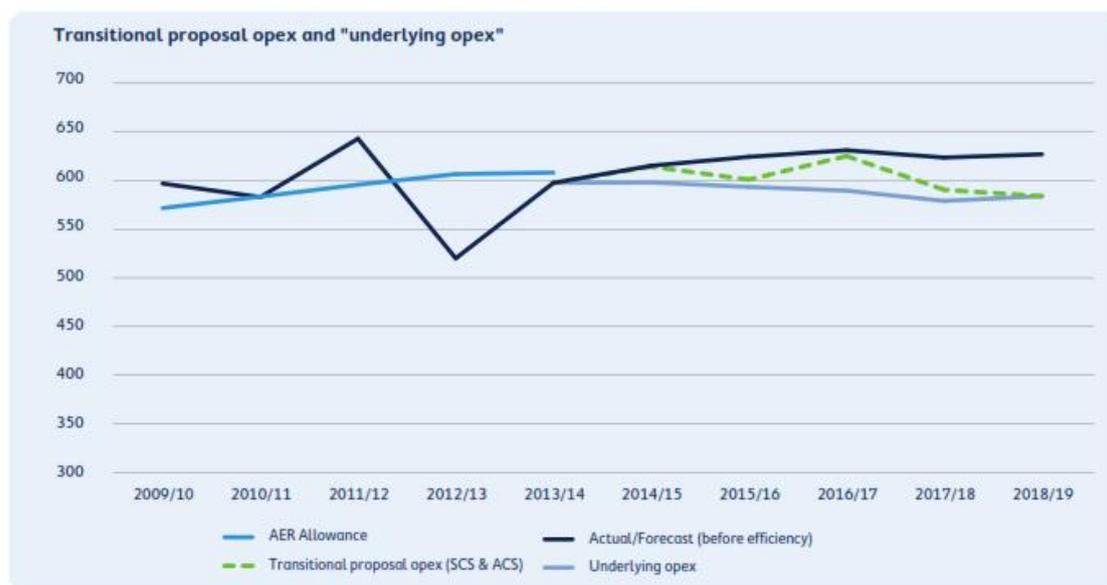
The base-step-trend approach

If the traditional approach to setting the controllable opex was followed, the opex for 2012/13 would be used as the base year and step changes allowed for the setting of the opex for the transition year and on. Although the AER has previously expressed a strong view that the base-step-trend approach is to be used universally (and this is reinforced in its new guideline), Ausgrid appears to

have used its own assessment for the transition year opex with passing reference to the base year of the current period. As they also seek a massive bonus under the EBSS, the MEU considers that the base year approach must be used if consumers are to benefit from the efficiencies introduced during the current period as is implied by the EBSS program. To use any other approach is not consistent.

Ausgrid clearly is of the view that the base year ('12/13 opex) is not the base year in its figure 12

Figure 12 - Underlying and proposed forecast opex (\$ million, 2013-14)



This shows that the low opex in 2012/13 is an anomaly and that the long term opex relates to that estimated for 2013/14

Ausgrid offers four step changes to inform the opex for the transition year:

- The loss of the transitional service agreement (TSA) synergy costs with the sale of the retail function to TRUenergy
- Change in operating environment where Ausgrid has to inspect private mains
- Sale and lease back of the corporate head office
- Price changes of inputs to be above CPI.

As well as these four step changes implying increased costs, Ausgrid also implies that the low capex in the latter years of the current period meant there was less growth than forecast and the MEU comments that this should have resulted in less opex. Other networks have tended to replace capex allocated for growth assets to increase their replacement capex. Ausgrid does not provide sufficient information to assess whether this occurred with Ausgrid, but if it did do so, increased replacement capex should have resulted in less opex due to replacing old with new. Neither of these two changes appears to be reflected in a lower opex step change.

One of the significant step changes would be the sale and lease of corporate offices. Ausgrid comments that this approach would reduce the RAB yet it is not clear whether this has occurred as the detail on capex (selling the corporate office would be negative capex) is insufficient to identify whether the sale of the offices and lease back is efficient from the view of consumers. If the sale of the corporate office returns less on an NPV basis than the increase in opex, then consumers should not be required to pay for an inefficient transaction.

Whilst Ausgrid explains the logic of the loss of the TSA synergy benefits, it does not provide any costings to support the amounts claimed. Further, the loss of the TSA synergies is not definite as Ausgrid comments that the decision to change is at the election of TRUenergy who might not require the change which could occur at the earliest in late November 2014.

There is no supporting information that Ausgrid provides to quantify any of these positive step changes, although the MEU considers that for application to just one year price escalation should be based only on CPI (see section 1.7 above).

Ausgrid includes in its forecasts of opex (table 31) the cost to implement efficiency initiatives and the likely reward from these. For the transition year, Ausgrid offers a net \$10.6m saving. What is concerning is that the savings seen in opex for 2012/13 seem to have disappeared. Whilst the MEU welcomes Ausgrid's attention to reducing costs in the future, those already achieved must be retained.

Ausgrid has not provided any breakdown of the elements of the historic opex so the MEU is not able to comment on the detail of why elements of the opex claimed might be reasonable or otherwise. This lack of detail prevents any ability to "drill down" into the causes of the opex increases which might allow the MEU to support some aspects of what is overall an apparent attempt by Ausgrid to be provided with an excessive allowance for its opex for the transition year.

EBSS

Appendix F Table 11.1 and table 30 both indicate that Ausgrid considers that it is entitled to a reward under the efficiency benefit sharing scheme (EBSS). Appendix F quantifies the carryover of this reward into the next regulatory period in \$13/14 terms and table 10 shows the carryover of this in nominal terms.

Year	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Incremental gain (\$million, 2013-14)		-19.0	35.4	-50.9	134.3	0.0	
Carryover							
2009-10			-19.0	-19.0	-19.0	-19.0	-19.0
2010-11				35.4	35.4	35.4	35.4
2011-12					-50.9	-50.9	-50.9
2012-13						134.3	134.3
2013-14							0.0
Total Carryover Amount (\$million, 2013-14)							99.7
PTRM inputs (\$million, 2013-14)							99.7

However, it must be noted that the allowance provided at the last reset significantly overstated the opex requirement when compared to the actual performance of Ausgrid during the current period. The opex allowance sought by Ausgrid and allowed by the AER showed total opex increasing in real terms from 2009/10 to 2013/14, whereas in real terms, actual total opex showed an overall decrease over the same years. In figure 12 Ausgrid shows that the actual total opex for the base year (2012/13) was over 25% lower than the opex allowed giving an EBSS benefit of \$134.3m!

Whilst the MEU supports the provision of a reward for achieving lower costs for passing onto consumers, the process itself is heavily biased by the ability of the network to "game" the regulator. For Ausgrid to have achieved such a significant reduction in opex implies that the original allowance was grossly overstated. The fact that this point was made by consumer stakeholders at the revenue reset yet the excessive allowance was provided.

Under the EBSS, Ausgrid is entitled to a bonus for its efforts in reducing its opex, on the basis that this benefit is passed to consumers in terms of the future opex allowances. For the revenue allowance for the transition year, Ausgrid is targeting to recoup all of the opex under-runs for the current period as a charge to the transition year revenue. Effectively the EBSS benefit for the opex under-run in the current period (calculated by Ausgrid to be an average of \$25m pa for the 4 applicable years) has the effect of increasing the "real" opex allowance (ie the sum of claimed opex plus the EBSS which is opex savings carried forward from the previous period) for the transition year by some 15%.

If a full five year period was to be set for the payment of the EBSS, the high cost in the early years would be amortised over the entire 5 year period. The MEU considers that the EBSS reward should be amortised equitably over the entire regulatory period both directly and through the smoothing approach and not to be so heavily imposed on the first year of the period.

4. Ausgrid Capex

Ausgrid capex is presented in figure 13 showing the actual capex in comparison to that allowed for the same period. This shows that that in four of the five years of the current regulatory period, Ausgrid significantly used less capex than was allowed by the AER at the last revenue reset.

Figure 13 – Comparative capex profile (\$ million, 2013-14)



In aggregate terms Ausgrid used only 80% of its allowed capex and as a result achieved a significant benefit of over \$160m from this under-run in capex

The capex proposal by Ausgrid for the transition year would appear to reflect the recent downward trend in capex seen over the current period, although there is a slight increase forecast for the transition year compared to the estimate for 2013/14 year. The MEU considers that what Ausgrid has achieved in its capex reductions is commendable and a reasonable estimate for the transition year would reflect the capex in the base year of ~\$950m, especially as Ausgrid is forecasting a reduction in capex over the next period to about \$725m in 2018/19.

Whilst Ausgrid provides detail of its different capex elements for the next period, it provides no breakdown as to where the capex was incurred in the current period. Therefore the MEU is unable to assess which elements of capex reflect reasonable allowances. In particular, as noted above, many networks have reduced their current period capex for growth assets and transferred considerable amounts to replacement assets, thereby using the capex released from being used for growth to reducing the average age of the assets overall. This transfer of capex use has considerable impact of other aspects (especially opex) but Ausgrid's lack of information precludes such useful comparisons.

However in Table 21, Ausgrid provides a breakdown of the forecast capex. What is intriguing is that "area plans" (augmentation and replacement of

subtransmission assets) and replacement and duty of care (replacement not in the "area plans" assets) comprise 75% of the forecast capex for the next period and nearly 80% of the capex for the transition year. The amount of detail provided to substantiate this massive amount of some \$800m in capex for the transition year is summarised into 5 short paragraphs.

Ausgrid has already identified that its network growth will be severely curtailed for the coming period as the growth expected in the current period did not eventuate and the expected peak demand in the coming period will not exceed the actual demand experienced in the past.

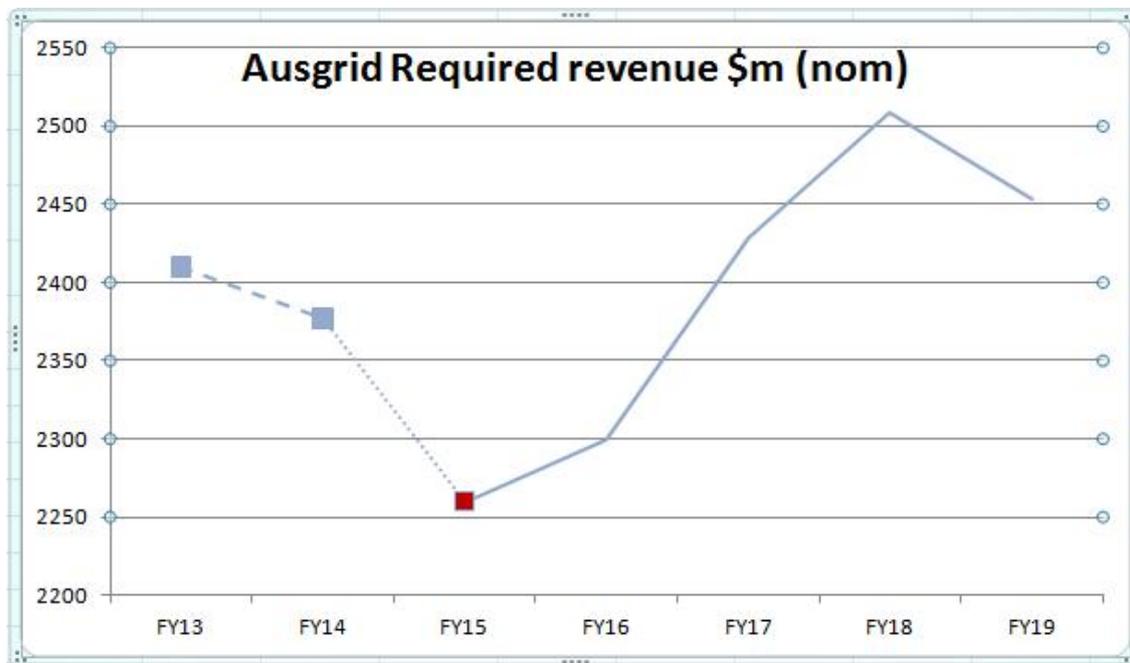
This observation leads to the conclusion that the bulk of the capex will be dedicated to replacement of assets, yet there is no justification provided substantiating such a large replacement program. In fact, the 2008 application from Ausgrid highlighted the need for a significant replacement program because of the age and condition profile of assets. The amount of replacement that should have been carried out in the current period should have led to a significant reduction in the average asset age and a major reduction in the amount of replacement needed in the future. The fact that Ausgrid had such an under-run on capex in the current period implies that it has achieved a reasonable balance on asset age and condition.

This view is reinforced by the forecast for future capex which shows a continuing downward trend for replacement assets.

Overall, the capex claim for the transition year appears to be overstated and that the capex for the transition year should be similar to that actually used in the base year or slightly less. , the MEU considers that it is higher than it needs be by at least \$150m which implies the claimed capex is probably too high by some 40%.

5. Revenue approach and smoothing

Ausgrid has identified that its revenues for the next five years will start at ~5% lower than in 2013/14 and then rise in nominal terms. This is shown in the following chart.



Source: Ausgrid application,

Analysis shows that the revenue is expected to increase in real terms as well. When this real increase is coupled to a decline in expected consumption (as shown in figure 11) then Ausgrid's application will result in an increase in prices on a real basis for the balance of the next regulatory period. What is also concerning is that despite the modest reduction in revenue claimed for the transition year, prices in the transition year will remain virtually static in real terms when the effect of the TUoS is added to the DUoS element .

There is no certainty that the AER will allow Ausgrid either the transition year allowance assessed or the forecast revenues for the following four years under the new rules and guidelines. In fact, there is an expectation that the new rules and guidelines will reduce the revenues allowed under the old rules and guidelines - otherwise why were the rule changes needed!

6. Service Standards

Ausgrid provides no projection for the service standards it proposes to achieve in the transition year. What it does provide is a view that the amalgamation of the three distribution networks has three objectives (page 3):

4. "To continuously improve safety performance for employees, contractors and the public.
5. To maintain the reliability and sustainability of the electricity distribution networks.
6. To strive to contain average increases in our share of customers' electricity bills at or below CPI (consumer price index)."

The second of the aspirations seeks to maintain reliability and sustainability at current levels. There is no aspiration to improve these aspects. To a degree this is understandable as the determinative approach used to provide reliability has ensured that service standards (at least for the majority of consumers) is already relatively high - such that customer consultation has stated unequivocally that (page 10)

"...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."

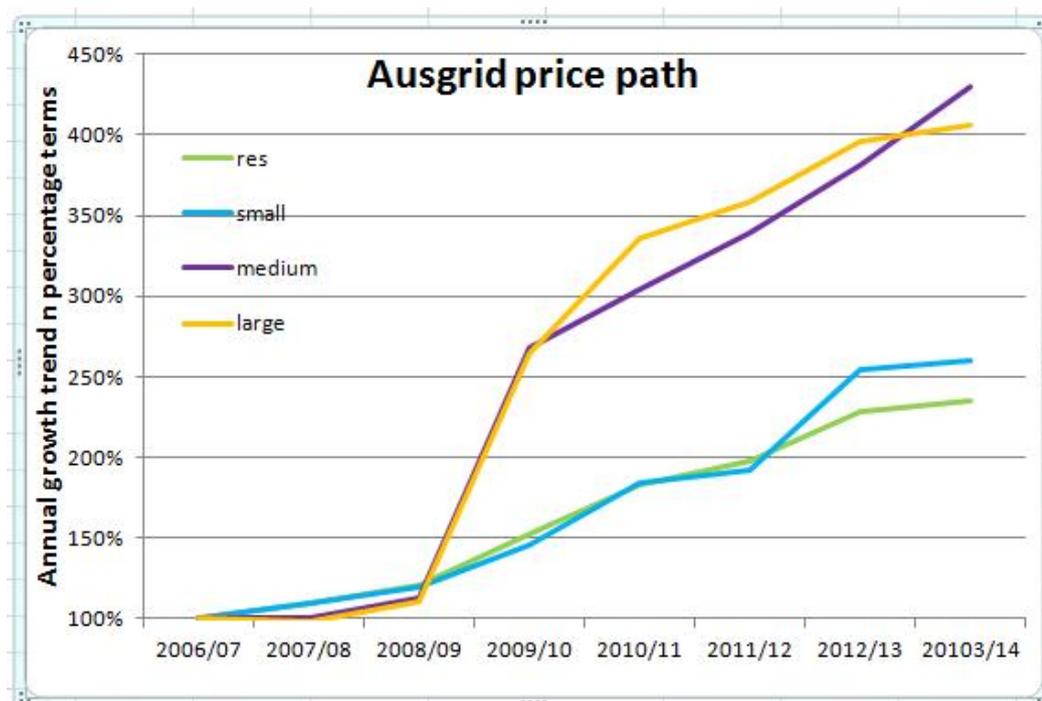
The MEU is concerned that reliability is probably higher (for the majority) than might be needed and that the costs consumers incur is greater than need be.

The MEU considers that there needs to be a requirement that certain standards of performance should be set for the transition year so that the cost of this reliability can be clearly balanced against the costs involved with its maintenance and achievement.

7. Pricing methodology

The MEU is extremely concerned about the outcomes of the Ausgrid pricing methodology. In a submission made recently to the AEMC the MEU provided the following longitudinal assessment of Ausgrid pricing

"The MEU has tracked the Ausgrid network prices over the past eight years. The distribution costs for the four different load profiles were tracked and the following chart shows the costs each consumer would pay in each of the past five years.



Source: Ausgrid tariff lists, MEU calculation

The massive increase in prices from 2008/09 to 2009/10 for large and medium businesses was reported by MEU members as was the rise again from 2009/10 to 2010/11.

An explanation given by Ausgrid to MEU members for the large increase in medium and large user tariffs was a large price increase in TransGrid charges, and the analysis in section 2.1.1 does not support the assertion as rises in TransGrid prices between 2008/09 and 2009/10 were relatively modest⁵; the price changes by TransGrid do not explain the magnitude of the Ausgrid price increase seen just by medium/large users. In practice, any increase in TransGrid charges should have impacted residential and small users to a similar extent seen by other users.

⁵ The spike in TransGrid prices seems to occur the following year

The fact that, overall, Ausgrid prices for residential and small users show little change from the general trend seen in the three years prior to the large step increase in revenue Ausgrid was awarded by the AER and the Competition Tribunal in 2009 indicates a clear bias by Ausgrid in where revenue increases were to be levied. It would appear that a decision was made by Ausgrid that medium and large users would carry the bulk of the large increase in revenue awarded in 2009.

One explanation for this might be that there had been under-recovery in revenue by these sectors in previous years. To a large degree this argument is spurious as Ausgrid could have made some adjustments to these tariffs prior to the revenue adjustment in 2009, or even at the 2004 revenue decision, but did not see a reason for doing so. In fact, prices for residential and small business users merely reflect the trend in price changes over the previous 3 years.

A major concern of medium and large consumers was the massive price hike about which they had no knowledge and therefore no ability to plan for the cost increases. The AER decision had indicated a step increase of some 15% would occur to the average tariff in 2009, yet an increase many times this actually occurred for the medium and large sector. That such an increase could occur demonstrates the clear ability a distribution network has to set prices to suit itself.

The fact that Ausgrid was able to so massively increase costs to larger electricity users yet allow residential and small business prices to remain at the same small annual price increase trend as previously applied **without formal explanation or independent verification** highlights consumer concerns that networks have little control placed on them as to how their revenue is to be recovered through pricing approaches."

The MEU is extremely concerned that Ausgrid pricing does not reflect the costs for the service provided. The AER has an obligation to ensure there are no anomalies in network pricing through the pricing methodology approved but the outcomes do not support this requirement.

The MEU accepts that in the foreshortened review process for the transition year, it will be difficult to investigate the reasons for such variation as have been seen. Equally, consumers expect that prices will be equitable and will generally track the AER approved revenue allowances. It is not acceptable for such significant inconsistencies to be allowed to continue.