Aurora Energy
Electricity Distribution Determination
1 July 2012 to 30 June 2017

Pre-determination conference

Andrew Reeves
Chairman AER

13 December 2011

Housekeeping

- Please sign the attendance sheet
- A record of this meeting will be made
- There will be morning tea served after the presentation

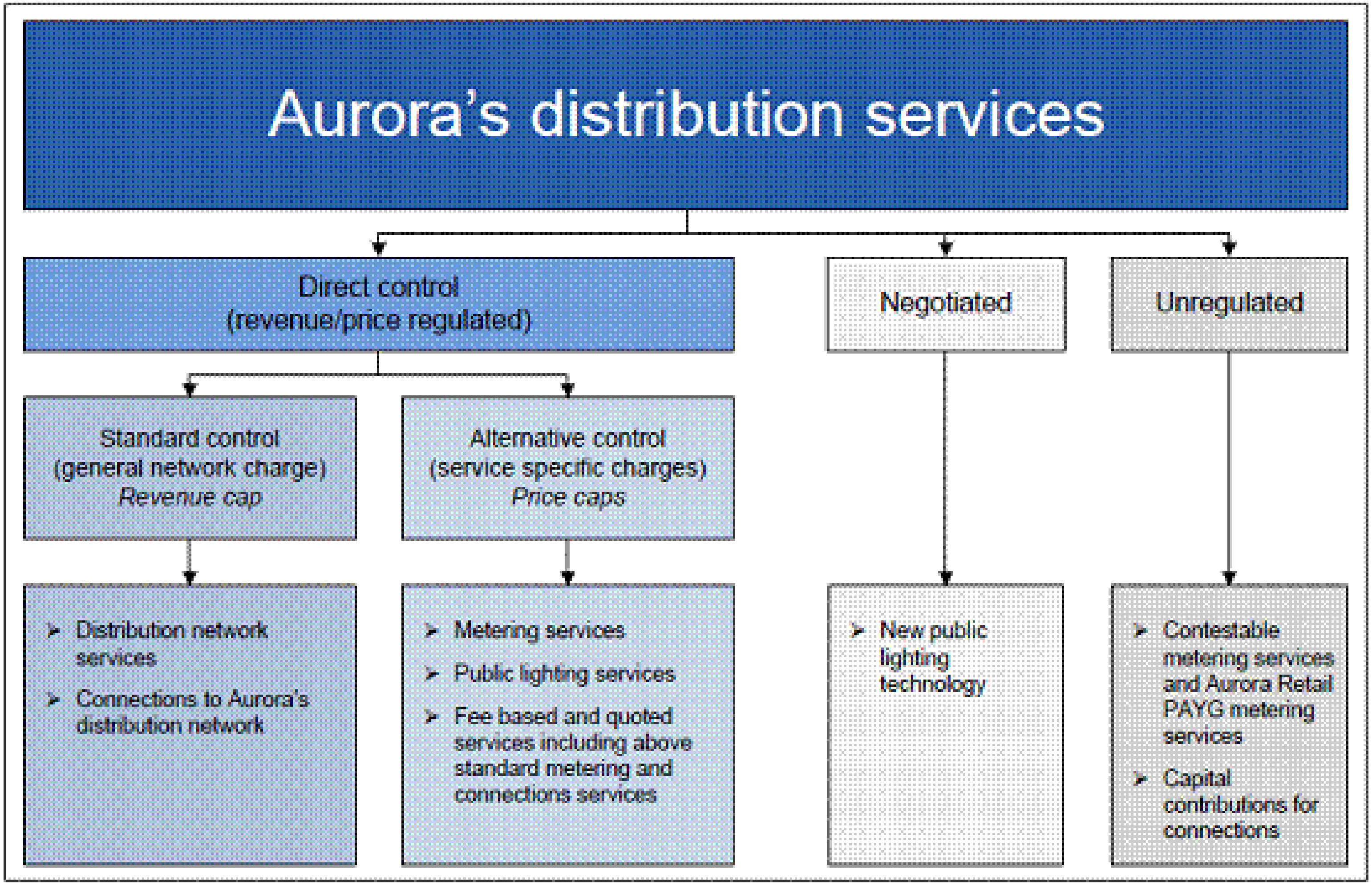
Framework

- Under the National Electricity Law (NEL), the AER is responsible for the economic regulation of distribution services.
- The NEL requires the AER to regulate distribution services in a manner that will promote efficient investment in, and the efficient operation and use of, electricity services for the long term benefit of consumers.
- Under the National Electricity Rules the AER must make a distribution determination covering, amongst other matters:
  - How Aurora's distribution services will be regulated
  - Aurora's allowed revenues and prices
  - Incentive schemes that will apply to Aurora

Aurora’s regulatory proposal

- Aurora’s regulatory proposal would have resulted in a once-off revenue increase of 13 per cent and then a moderate annual decrease (before inflation).
- Aurora’s proposed expenditure was broadly in line with its current expenditure.
- The AER has accepted much of Aurora’s regulatory proposal as being consistent with the requirements of the NER.

Classification of Aurora’s services



Cost allocation

- Aurora must allocate costs to its distribution services in accordance with its Cost Allocation Method (CAM).
- The AER approved the latest version of Aurora’s CAM in May this year.
- The CAM prevents cross-subsidisation between the distribution and other services that Aurora provides.

Standard control services

- The AER has determined lower revenues & prices than those proposed by Aurora.
- The AER's draft determination would result in no average increase to a typical residential electricity bill, arising from this determination.

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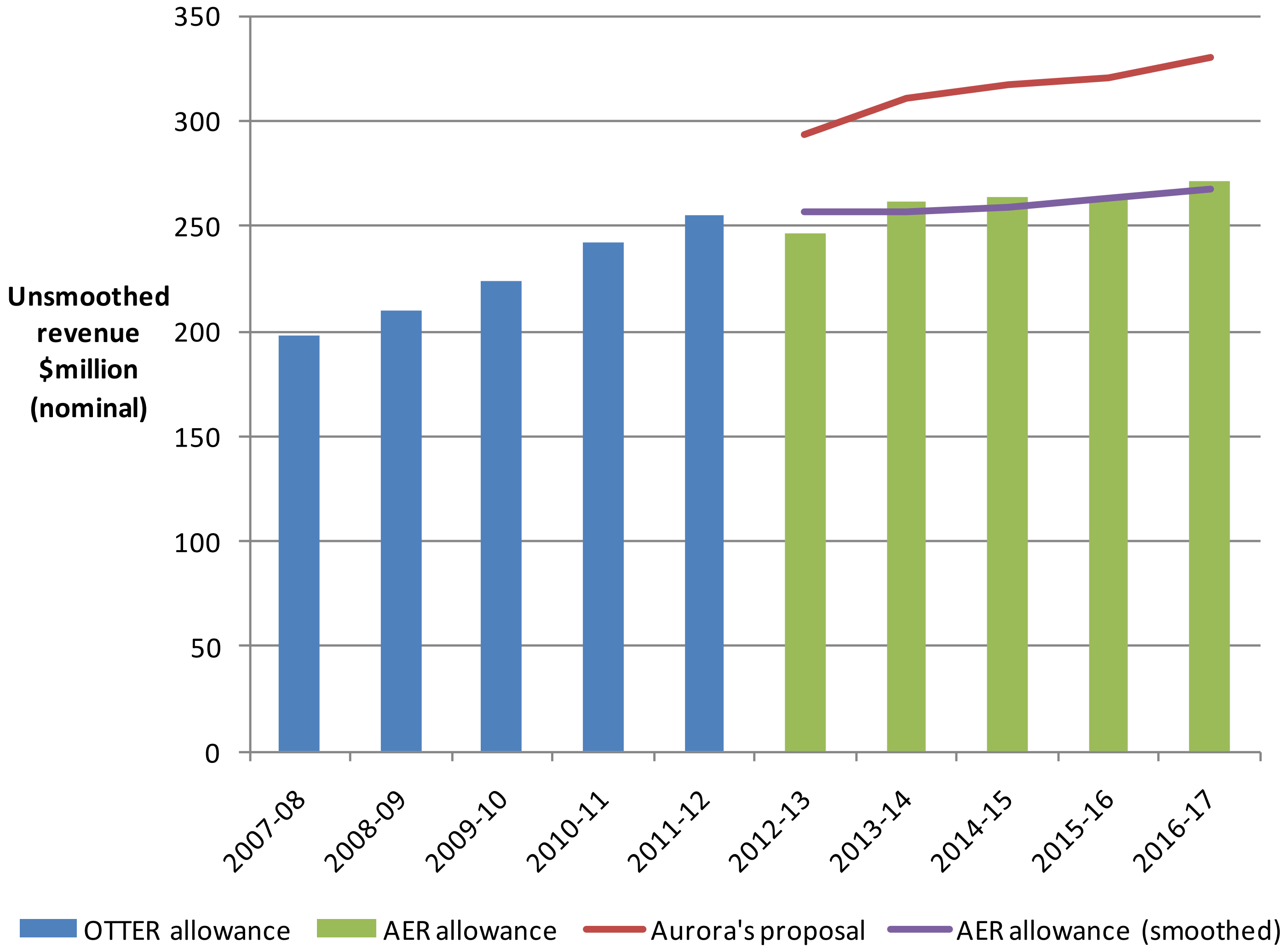
Revenue



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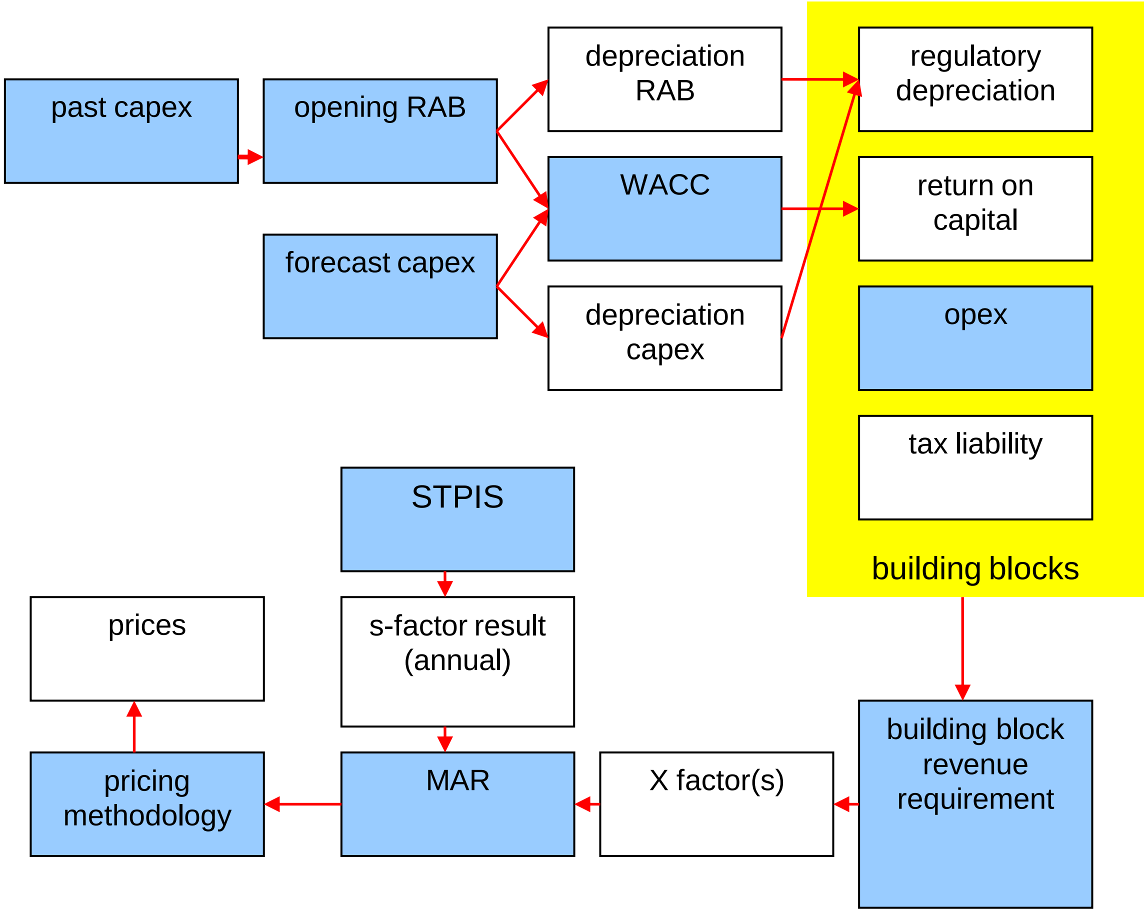
Change in prices

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	Average
Proposed by Aurora							
Residential bill	$2,000	$2,147	$2,164	$2,181	$2,199	$2,216	
Percentage change in residential bill		7.37%	0.78%	0.79%	0.79%	0.80%	2.1%
AER draft determination							
Residential bill	$2,000	$1,990	$1,980	$1,979	$1,985	$1,991	
Percentage change in residential bill		-0.50%	-0.49%	-0.08%	0.30%	0.30%	-0.1%

Outcomes from Final Determination will take account of Aurora response and circumstances in financial markets

Revenue

- The revenue allowance is calculated from the following components



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Key drivers of revenue reductions

- Aurora proposed total revenue for the regulatory control period of $1,571.6 million ($nominal).
- The AER's draft determination is for total (smoothed) expected revenues of $1,305.4 million ($nominal) for the regulatory control period – 17 per cent below Aurora's proposal.
- The main reductions are due to the AER's position on the proposed return on investment, forecast capex and forecast opex.

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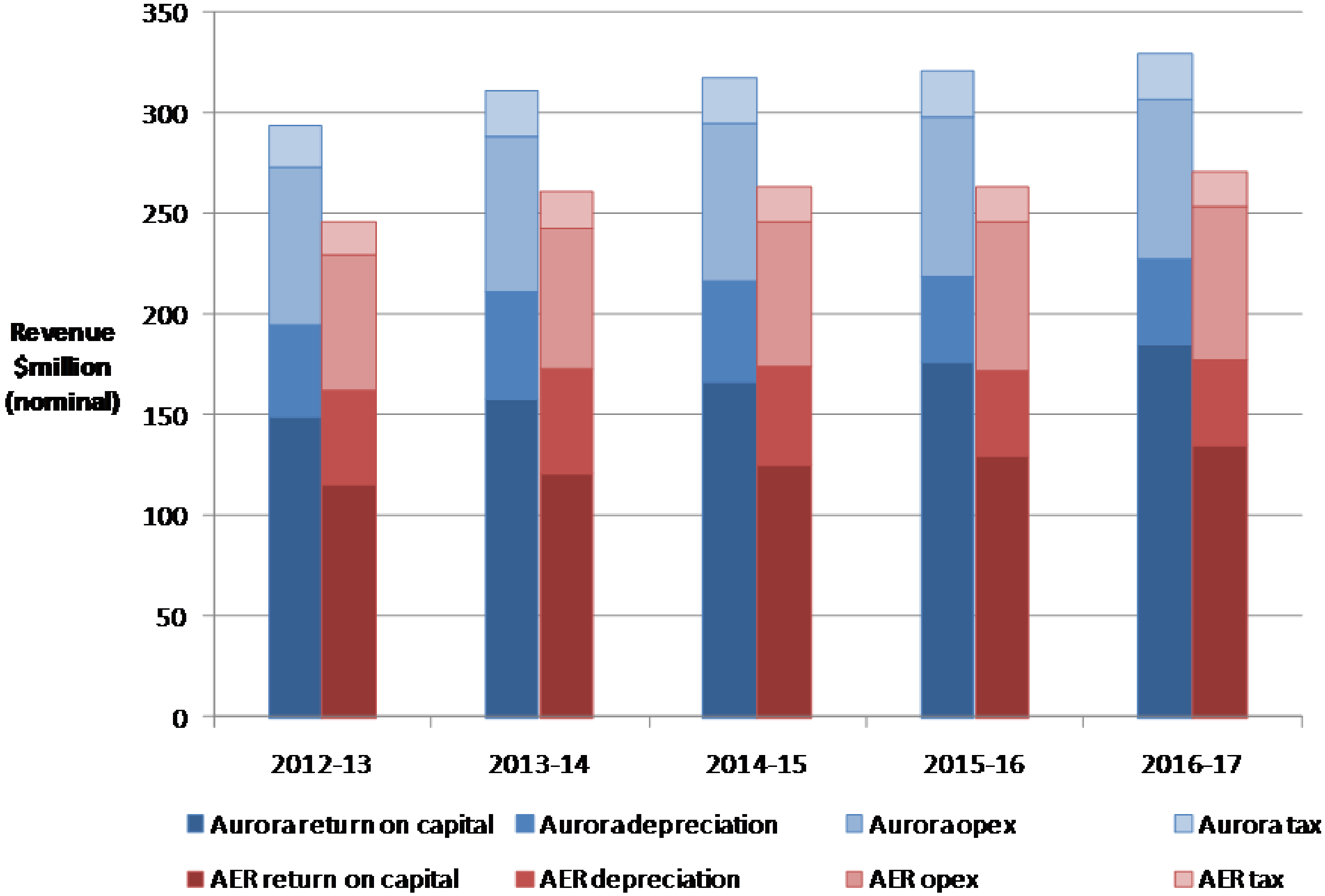
Revenue comparison



Return on investment

- The NER requires the AER to determine an appropriate return on Aurora’s investment in distribution assets.
- The rate of return is represented by the Weighted Average Cost of Capital (WACC).
- The AER’s position on the WACC is the most significant driver of the AER’s reductions to Aurora’s proposed revenues.
- The WACC values will be updated in the final determination for prevailing market conditions.

WACC parameters

Parameter	Aurora's proposal	AER draft determination
Nominal risk free rate	5.53%	4.28%
Equity beta	0.8	0.8
Market risk premium	6.50%	6.00%
Gearing level (debt/debt plus equity)	60%	60%
Debt risk premium	4.54%	3.14%
Assumed utilisation of imputation credits (gamma)	0.25	0.25
Inflation forecast	2.58%	2.62%
Cost of equity	10.73%	9.08%
Cost of debt	10.07%	7.42%
Nominal vanilla WACC	10.33%	8.08%

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Return on investment (WACC)

Aurora's proposal

- 10.33 per cent

AER draft determination

- 8.08 per cent

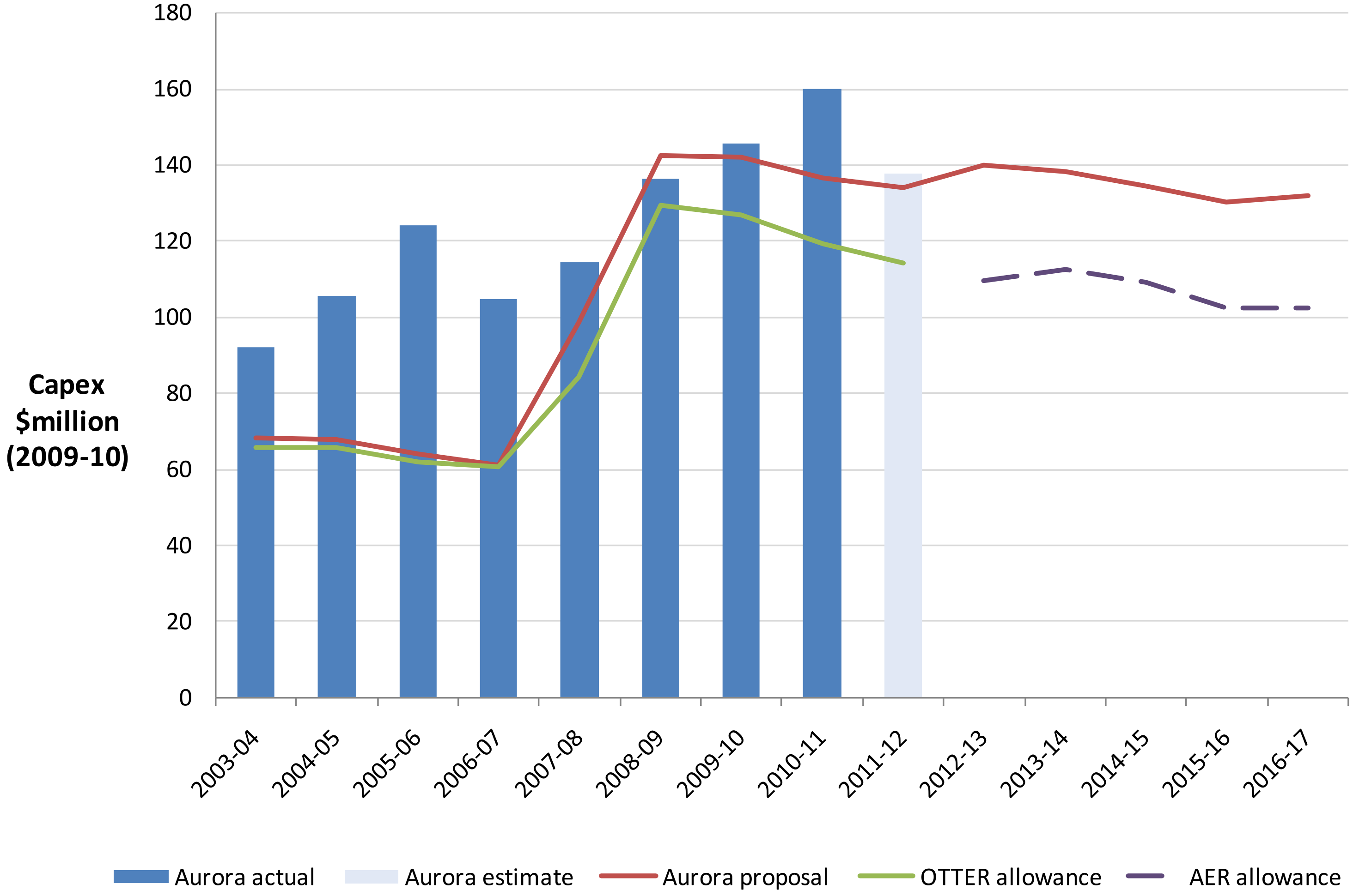
Reasons

- A change in market conditions is the driver of a lower nominal risk free rate.
- A lower DRP results from the AER's updated methodology using observed market data.
- The AER considers that there is persuasive evidence to deviate from a MRP of 6.5%.

Return on investment (WACC)

	decreased in revenues ($million, nominal)	decrease in revenues (per cent)
Risk free rate (Rf)	109.4	8.4
Debt risk premium (DRP)	66.0	5.1
Market risk premium (MRP)	16.2	1.2
Rf + DRP + MRP	191.6	14.7

Total Capex



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Capital Expenditure

Aurora's proposal

- $675.3 million ($2009-10)

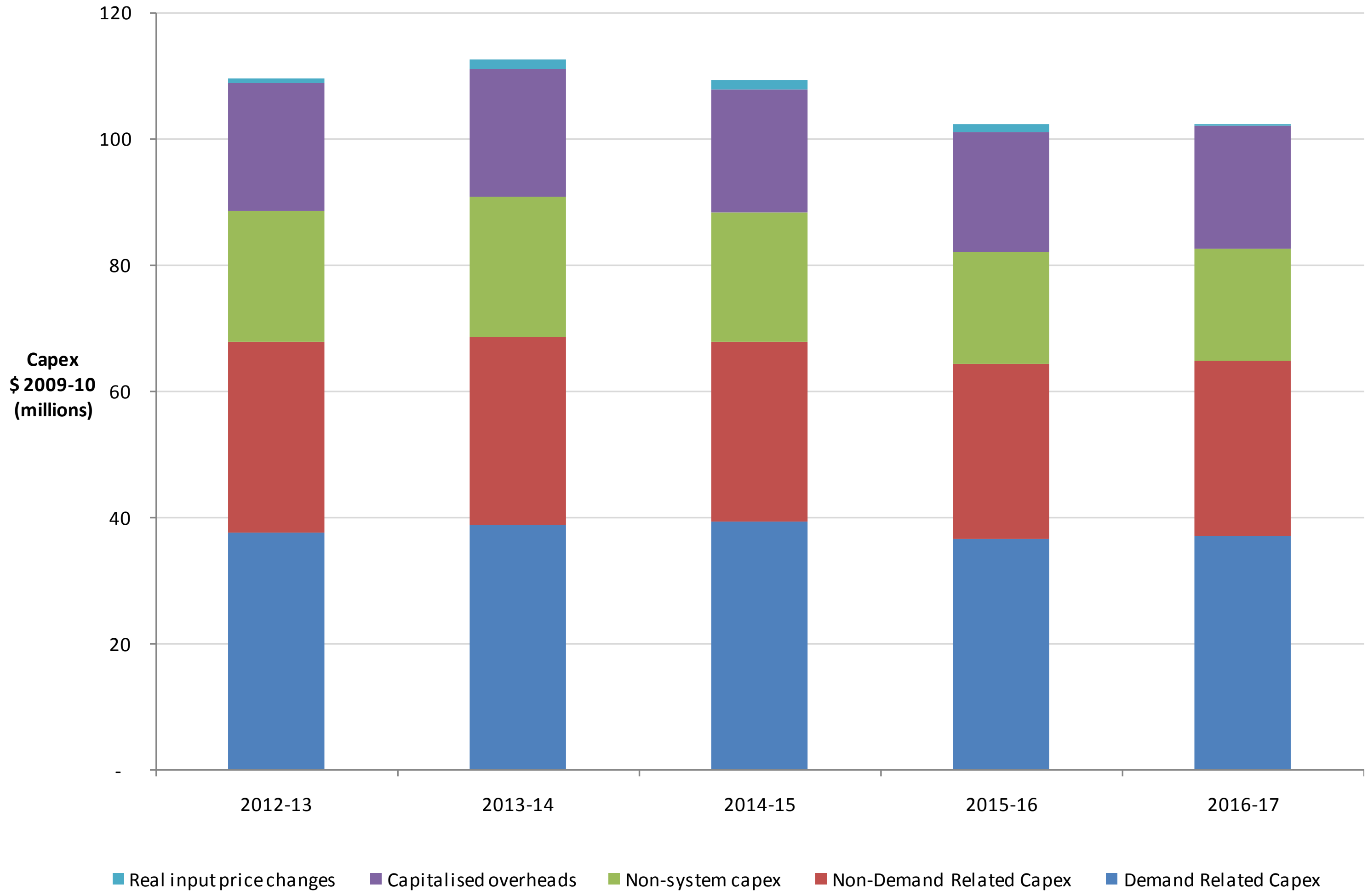
AER draft determination

- $535.8 million ($2009-10)
- Decrease of 21 per cent

Reasons

- reduced customer connections forecast
- Above necessary capital expenditure for projects to improve reliability or reduce operating costs

Approved capex breakdown



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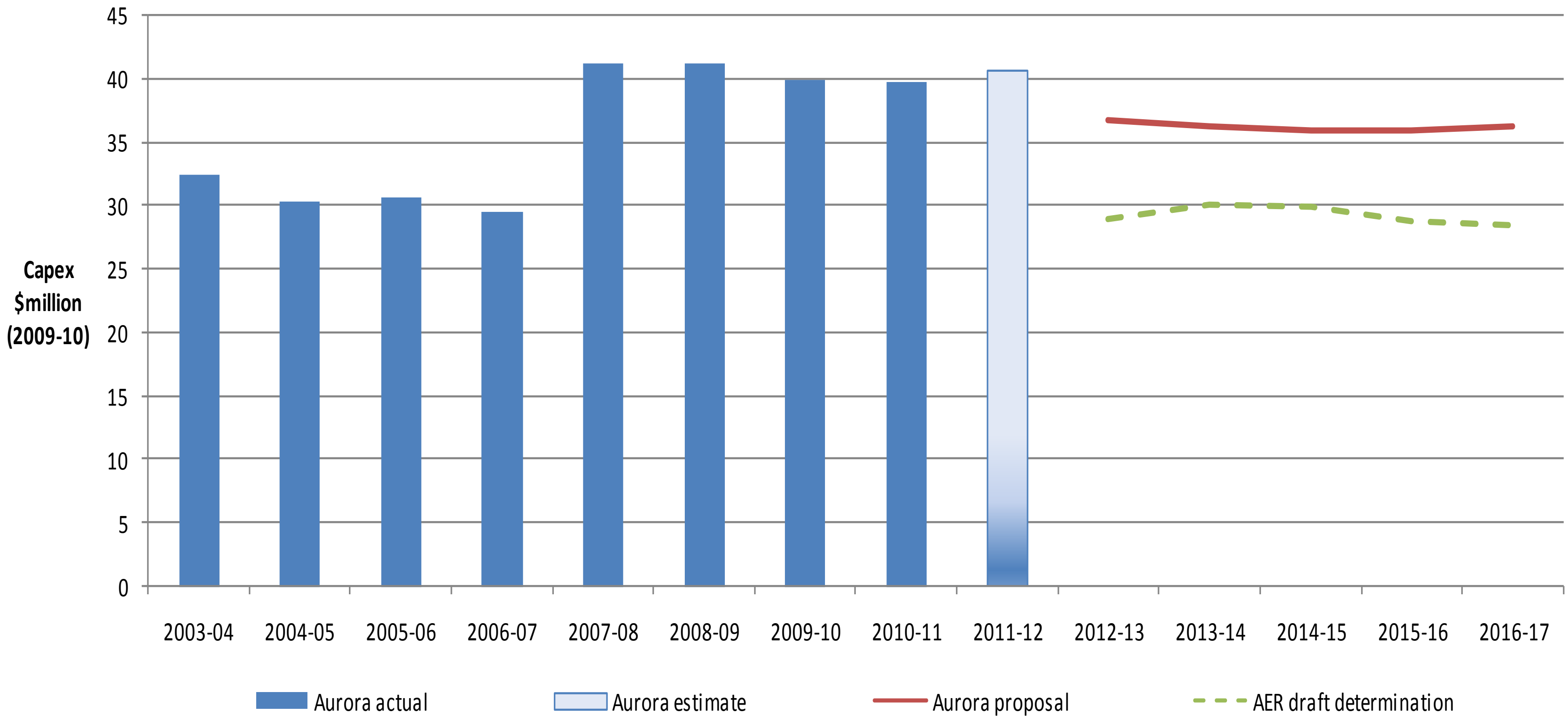
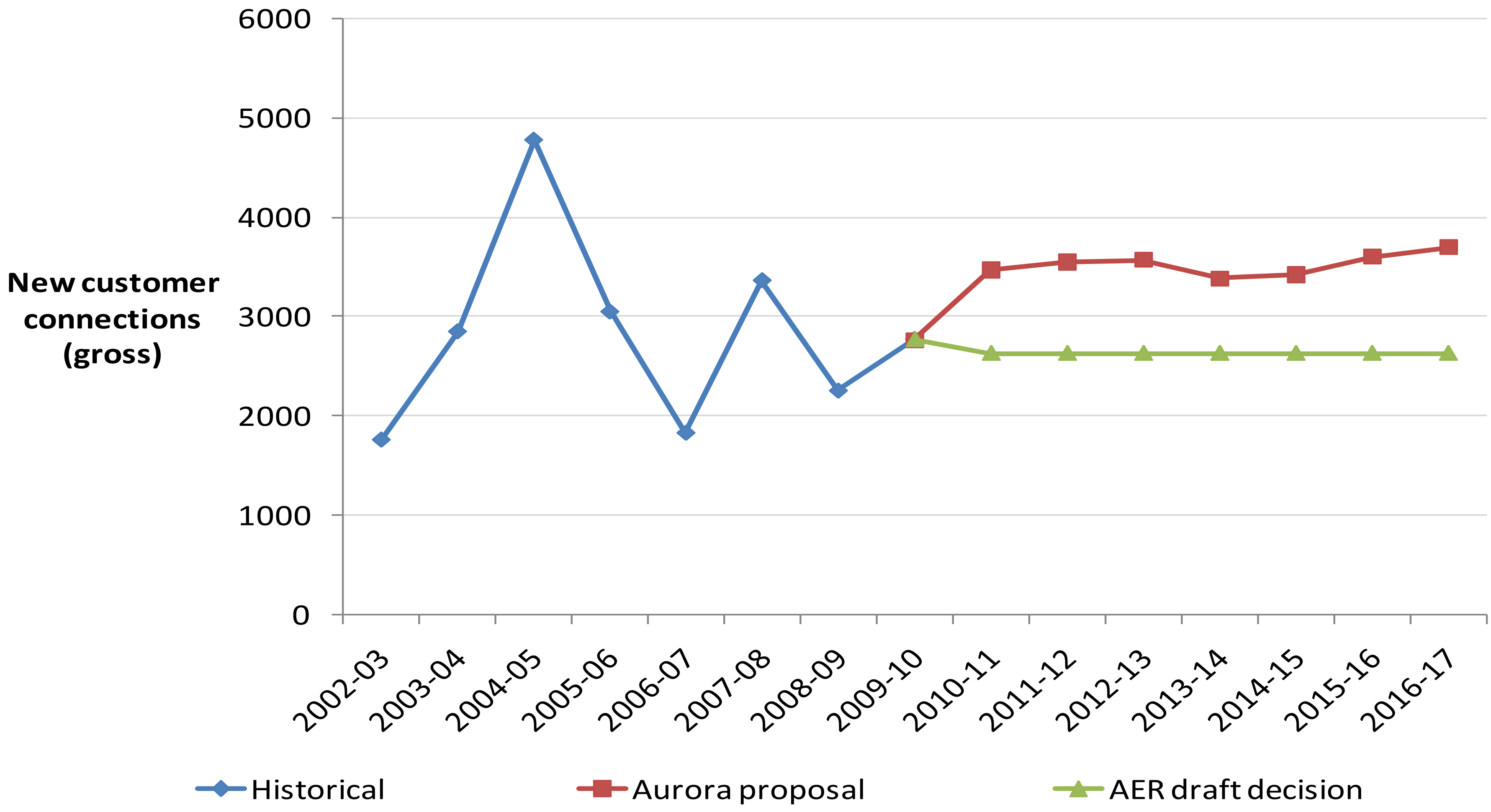
Capex - connections

- The AER considers that a reduction of $35.2 million to customer connections capex is required.
- Aurora’s forecast of new residential connections is too high.
- Aurora’s unit costs for new commercial connections is too high.

Capex - connections



Residential customer connections



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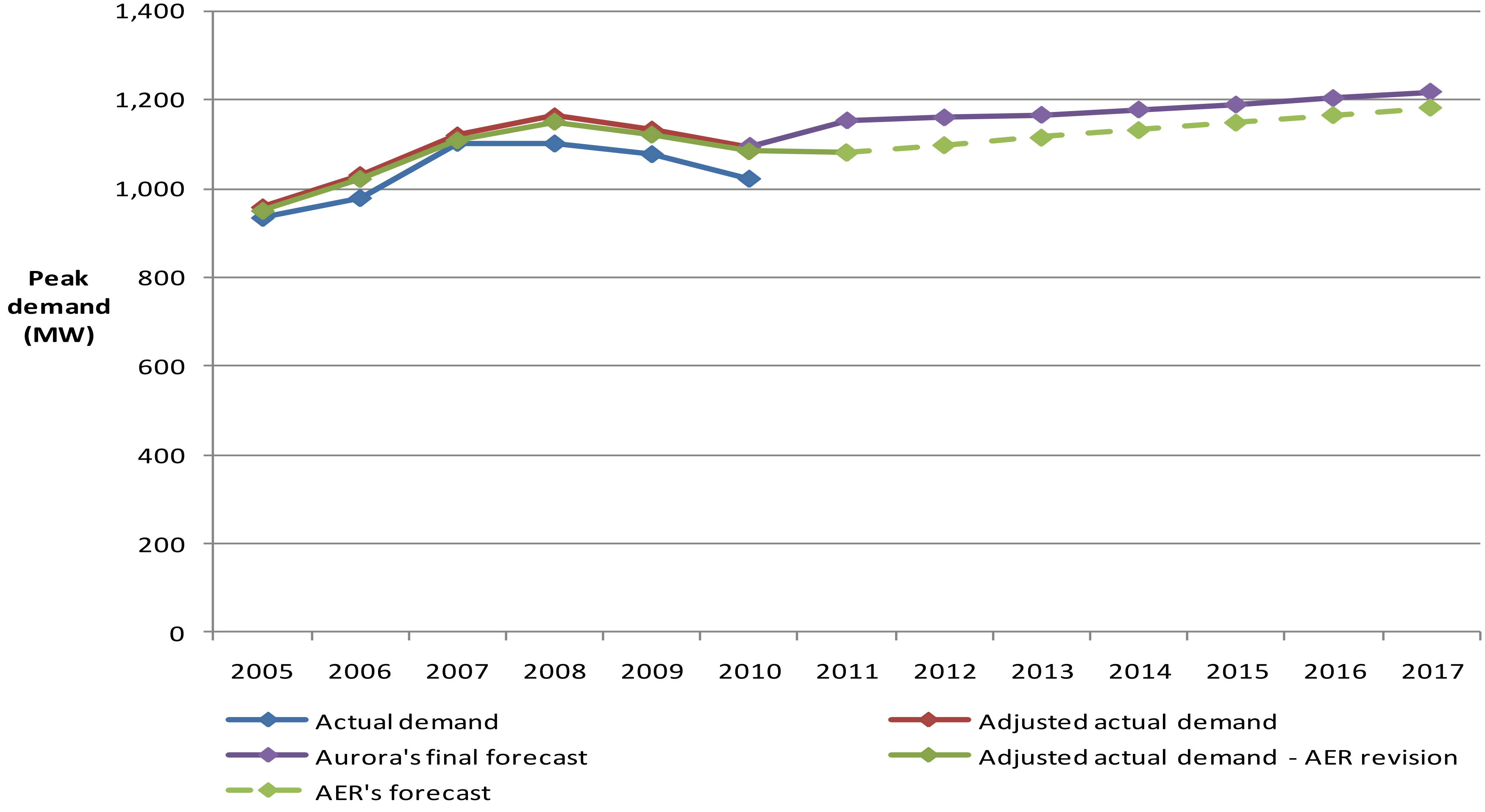
Capex - reinforcement

- The AER considers that a reduction of $44 million to Aurora's proposed reinforcement capex is required
- Some of the expenditure seems to be driven by operational efficiencies and/or improvements in reliability.
- In some instances Aurora has not adequately demonstrated that its proposed expenditure reflects the efficient costs of meeting the capex objectives.

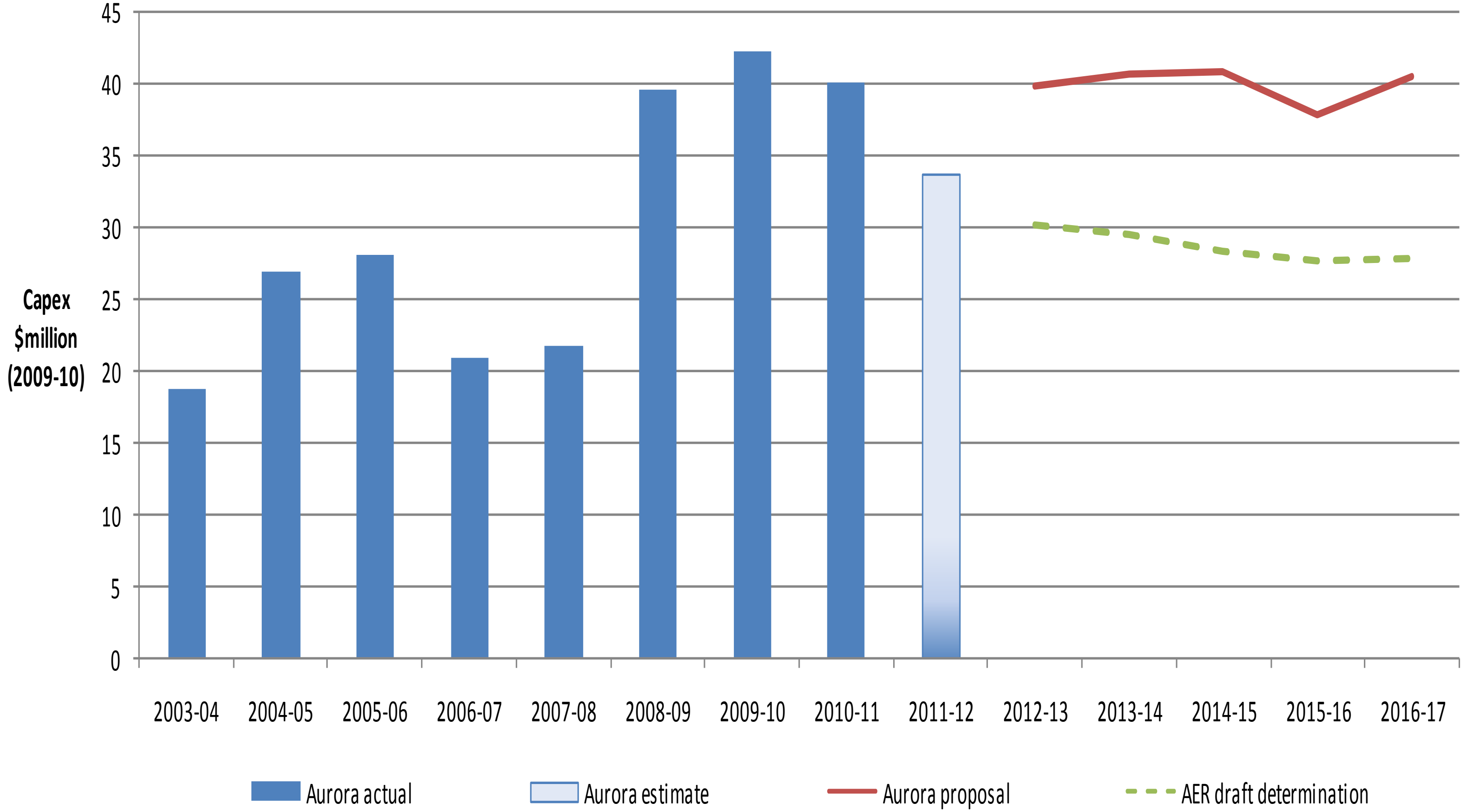
Maximum Demand



Capex - Non demand

- Much of Aurora's proposed capex is for purposes other than managing demand, such as replacement of ageing assets.
- The AER found that some of Aurora's proposed non demand capex was in excess of what is required under the NER.
  - Much of this was capex resulting in service improvement and operating efficiencies. The AER's incentive schemes are another means by which Aurora may recover the costs of this investment.

Capex - Non demand



Operating Expenditure

Aurora's proposal

- $340.1 million ($2009-10)

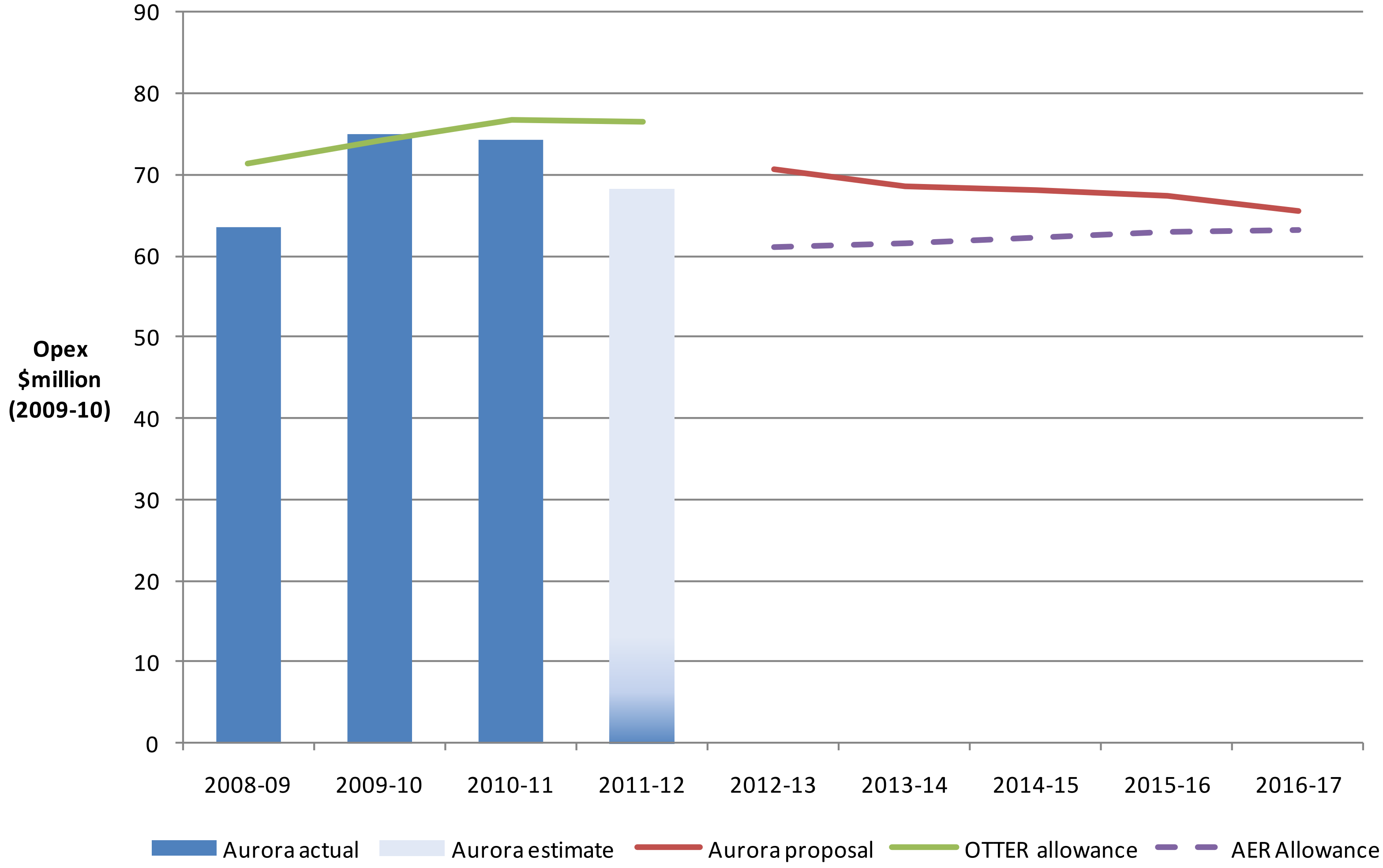
AER's draft determination

- $311 million (2009-10)
- Decrease of 8.6 per cent

Reasons

- There is reason to doubt Aurora's opex forecast approach
  - uncommon detailed cost build up
  - aspirational 3 per cent labour efficiency adjustment
- The AER compared Aurora's proposed forecast opex with an alternative base year forecast.
- The base year forecast started with Aurora's recurrent expenditure and accounted for other factors expected to affect Aurora's costs.

Total Opex



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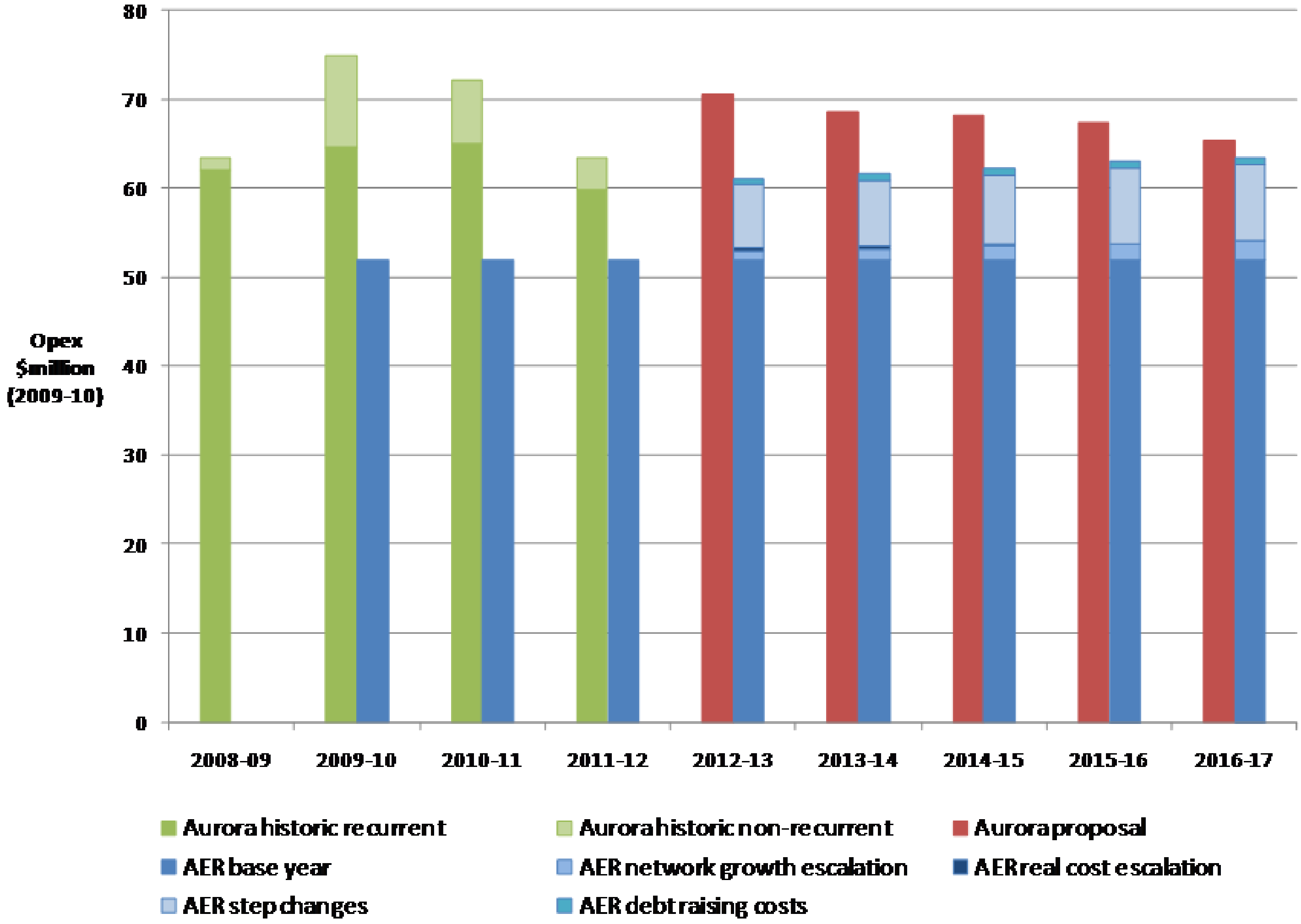
opex draft determination



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Incentive schemes

- The AER has proposed to apply the following incentive schemes to Aurora
  - Service target performance incentive scheme (STPIS)
  - Efficiency benefit sharing scheme (EBSS)
  - Demand management incentive scheme (DMIS)

STPIS

- The STPIS will provide a financial incentive for Aurora to maintain and improve its performance.
- Targets have been set to reflect the performance Aurora has been funded to deliver.
- Maximum penalty or reward of five per cent of revenue.
- Performance measures align with Tasmanian service standards.

EBSS

- The EBSS will provide Aurora with a continuous incentive to reduce opex across the regulatory period.
- It provides this continuous incentive by allowing Aurora to retain efficiency gains for five years before passing them to consumers.

DMIS

- The DMIS provides an incentive for Aurora to implement efficient non-network alternatives.
- Under the DMIS, Aurora may gain a annual demand management incentive allowance (DMIA).
- The DMIA funds expenditure on initiatives approved by the AER.

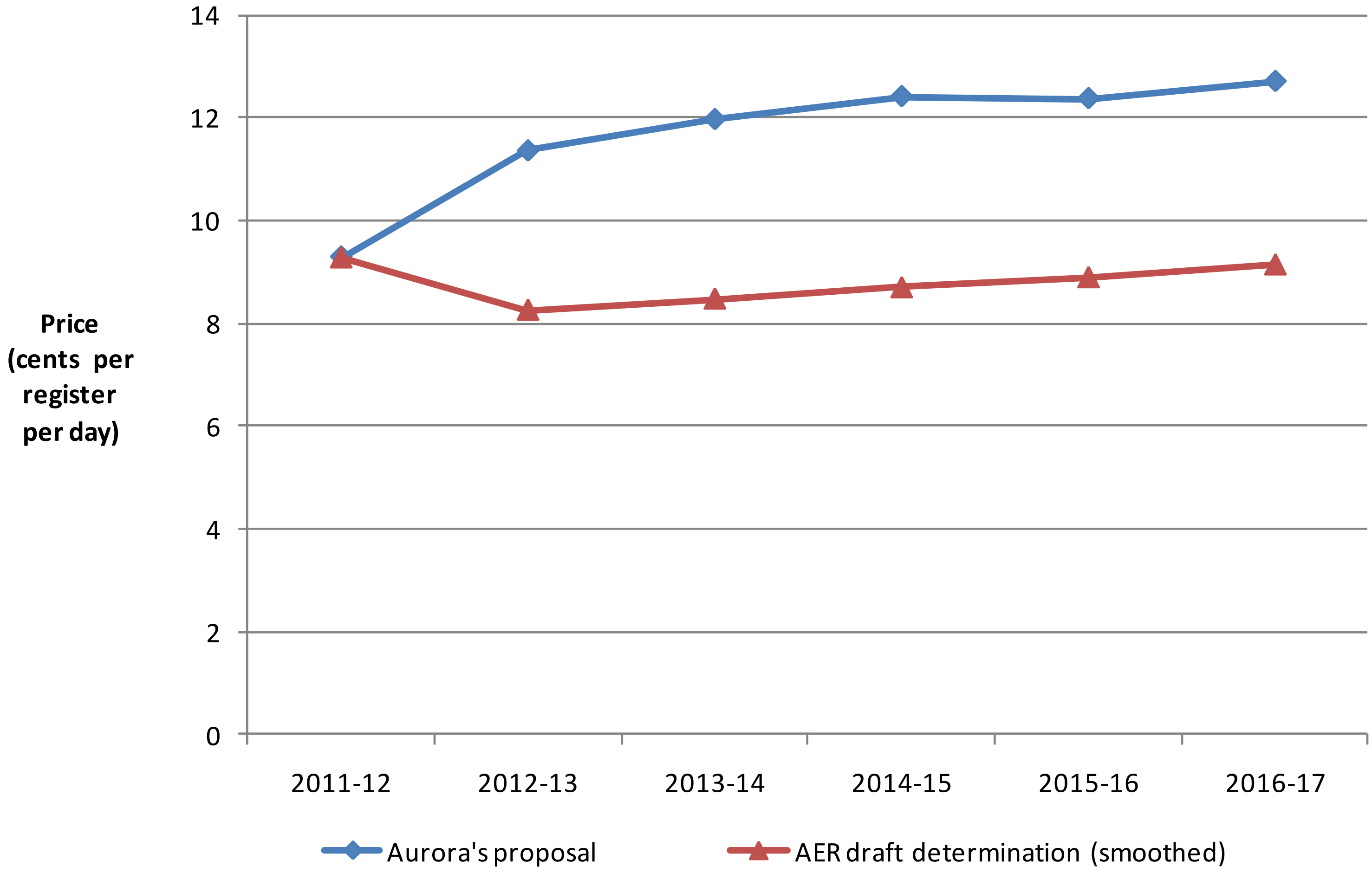
Pass throughs

- Aurora may pass through the costs of certain events which are too uncertain to forecast accurately.
- Aurora nominated 9 pass through events (in addition to the four pass through events prescribed in the NER)
- The AER accepted the following three:
  - Natural disasters
  - Liability above insurance cap
  - Insurer credit risk
- The AER considered that the other events proposed by Aurora were already covered by other pass through events.

Alternative control services

- The AER determined that metering, public lighting, fee based services and quoted services will have price caps
- The AER's draft determination meter prices are on average 29 per cent below those proposed by Aurora.
- The key driver of the price difference is that the AER has used a regulated asset base roll forward approach for calculating the annual capital allowance for metering.
- This differs from Aurora's proposal to apply a replacement cost annuity approach for these services

Prices for meters



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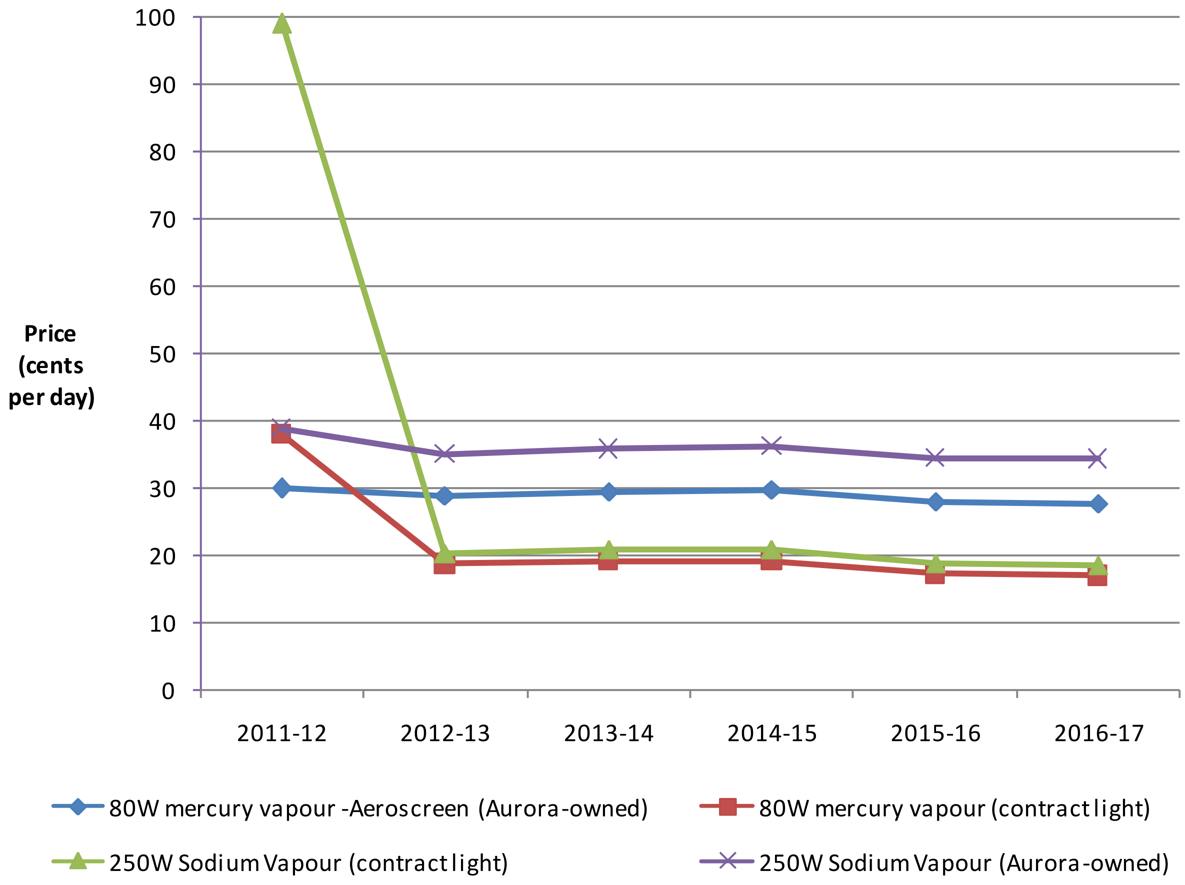
Alternative control services

- The AER's draft determination on public lighting services has resulted in price caps that are on average 19 per cent below those proposed by Aurora.
- The AER has set price caps for discrete services that Aurora provides such as, deenergization, reenergization and meter alterations
- The AER has also set caps on the charge out rates of labour, and materials costs for quoted services.

Prices for public lighting assets



Timelines

- Revised proposal due 16 January 2012
- Submissions due 20 February 2012
- AER Final decision 30 April 2012

Submissions

- Aurora’s revised proposal in response to the AER’s draft determination is due 16 January 2012
- Submission on the AER’s draft determination and Aurora’s revised proposal can be submitted at AERInquiry@aer.gov.au until 20 February 2012
- The AER’s draft determination and associated documents are available at www.aer.gov.au
- Timeframes under the NER limit the AER’s ability to consider late submissions

Comments and Questions