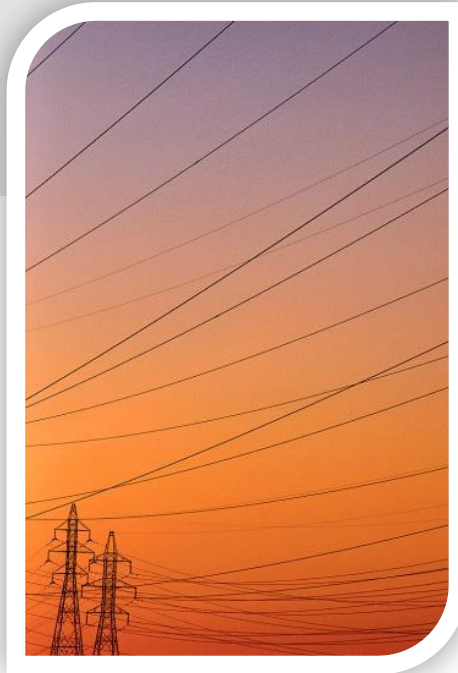


Australian Energy Regulator



**Predetermination
conference
AER draft decision on
ActewAGL's electricity
distribution regulatory
proposal 2015-19
9 December 2014**

AER draft decision on ActewAGL's regulatory proposal

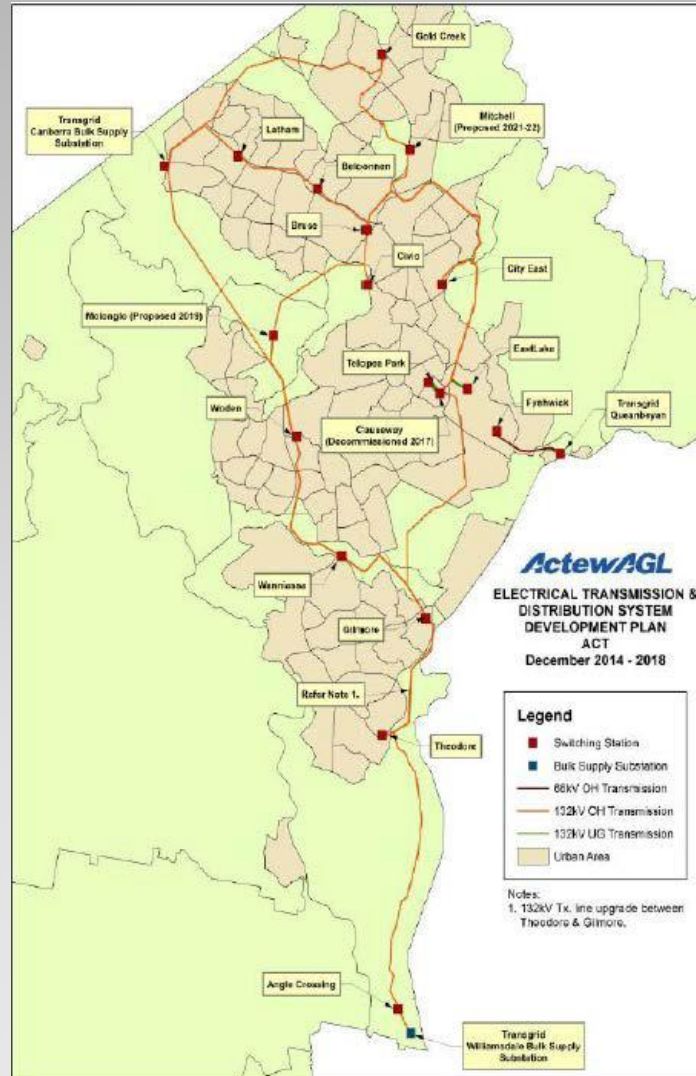
Warwick Anderson

Contents

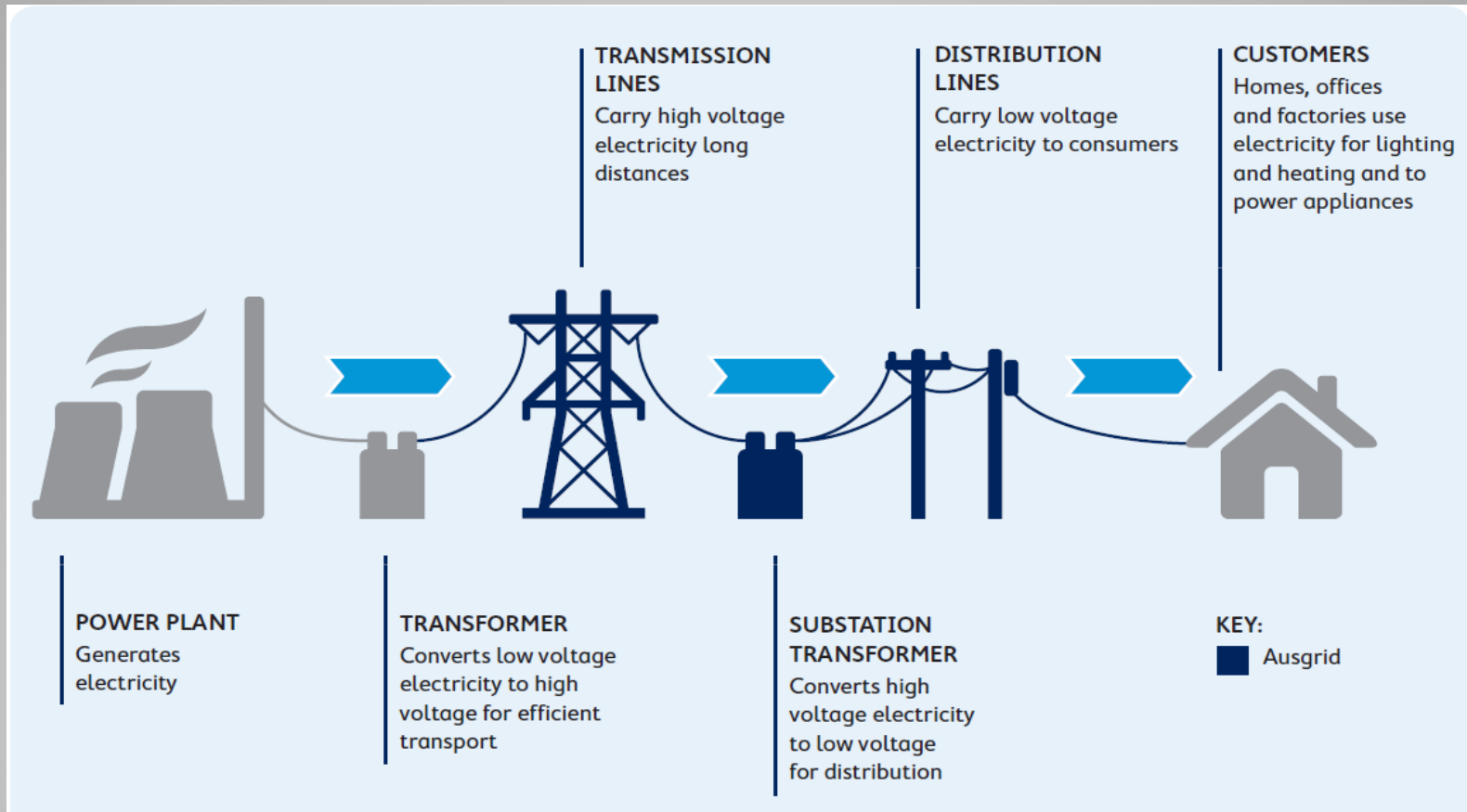
- High level generalised presentation
- ActewAGL's distribution business
- The AER and our role
- Overview of the proposal and draft decision
- Key drivers
- Main elements
 - RAB
 - Capex
 - Opex
 - Rate of return
- Next steps

ActewAGL's distribution business

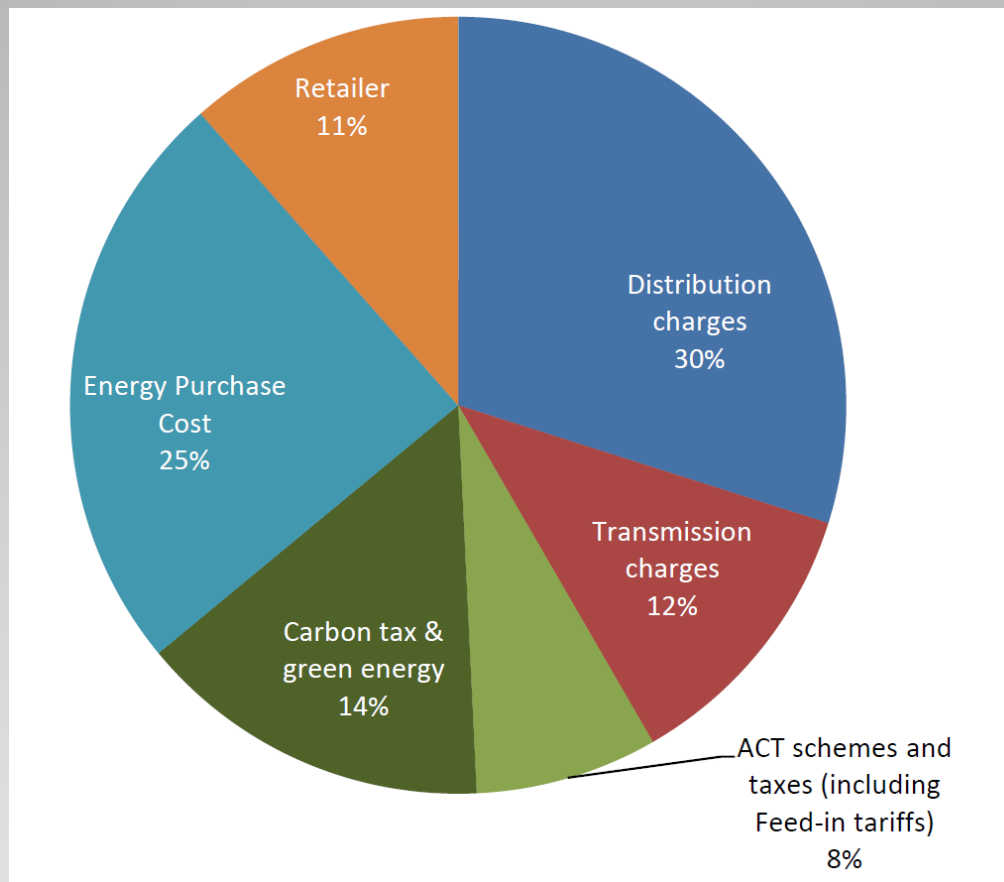
ActewAGL's service area



Electricity industry structure



Contribution to total bill



Source: ActewAGL Regulatory proposal, p. 4.

The AER and our role

The current process

- Draft decisions released on 27 Nov 2014 for:
 - 4 distribution businesses (1 in ACT, 3 in NSW)
 - 3 transmission businesses (2 in NSW, 1 in Tasmania)
 - 1 gas distribution business (Jemena Gas Networks NSW)
- Final decisions due 30 April 2015 (Jemena a bit later)
- We are also assessing three regulatory proposals for Qld/SA distribution businesses
- Preliminary decisions on the Qld/SA proposals are to be released by 30 Apr 2015 and final decisions by 31 Oct 2015

The NEO

- Our task – to set a maximum allowance that the networks are permitted to recover from customers consistent with the NEO:
- To promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to –
 - Price, quality, safety, reliability and security of supply of electricity; and
 - The reliability, safety and security of the national electricity system

Better regulation

- Expenditure forecast assessment guideline
- Expenditure incentives guideline
- Rate of return guideline
- Consumer engagement guideline
- Shared assets guideline
- Confidentiality guideline

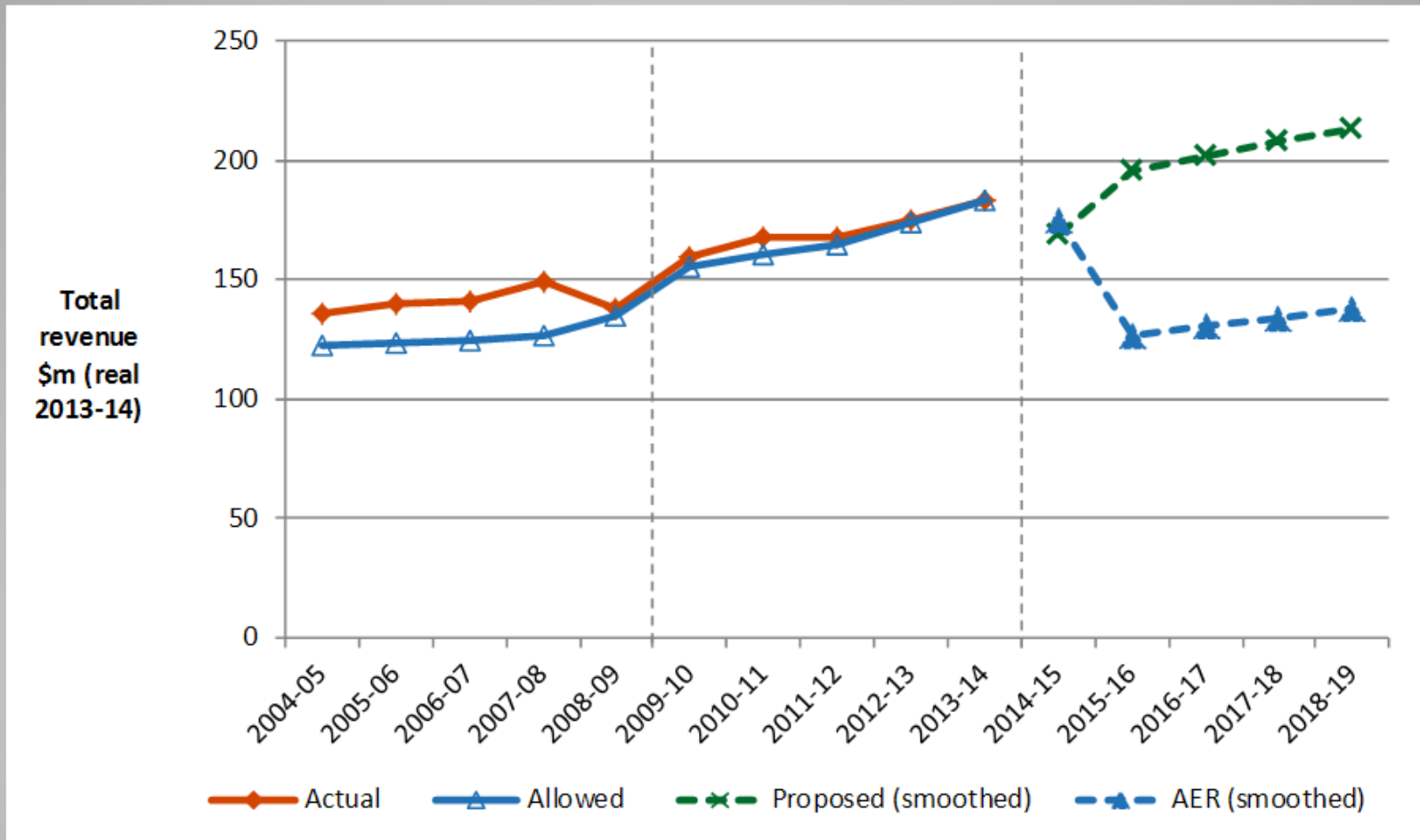
The proposal and AER draft decision

AER draft decision

- Not to accept proposal
- We are not satisfied the proposals advance the NEO to the greatest degree
- Instead we have made draft decisions that we are satisfied reflects the underlying drivers
- We see the influence of these drivers in the main components of our draft decision

Total revenue

Total revenue - ActewAGL



Key drivers

Key drivers

Our draft decisions reflect the key drivers:

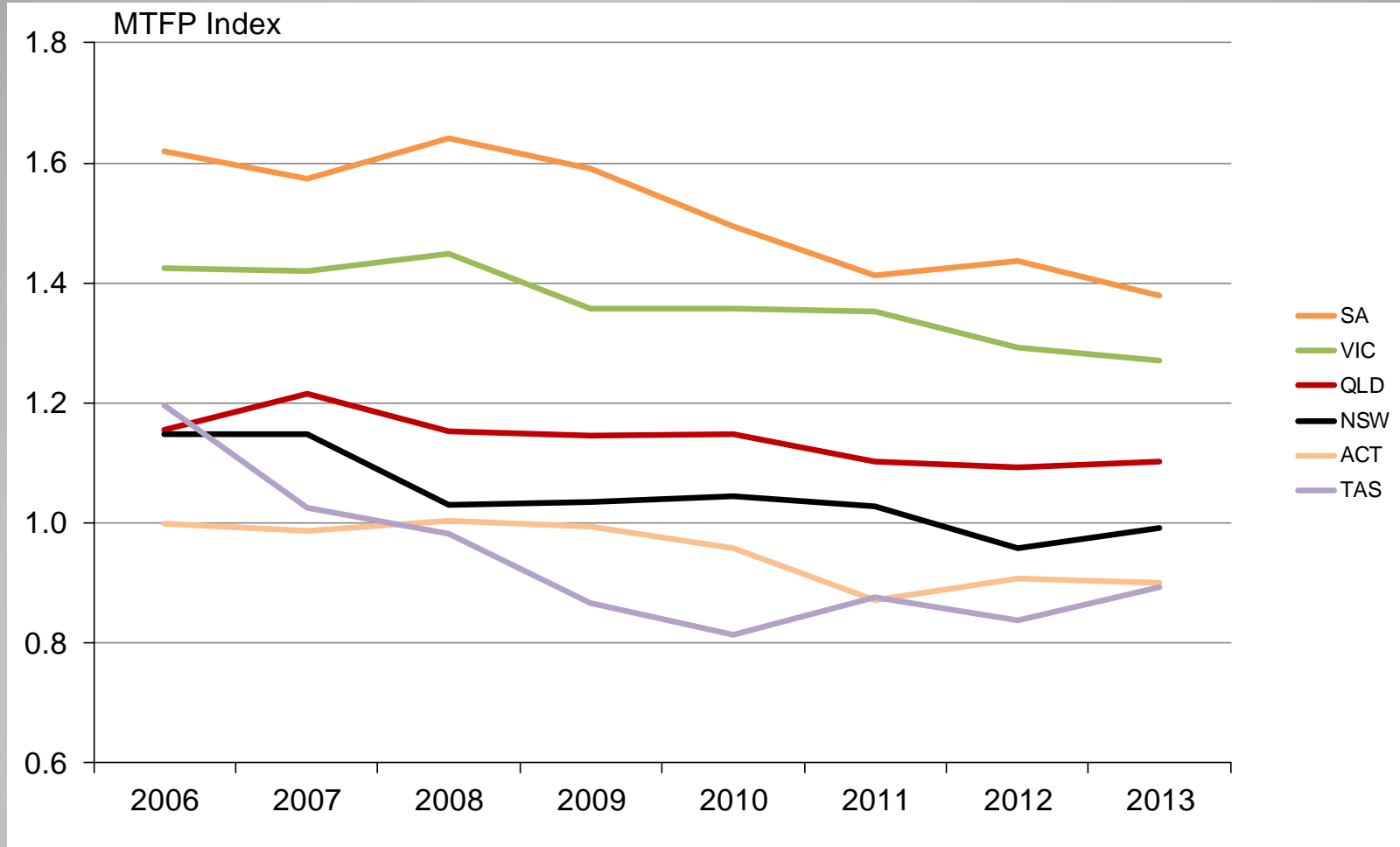
- Opportunities for services to be provided more efficiently
- Assessment and management of risk
- Demand
- Financial market conditions

**Key driver –
efficiency**

Key driver - efficiency

- Better Regulation benchmarking consultation started in 2012
- Produced robust, consistent data set
- Models prepared by benchmarking consultant – Economic Insights
- Overall benchmarks (MTFP) indicate:
 - Productivity across the sector been in decline
 - VIC / SA DNSPs most productive
 - NSW/ACT least productive

Key driver – efficiency

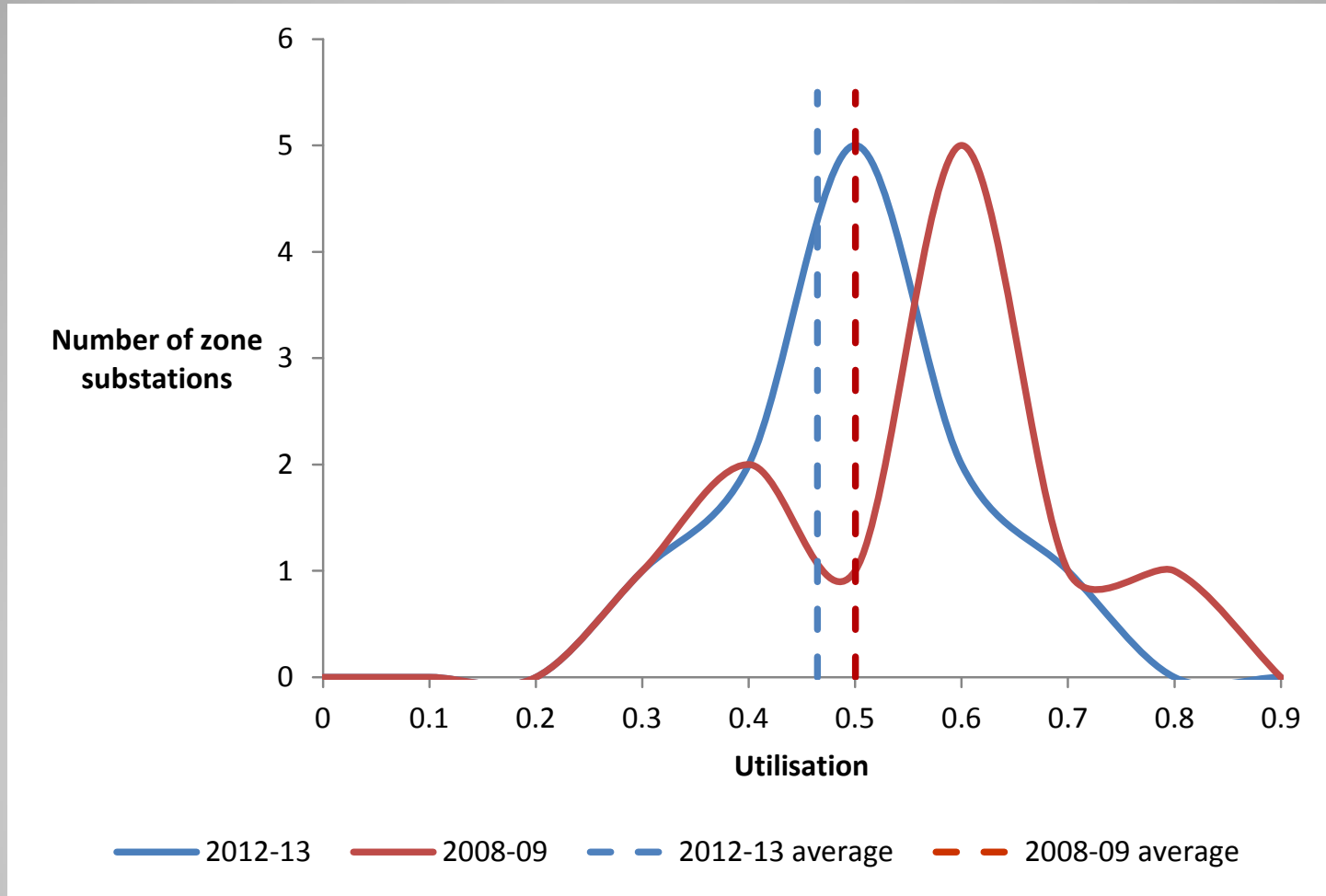


Key driver – risk assessment and management

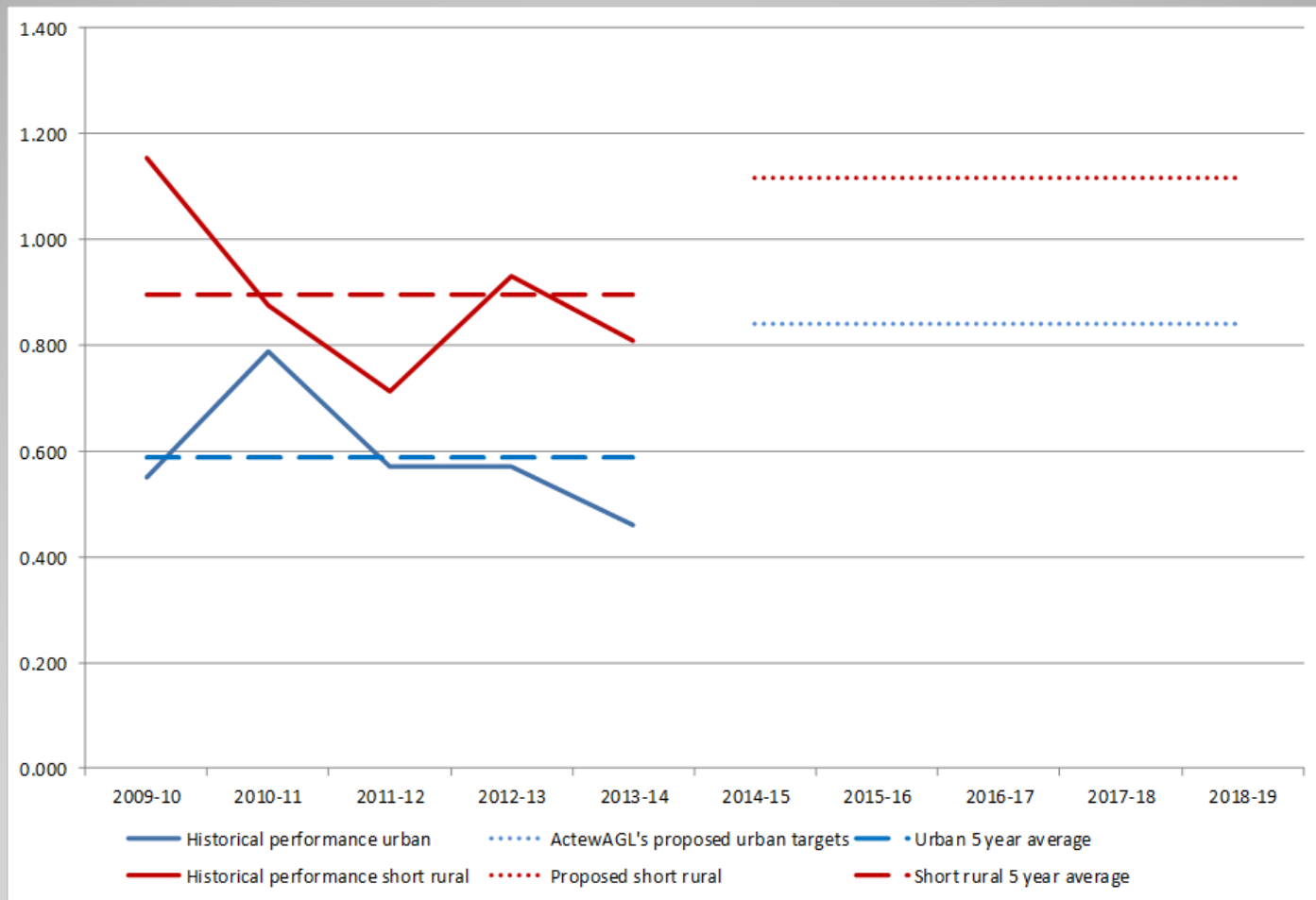
Issues in risk assessment and management

- Generally seeing improvement in the risk profile of the businesses
- ACT Government has adjusted reliability standards
- In addition, trend improvement in high level indicators of risk on the networks
 - Utilisation
 - Service performance

Network utilisation - ActewAGL



ActewAGL SAIFI – urban and short rural



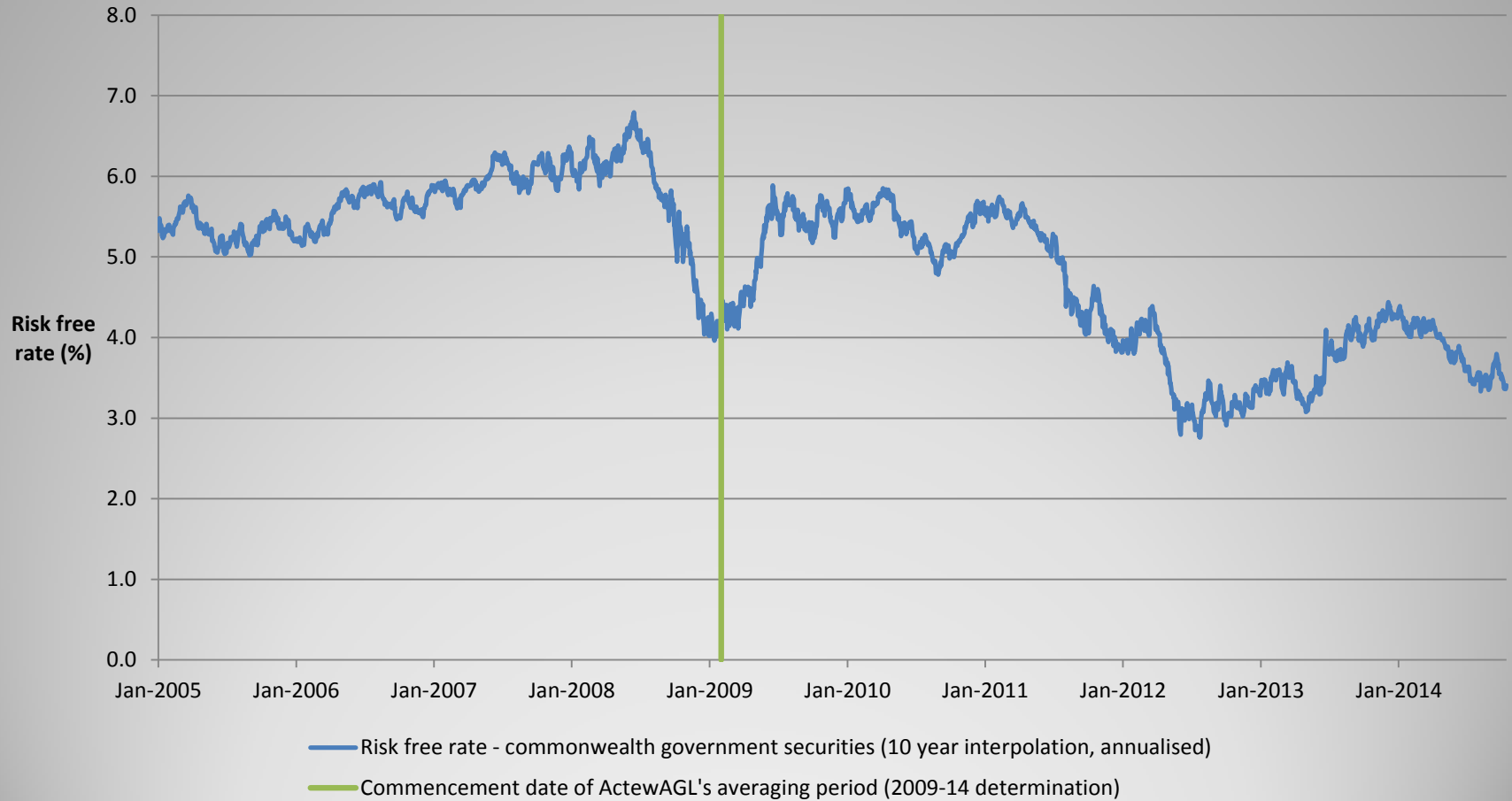
**Key driver -
demand**

Demand forecast – ActewAGL and AEMO



Key driver – financial market conditions

Financial market conditions



Main elements of the decision

Elements

- Regulatory Asset Base (RAB)
- Capital expenditure (capex)
- Operating expenditure (opex)
- Rate of Return (RoR)

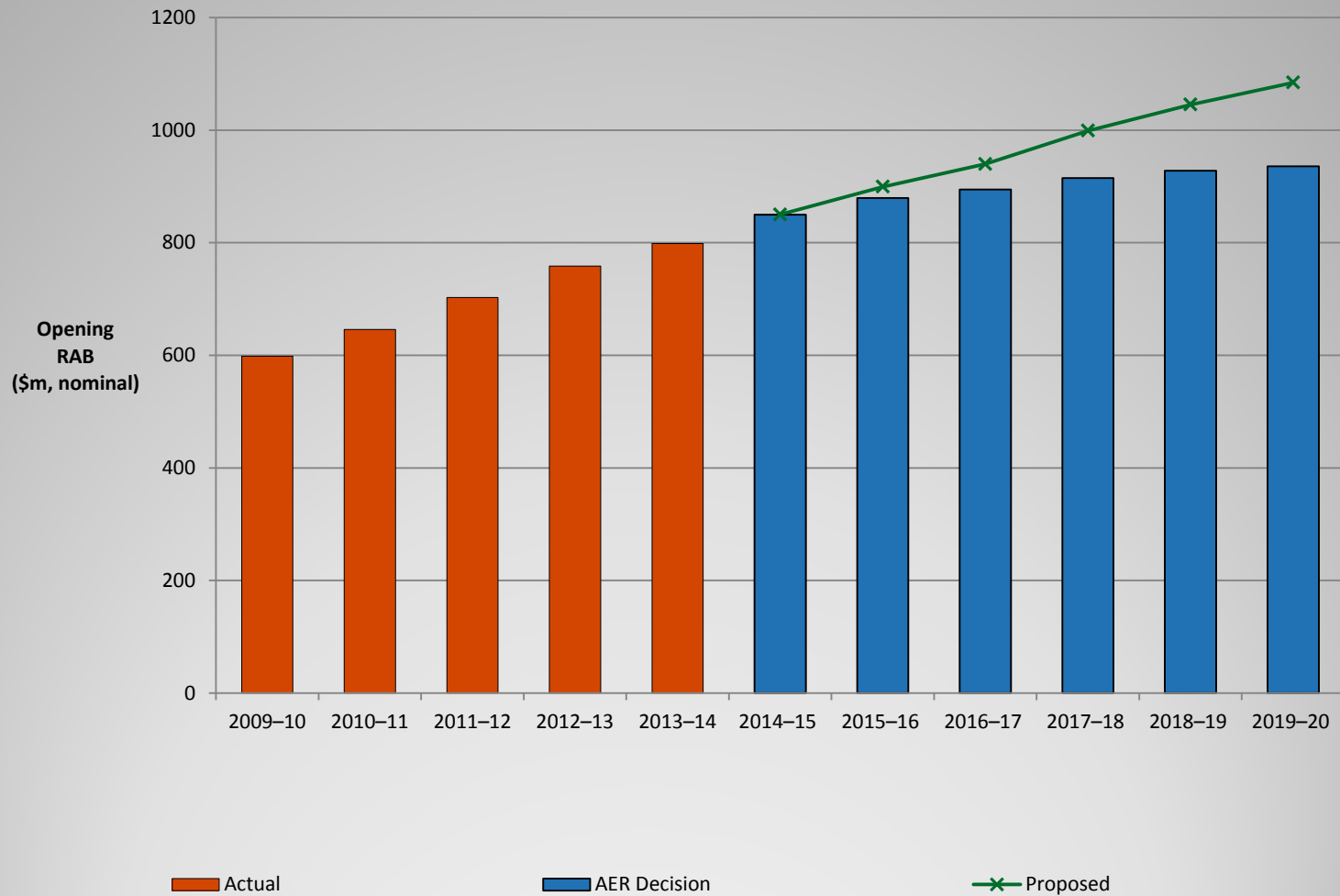
Regulatory asset base (RAB)

RAB

- Our draft decisions provide for increases in the businesses' RAB
- But at a lower rate than proposed

Regulatory asset base – ActewAGL

- Distribution and transmission



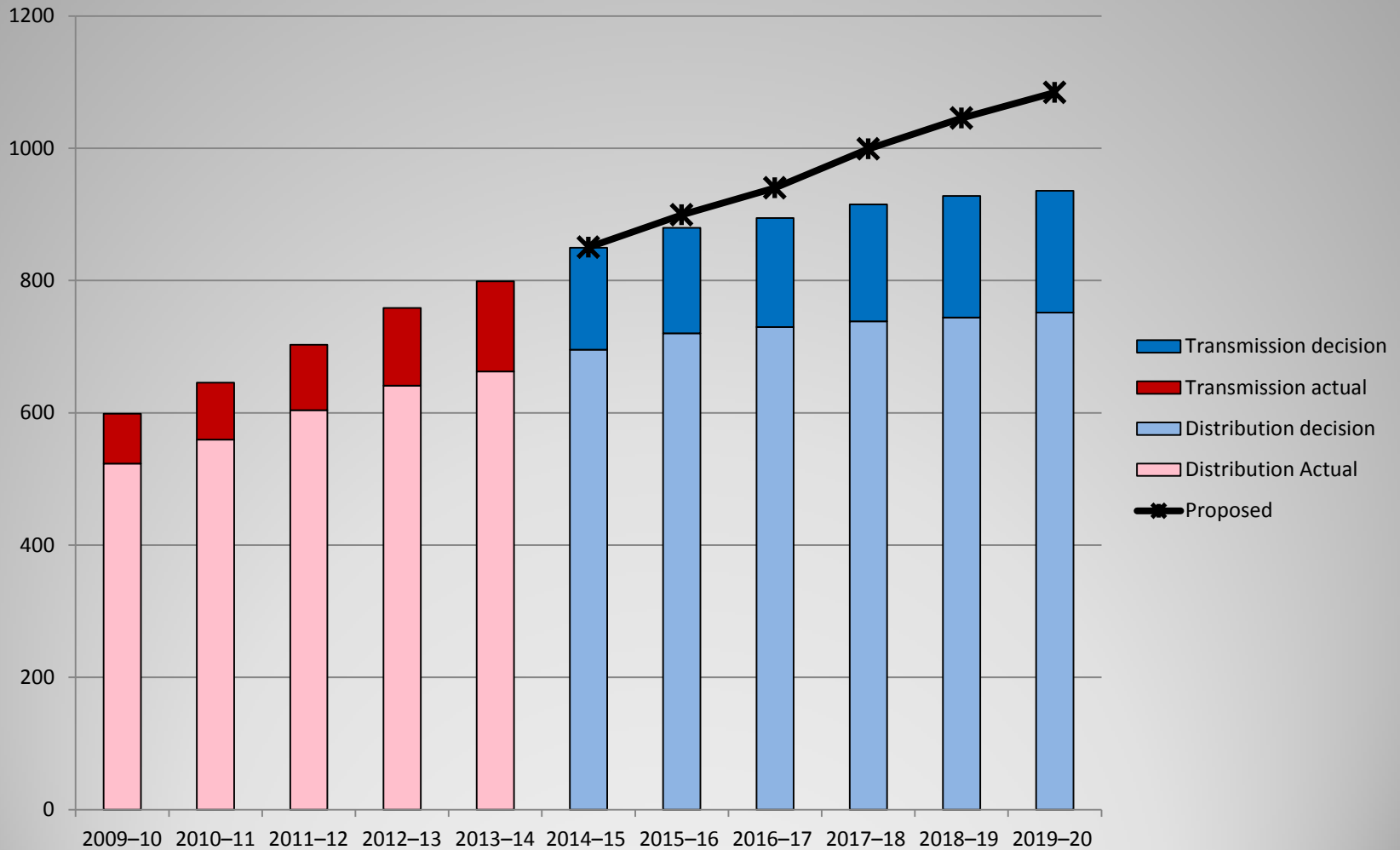
Dual function assets

Regulatory asset base—ActewAGL distribution

- Due to the addition of a second supply point into Canberra, ActewAGL's network can act like a transmission network.
- Under the Rules, ActewAGL can apply transmission pricing to those assets that provide a transmission service: dual function assets.
- We estimate 18% of ActewAGL's assets are dual function assets.
- Note, transmission charges are also recovered all of NSW.
- Net result is that a significant amount of ActewAGL's revenues can be recovered from NSW customers (putting downward pressure on ACT network charges).

Dual function assets – ActewAGL

- transmission and distribution RAB

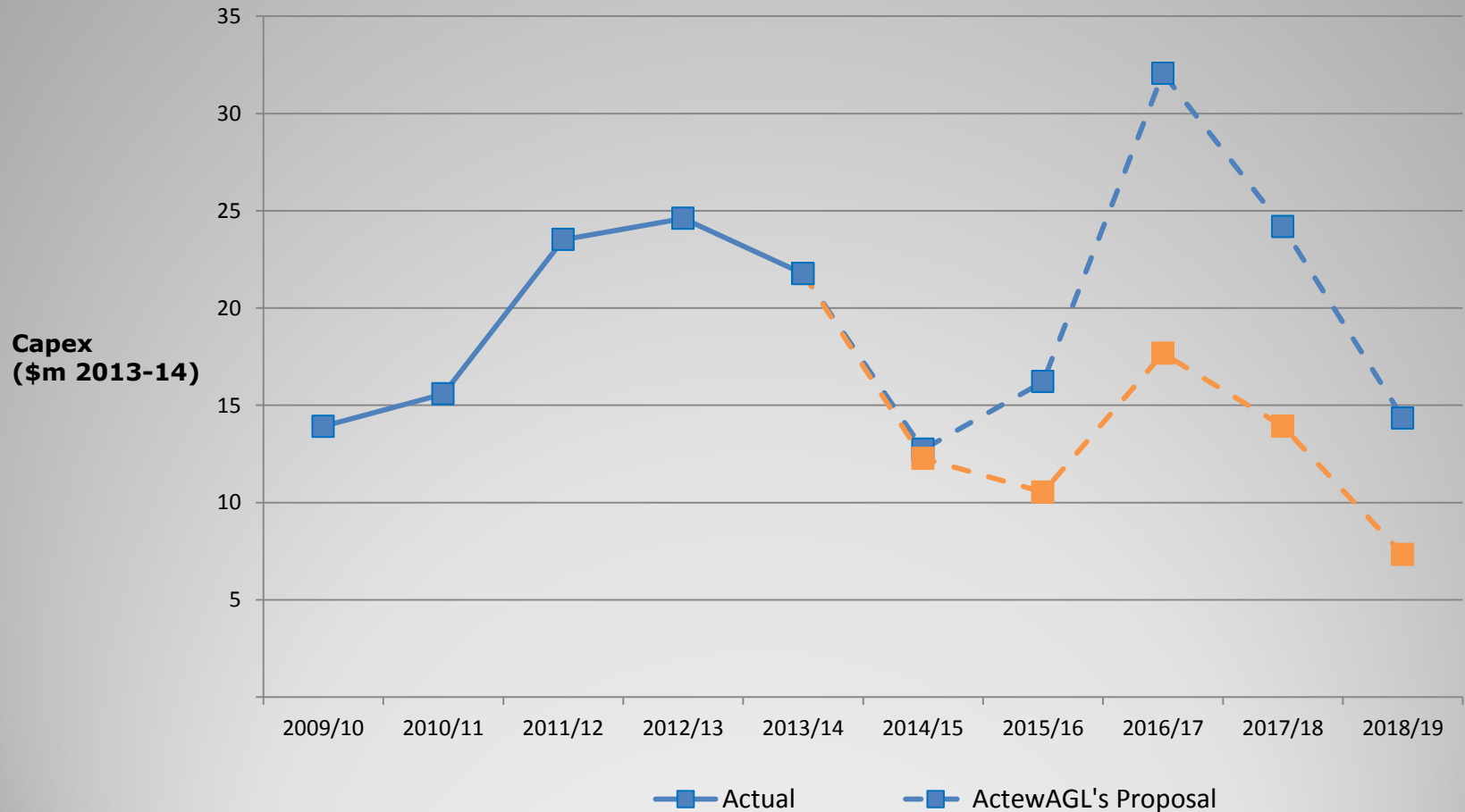


Capital expenditure (Capex)

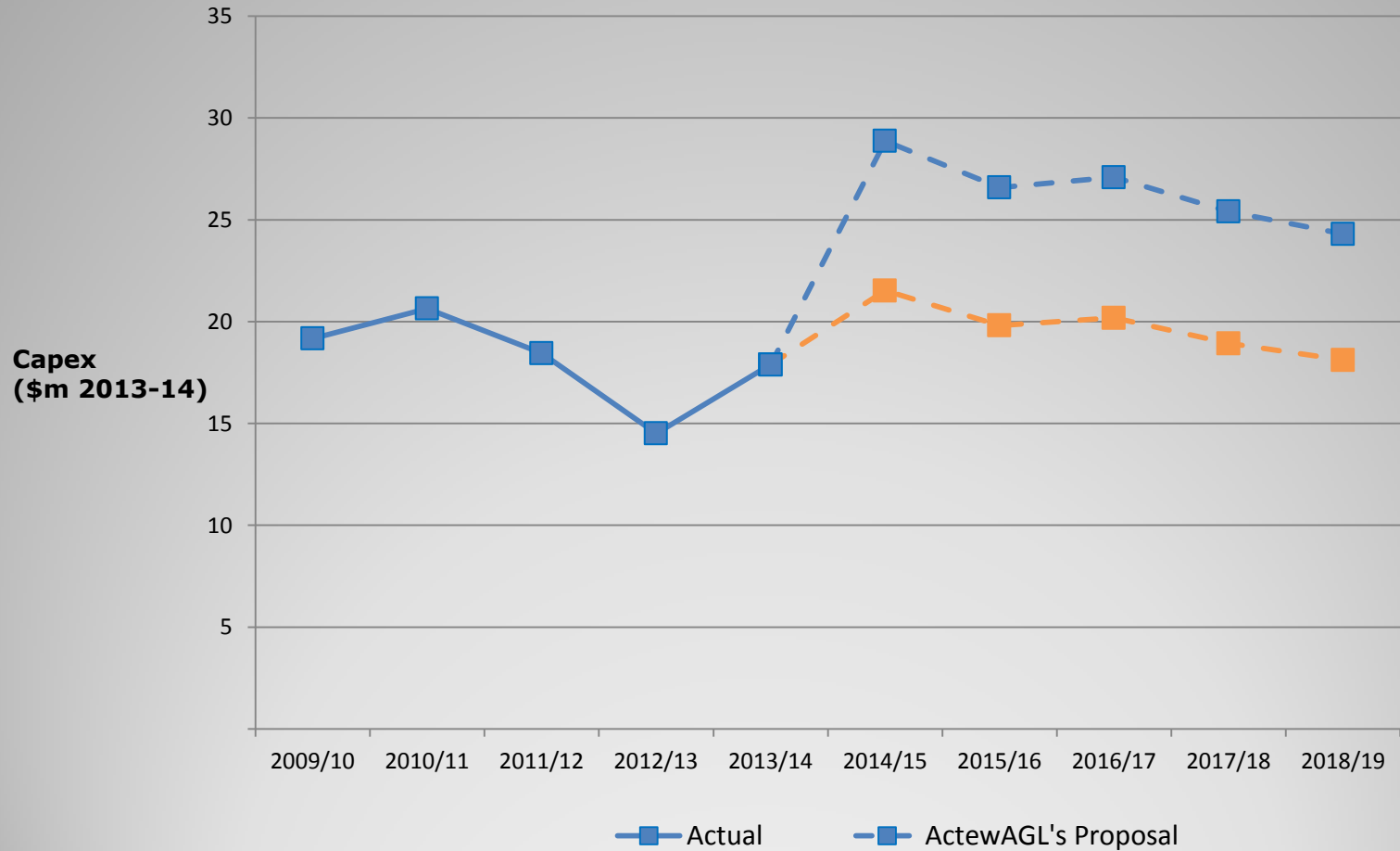
Capex

- Augmentation expenditure (augex)
 - Key drivers of augmentation expenditure are
 - maximum demand and
 - reliability standards
- Replacement expenditure (repex)
 - Replacing an asset with its modern equivalent where the asset has reached the end of its economic life.

ActewAGL – Augex



ActewAGL – Repex



Operating expenditure (Opex)

Opex criteria

- The opex criteria provide that the total forecast must reasonably reflect:
 - the efficient costs of achieving the operating expenditure objectives
 - the costs that a prudent operator would require to achieve the operating expenditure objectives
 - a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives.

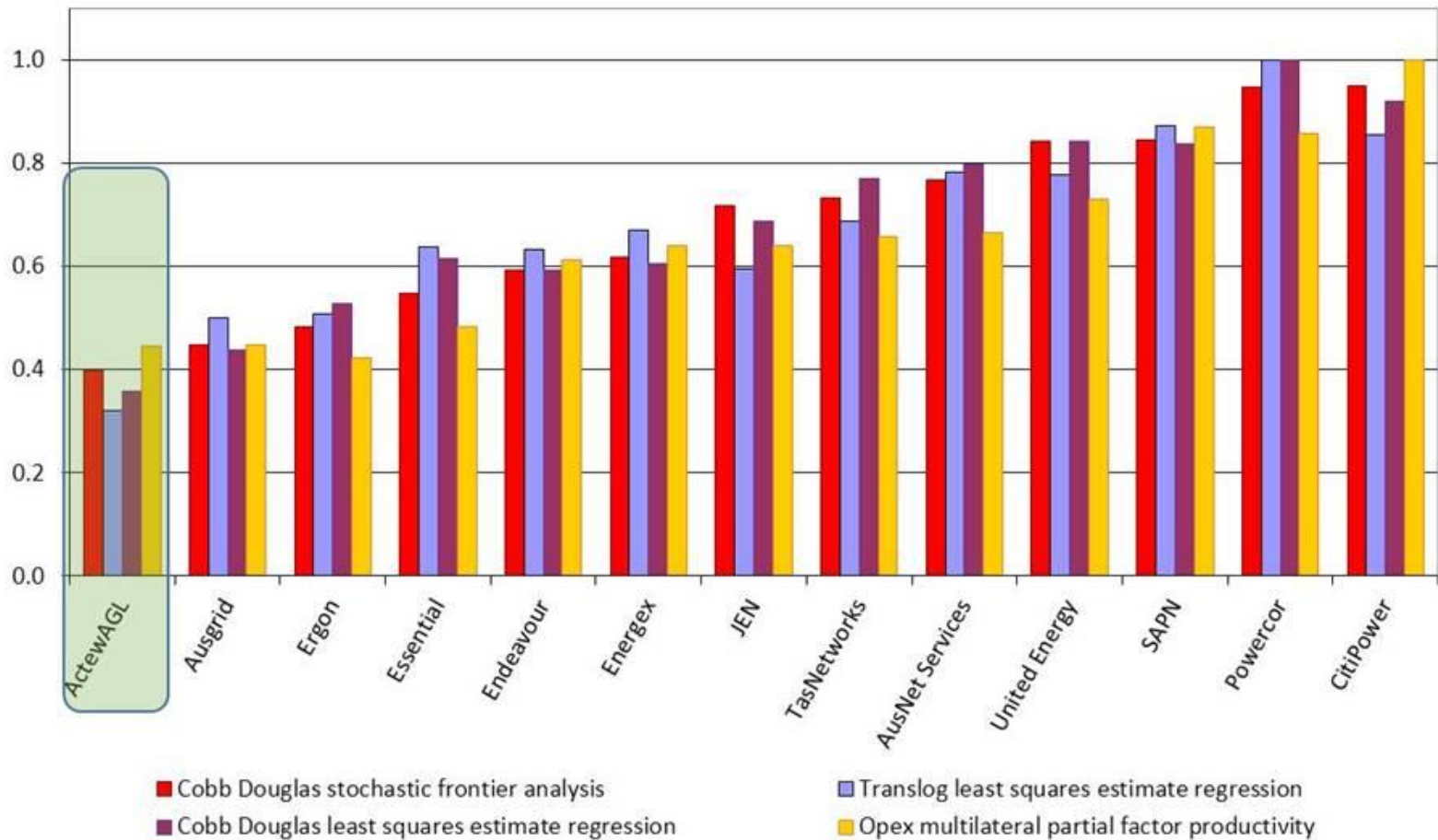
Opex

- Base-step-trend approach
 - Select an efficient base level
 - Typically the revealed cost in a particular year
 - In this case we have looked carefully at the efficiency of the base year
 - Step changes to take account of external drivers such as changes to regulatory obligations
 - Trend underlying costs such as labour cost escalations

Base opex

- In light of previous productivity estimates we have carefully reviewed the efficiency of the base opex of each business
- Developed cost modelling and other detailed assessments
 - Accounts for customer density, demand density and underground assets
 - Also considered voltages, asset age and climate
- Peers in other states are able to provide safe reliable services at lower overall levels of opex

Benchmarking



Contributing factors

- **Labour and workforce management**
 - Increases in the number and costs of employees during period
 - Restrictions on outsourcing, and low outsourcing relative to peers
 - Restructuring that has led to an outlay of costs but corresponding benefit not quantified
- **Vegetation management**
 - Proactive instead of reactive approach could have mitigated recent increases
 - Approach to contracting does not provide appropriate incentives to reduce costs

Adjustment to base opex

- AER concluded that combination of evidence indicated that base opex for ActewAGL could not be used as our starting point
- Benchmarking used to determine scope of adjustment

Step changes – ActewAGL

- ActewAGL proposed \$35 million in step changes
- For most proposed step changes, we were not satisfied ActewAGL would face an increase in its opex
- We included \$1.4 million in step changes in our opex forecast where we were satisfied ActewAGL would face increased costs due to new regulatory obligations.

Rate of return

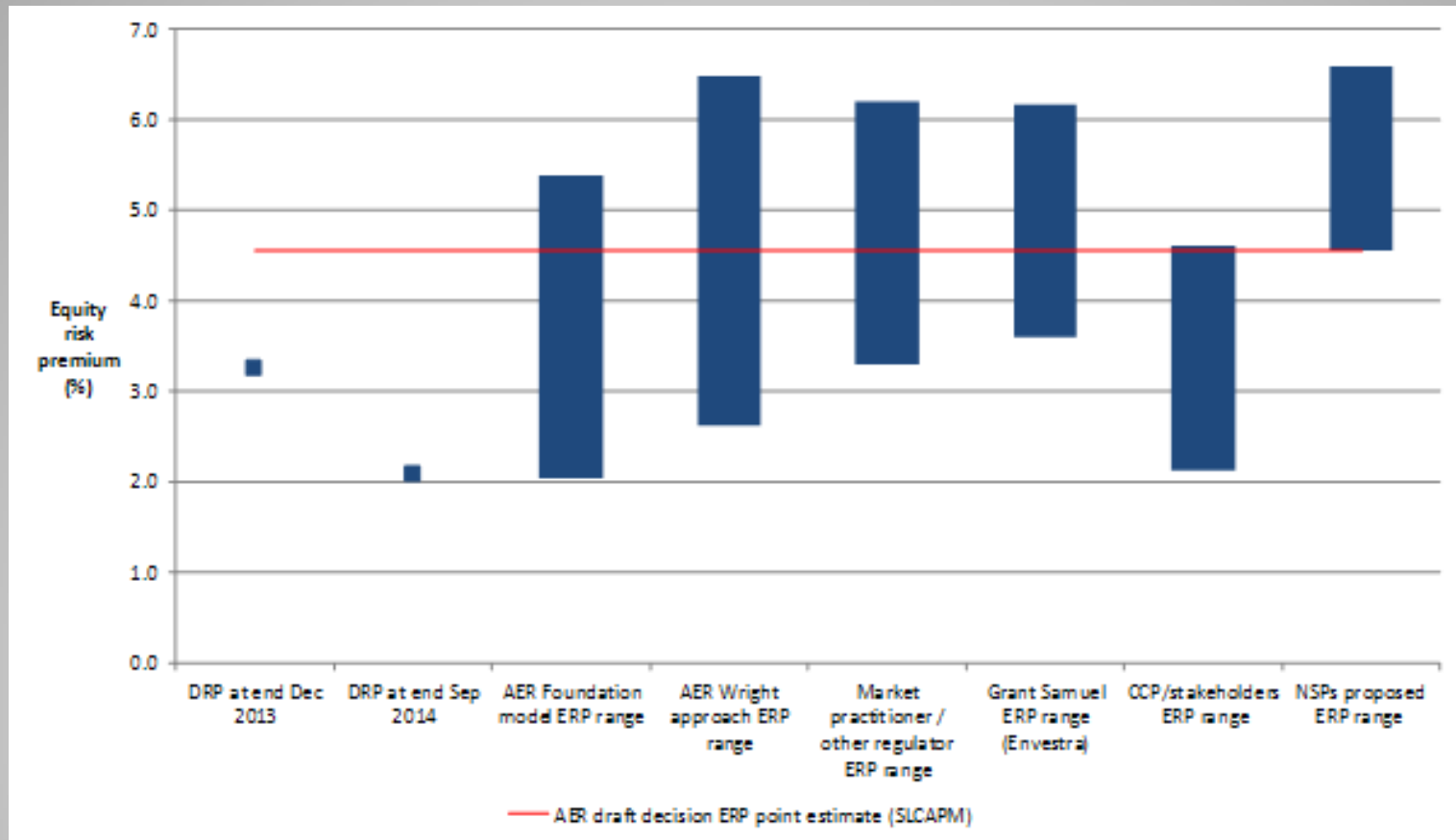
RoR

	2009–14 AER decision	2015–19 ActewAGL's proposal	2015–19 AER draft decision
Nominal risk free rate (cost of equity)	4.29%	4.12%	3.55%
Nominal post–tax return on equity	10.29%	10.71%	8.1%
Nominal pre–tax return on debt	7.78%	7.85%	6.07%
Nominal vanilla WACC	8.79%	8.99%	6.88%

Return on Equity (RoE)

- No single objective measure of expected RoE
- Employ a 6 step process to make use of all available information according to its merits
- Use Capital Asset Pricing Model (CAPM) as our foundation model
- Then review outcome of foundation model against other information that can inform our decision
- Outcome of foundation model consistent with other indicators

RoE



Return on Debt

- How to estimate RoD?
 - RBA series or Bloomberg series
- Type of methodology
 - On-the-day, trailing average or some combination
- Advantages and disadvantages of each approach, but we selected the trailing average approach
 - Wide support from customers and networks
 - Reduces year to year volatility in prices
 - Reduces interest rate risk for networks

How to commence the trailing average?

- We applied the approach set out in our RoR guideline
 - New debt incorporated as it is progressively refinanced each year
 - Our starting point for existing debt is continuation of on-the-day approach
 - Consistent with the application of the benchmark efficient approach
 - Avoids windfall gains and losses
 - Preserves the outcomes and risk profile of the debt strategies chosen by the businesses under incentive regulation

Gamma

- No single objective indicator
- Draw on a wide range of material to inform our decision
- In guideline we said 0.5
- After reviewing material and latest estimates we have updated to 0.4

Consumer engagement

Consumer engagement

- Seen as increasingly important
 - AEMC in its 2012 rule determination require
 - .. the NSP to indicate in its regulatory proposal the extent to which it has engaged with consumer representatives. The NSP must also include an overview paper in its proposal for consumers...
- Still a work in progress from all parties, but we are making advances
 - Unprecedented level of consumer engagement in the AER's decision making process
 - Better regulation process
 - Submissions
 - Engagement activities of businesses

CCP

- On 1 July 2013, the AER established the CCP as part of our Better Regulation program
- The CCP assists the AER to make better regulatory determinations by providing input on issues of importance to consumers.
- In December 2013 the AER published its consumer engagement guideline

Summary of submissions

- Around 10 submissions
- Most submissions considered regulatory proposals are not in the long term interests of consumers
- We have taken all submissions from stakeholders into account in reaching our draft decision
- Based on the submissions and our consultation with consumers, we are not satisfied that the proposals adequately reflects the views of consumers

Next steps

Task	Date
Pre-determination conference/ public forum on AER draft decisions	8 December 2014
Distributors submit revised revenue proposals	20 January 2015
Stakeholder submissions on AER draft decisions and revised revenue proposals close	13 February 2015
AER issues final decision	By 30 April 2015