



30 November 2017

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Dear Mr Roberts,

***Operating Expenditure Issues Paper on the remitted decisions for NSW/ACT 2014-19 electricity distribution determinations***

Ausgrid welcomes the opportunity to comment on the Australian Energy Regulator's (AER's) issues paper entitled "Remitted decisions for NSW/ACT 2014-19 electricity distribution determinations | Operating Expenditure" (Issues Paper) published on 19 October 2017. We make the following key points in this submission:

1. **Ausgrid has achieved substantial reductions in operating expenditure over 2014-19.** Overall we have reduced our ongoing operating expenditure by close to 20% compared to levels contemplated in our 2014-19 revised proposal (from January 2015). This significant change to the cost structure was difficult for the business and particularly for affected employees.
2. **There were considerable constraints on the speed and the cost at which Ausgrid could reduce the size of its workforce.** These constraints were imposed by the enterprise bargaining agreements (EBAs) and the *Electricity Network Assets (Authorised Transactions) Act 2015 (NSW) (ENAA Act)* which was implemented to enable IFM and AustralianSuper's long term lease of 50.4% of Ausgrid. We have worked within the constraints of our EBA and the ENAA Legislation to meet our obligations to our employees and at the same time deliver lasting savings to customers.
3. **Ausgrid has had no certainty that it would be able to recover the costs incurred,** providing extremely strong incentives to deliver the savings and ongoing operations and maintenance at lowest possible cost.
4. **We are proposing that customers receive all of the benefits of the reduced levels of operating expenditure we have achieved.** This is a better outcome for customers than would be achieved under the standard incentive framework within the rules. In this process we are seeking to recover the efficient costs incurred and those required to reduce our operating expenditure to levels in line with the AER's original 2014-19 determination.

Over the 2014-19 period, Ausgrid embarked on a transformation program that is on track to deliver substantial and ongoing savings for customers. Through this transformation program, Ausgrid will realise annual opex savings of close to 20 per cent, the benefits of which we propose be fully passed through to customers in the 2019-24 period. These savings are the result of us responding to the significant reductions to operating expenditure allowances applied in the AER's original 2014-19 determination. We have had to find a way to operate our network with a lower cost base without sacrificing safety or reliability.

The strides we have taken to lower our cost base reflect our acknowledgement of customer calls for more affordable electricity network services over the 2014-19 period. However, rather than simply moving from a prior 'inefficient' level of opex to a now lower 'efficient' level of opex, the lower cost base reflects a change from the prior period where Ausgrid's primary challenges related to the need to augment our network to address growth in summer peak demand and to comply with new reliability performance standards.

In the past, mandated licence conditions, which increased reliability standards, and rising peak demand led to a rapid increase in capex from 2007 to 2012. Our operating cost base also had to increase to support this higher level of activity. Now we are adapting to changes in the energy sector and addressing customer concerns regarding affordability. In response, we have lowered our costs as quickly and efficiently as possible.

## Efficiency of Ausgrid’s revealed costs to date

### Responds to Question 1 of the AER’s issues paper

The Issues Paper asks whether it is reasonable for the AER to rely on the revealed opex costs or revised opex targets of network service providers (NSPs).

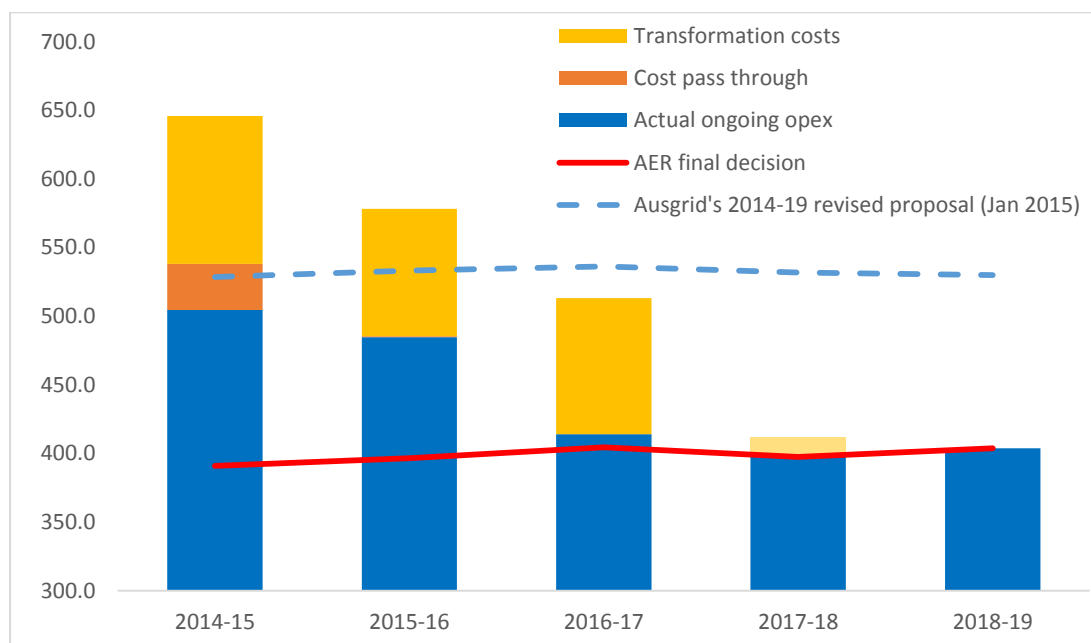
The costs we have incurred, including those needed to deliver opex savings reveal the efficient costs required to achieve a significantly lower cost base (close to the AER’s original determination allowance) by the end of 2017-18. Ausgrid has had no certainty about the costs that we would be allowed to recover through the remittal process. We have therefore had to achieve the quickest transformation at the lowest possible cost. To do otherwise would have further reduced the tight operating margins that Ausgrid faced over 2014-19 period.

Over the 2014-19 period, Ausgrid has achieved consistent improvements in its opex performance. The Issues Paper notes that Ausgrid’s total opex peaked in 2014-15, but this figure does not reflect our success in driving future affordability outcomes for customers. Specifically, the total opex includes:

- the cost incurred by Ausgrid to respond to the severe 2014 storms, these costs have been reviewed by the AER and accepted as an approved cost pass through; and
- the costs of our transformation program, i.e. the costs of releasing staff identified as redundant, which is the primary driver of the reductions in our ongoing opex costs.

These costs are not anticipated to be incurred on an ongoing basis. Removing these costs provides a better picture of our success in delivering affordability outcomes to customers. Figure 1 sets out the movement in Ausgrid’s ongoing opex.

**Figure 1 – Ausgrid actual/forecast opex and final decision (\$m, real 2013-14)\***



*Note: We have estimated transformation costs that will be incurred in 2017-18, but this is subject to change depending on circumstances over the rest of this financial year. We have forecast actual opex in 2018-19 to be aligned with the original AER determination for 2014-19, but this is also subject to change based on circumstances up to the end of 2018-19.*

The transformation program is on target to realise a significant reduction in ongoing opex and we anticipate that our opex (excluding transformation costs) will be at or below that set out in the AER’s original 2014-19 determination by the end of 2018-19.

## Treatment of transition costs

### Responds to Question 3 and 4 and 7 of the AER's issues paper

The Issues Paper invites views of stakeholders on how transition costs should be treated.

It is not clear from the Issues Paper exactly which costs the AER intends to classify as 'transition costs'. However we understand that the AER may be referring to any costs incurred during transition years over and above the end point (or target) allowance. The AER refers to the difference between actual opex in each year and the AER forecast as providing an 'upper ceiling on potential transition costs'.

The AER refers to two types of costs that may arise during a transition to a lower level of opex:

- transitional transaction costs, which typically include the cost of making redundancy payments and/or early termination payments; and
- inefficient costs that a distributor may continue to incur in the short term as it moves towards a lower level of opex.

In Ausgrid's experience, not all transition costs (in the sense referred to above) will fall into these two categories. There may be efficient costs incurred during a transition to a lower level of opex that are not transaction costs. For example, as noted above, the relatively high level of total opex in 2014-15 was partly driven by factors unrelated to transitional transaction costs (e.g. Ausgrid's response to severe storms, the cost of which was found to have been efficient). Therefore it is not correct to treat any expenditure above the end-point allowance as either attributable to transaction costs or as being simply inefficient.

For Ausgrid, in addition to severe weather there are several other reasons why actual costs over the past three regulatory years have been above the AER's original 2014-19 determination opex allowance. The primary driver of our transformation costs is related to reducing our workforce size. Since 2010-11, Ausgrid has eliminated almost 3,000 full-time equivalent positions, a 44% reduction in our workforce. This has had a profound impact not just on the employees directly affected but also on our wider workforce.

We are managing our workforce and improving its productivity within the current industrial environment. However, the changes to our workforce have come at a cost. These costs primarily arise from obligations imposed by our enterprise bargaining agreements (EBAs).

During the period of transition, Ausgrid has also been subject to employment guarantee obligations and prohibitions on forced redundancies under the *Electricity Network Assets (Authorised Transactions) Act 2015* (NSW) (ENAAAT Act). Since 1 July 2015, Ausgrid has been required to retain at least 3,570 full time equivalent employees, pursuant to Schedule 4 of the ENAAAT Act. The ENAAAT Act also prohibits forced redundancies (except as agreed with employees or in accordance with the *Fair Work Act 2009* (Cth)) and restricts Ausgrid's ability to vary enterprise agreements. This is an additional regulatory obligation that has come into force since the AER made its original decision for the 2014-19 regulatory control period, and which materially affects the supply of electricity network services.

The reasons of the Australian Competition Tribunal (the Tribunal)<sup>1</sup> provided significant support to our view that opex incurred pursuant to the obligations under our EBAs is required to achieve the opex objectives and reflects the opex criteria. Specifically, the Tribunal stated that:<sup>2</sup>

*That is because the EBAs may be reasonably regarded as:*

- (a) otherwise required to achieve an opex objective, namely, the r 6.5.6(a)(4) objective to: "maintain the safety of the distribution system through the supply of standard control services"; and*
- (b) reasonably reflecting the opex criteria in r 6.5.6(c)(3): "a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives."*

The Tribunal also noted that even if EBA's were not a regulatory requirement or obligation:<sup>3</sup>

*... the Networks NSW DNSPs are bound by their EBAs as a matter of law. Unlike a contract, which according to its terms may be terminated, an EBA continues in force until its nominal expiry date after which it may, with the approval of the Fair Work Commission, be terminated by agreement between an employer and the employees it covers.*

<sup>1</sup> Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1.

<sup>2</sup> Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, paragraph 418.

<sup>3</sup> Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, paragraph 427.

Further, the Tribunal stated that the transformation costs imposed by our EBAs are unavoidable.<sup>4</sup>

*Here the Networks NSW DNSPs are shackled with EBAs that effectively restrict their ability to efficiently reduce their workforce in the regulatory period – that restriction being attributable to an exogenous factor, namely, the Fair Work Act 2009 (Cth).*

The Tribunal ultimately found that the AER erred in treating the EBAs as an endogenous factor to be ignored in the AER’s estimate of total opex to be made pursuant to cl 6.12.1(4)(ii). The Tribunal observed that Ausgrid remains bound by the EBAs, and that they should not be viewed as an endogenous managerial choice. The Tribunal rejected an approach which simply characterised an obligation as endogenous and to be ignored or as exogenous and to be considered. This suggests the EBA obligations should be considered as part of a fulsome analysis to determine efficient opex costs.

In circumstances where Ausgrid has committed to reducing the size of its workforce in order to deliver cost savings for customers, it must incur transformation costs to deliver these savings. Ausgrid is bound to incur these costs as a matter of law. To the extent that Ausgrid management faced a choice, it was a choice between:

- not incurring transformation costs and retaining a larger workforce; or
- incurring transformation costs and moving to a smaller workforce and commensurately lower level of opex.

By virtue of the EBAs, Ausgrid management did not have an option to move to a smaller workforce without incurring transformation costs.

In other words, the ongoing opex savings achieved over the 2014-19 period have been made possible through our investment in the transformation program. The costs of this investment are efficient since they are the lowest cost means of achieving the ongoing opex savings while complying with our obligations under our EBAs. While it was possible for us to rely on natural attrition to reduce our workforce size, this strategy would have been insufficient to reduce our operating costs by 20 per cent over a five-year period. **Our preliminary internal analysis suggests that every dollar spent on the transformation program will deliver five dollars of opex savings to customers.**

The reductions in our actual and forecast opex compared with a base-step-trend approach over the 2014-19 period are set out below in Figure 2.

**Figure 2 Ausgrid’s actual/forecast opex compared to Ausgrid’s Jan 2015 revised proposal (\$’m, 2013-14)**

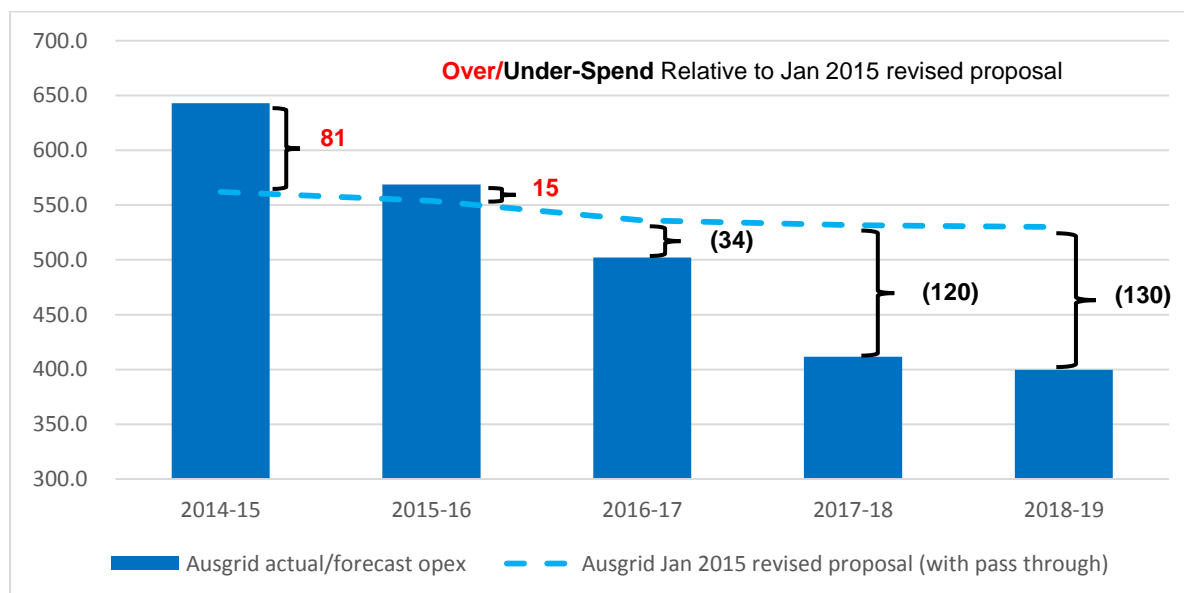


Figure 2 shows that in 2014-15 we overspent on opex compared with our revised proposal (including pass through amounts) by \$81.1 million (\$real 2013-14). However, our transformation program is on track to deliver a reduction in ongoing opex of \$130.2 million (\$real 2013-14) by 2018-19 compared to our revised proposal.

<sup>4</sup> Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, paragraph 435.

## The costs and benefits from transition to a lower level of opex

### Responds to Questions 3 and 5 of the AER's issues paper

The AER's Issues Paper asks whether the costs of transition to a lower level of opex should be borne by customers or businesses (or shared between customers and businesses).

As explained above, the costs that have been (and continue to be) incurred by Ausgrid in transitioning to a lower level of opex reflect the efficient costs of achieving the operating expenditure objectives, and the costs that a prudent operator would require to achieve those objectives. Put another way, these reflect the efficient costs that Ausgrid has incurred (and continues to incur) in providing direct control network services and complying with relevant regulatory obligations in the current regulatory control period. Therefore Ausgrid must be afforded a reasonable opportunity to recover these costs.

The key question is *how* these costs are recovered, and what this recovery profile implies for sharing of the costs and benefits associated with the transition to a lower cost base, as between Ausgrid and our customers.

Ausgrid proposes a transition path that ensures customers get the maximum value of the lower ongoing level of opex that Ausgrid will achieve by the end of the 2014-19 regulatory period. This is a better outcome for customers than would be achieved under the standard incentive regime established under Chapter 6 of the NER.

It would heavily undermine the incentives to reduce opex under the regulatory regime if businesses had to fund the transition costs required to provide ongoing opex savings to customers. If businesses were required to fund the costs of transition in this way, they would effectively be penalised for reducing opex and there would arguably be a strong incentive not to reduce opex.

Allowing the recovery of efficient transformation costs will provide businesses with the confidence to make the right investments necessary to adapt in the future. Providing businesses such confidence will ensure that investments are made to transform their operations - even when it implies the previous operating model is no longer the most efficient.

We have analysed two scenarios to illustrate the costs and benefits accruing to customers from the transformation program that Ausgrid has undertaken:

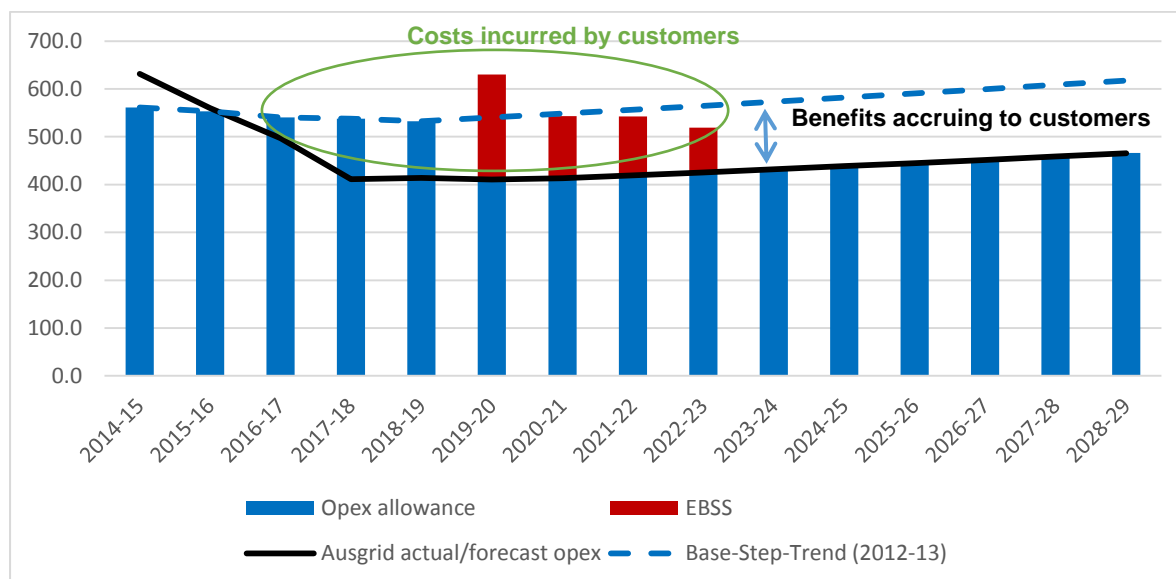
- Scenario 1 – Standard base step trend allowance with opex Efficiency Benefit Sharing Scheme (EBSS) for 2014-19; and
- Scenario 2 – Use of revealed efficient transition costs for 2014-19

As demonstrated below, under scenario 2 the benefit to customers is maximised. This is because the benefit of efficiency gains associated with Ausgrid's transformation program are immediately passed through to customers, instead of these gains being partially retained by Ausgrid after they accrue.

#### **Scenario 1 – Standard base step trend allowance with EBSS for 2014-19**

Under the standard framework that applies to all electricity networks regulated by the AER – other than Ausgrid, ActewAGL and Essential Energy for 2014-19 – the benefits of any efficiency savings that businesses achieve are shared 70:30 between customers and businesses, respectively, through the operation of the EBSS. The EBSS framework envisages that NSPs retain the benefits of reduced operating expenditure for a period of six years (the year in which the efficiency is achieved and 5 years after), but beyond that point the benefits of the reduced operating expenditure are passed through to customers. Figure 3 illustrates the operation of the EBSS.

**Figure 3 Ausgrid’s actual/forecast opex and net opex allowance under the EBSS (\$’m, real 2013-14)**



**Under Scenario 1:**

**Costs incurred by consumers**

= Opex allowance for 2014-19 in excess of Actuals + EBSS incentive payment to Ausgrid  
 = \$526m

**Benefits to customers**

= Ongoing reductions in opex accruing to customers  
 = \$1,519m

Under this scenario for every dollar incurred by customers under this scenario, customers receive around 3 dollars of savings over the long term.

Figure 3 shows that, under the standard framework, Ausgrid would fund the transition cost above the base-step-trend opex allowance (the blue dotted line) in 2014-15 and 2015-16, but then would retain the benefits of lower opex in 2016-17, 2017-18 and 2018-19 and receive an efficiency reward over the 2019-24 regulatory period. By the end of the 2019-24 period, all the costs and benefits of the transition costs incurred would be passed through to customers, thereby driving substantial cost savings for customers into the future. Importantly, the EBSS would also provide a penalty if Ausgrid’s opex increased above the base-step-trend allowance.

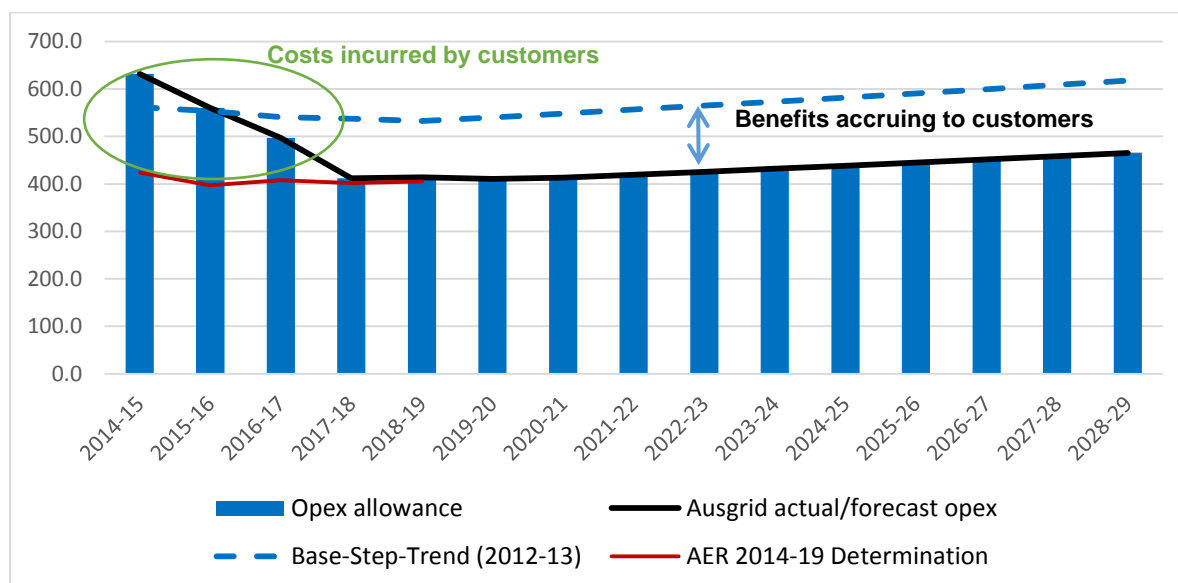
The EBSS framework provides incentives for a NSP to implement programs that ultimately result in lower network costs for customers. Further, the opex incentives also complement both:

- the capital expenditure incentives that ensure that opex reductions are not achieved through inefficient reductions in capital expenditure; and
- the service quality incentives that make sure that opex reductions are not achieved through inefficient reductions in service quality.

**Scenario 2 – Use of revealed efficient transition costs for 2014-19**

Rather than adopt the standard framework for 2014-19 we submit that from 2016-17 customers receive 100% of the opex savings Ausgrid has achieved and only fund the efficient transformation costs necessary to deliver those opex reductions. Figure 4 illustrates our proposal for customers to retain 100 per cent of the long-term benefits of the transformation program and fund only the short-term transitional costs.

**Figure 4 Ausgrid’s actual/forecast opex and net opex allowance under our proposal (\$’m, real 2013-14)**



**Under Scenario 2:**

**Costs incurred by consumers**

- = The efficient costs of transformation above the original AER determination allowances
- = \$431m

**Benefits to customers**

- = Total value of ongoing reductions in opex compared to no transformation scenario
- = \$2,059m

Under this scenario, for every dollar incurred by customers, they receive close to 5 dollars of savings over the long term.

Figure 4 shows that our proposal will pass to customers all reductions in opex generated by our transformation program from 2016-17 and would only fund the efficient transformation costs necessary to deliver those opex reductions. This proposal drives a reduction in opex per customer of \$77 per annum from the start of the next regulatory control period, 2019-24 compared to a situation where we had not pursued cost reduction initiatives.

**Comparison of total costs and benefits to customers under Scenarios 1 and 2**

Under Scenario 1, the total costs that customers would incur as part of the remittal process would be higher than under a standard approach where the 2014-19 determination allowance was set based on the standard base-step-trend approach. This is because the original AER determination used a benchmarking based opex allowance, which provided a lower allowance than the base-step-trend approach.

As a result of the 2014-19 opex allowance being set using a benchmarking based approach, the additional costs customers would need to incur through this remittal process would actually be higher than under a standard approach, the total costs customers would incur, would be \$956m (\$real 2013-14).

If we compare the total costs and benefits to customers that would accrue to customers under each scenario on a like-for-like basis:

- under scenario 1 customers would receive \$1.6 for every \$1 of costs incurred.
- Under scenario 2, customers receive \$4.8 for every \$1 of costs incurred through the remittal process.

This is outlined below.

**Under Scenario 1:**

**Total costs incurred by consumers**

= Base-step-trend opex above the original 2014-19 determination + EBSS incentive payment to Ausgrid  
= \$956m

**Benefits to consumers**

= \$1,519m  
= \$1.6 for every \$1 of costs incurred

**Under Scenario 2:**

**Total Costs incurred by consumers**

= The efficient costs of transformation above the original AER determination allowances  
= \$431m

**Benefits to customers**

= \$2,059m  
= \$4.8 for every \$1 of costs incurred

We consider that given the certainty we have about the costs and benefits of the transformation program that Ausgrid has undertaken, it is appropriate for 100 per cent of the benefits of the reduced ongoing level of opex to accrue to customers. On a forward looking basis, passing through **all** of the benefits arising due to reductions in opex to customers would provide no incentive for network businesses to reduce their ongoing level of opex. However, in current circumstances, we have clarity about the actual costs incurred and confidence about the ongoing savings that will be provided to customers, which enable us to pass through all of the benefits of our cost reduction initiatives to customers.

**The Revenue and Pricing Principles and the National Electricity Objective**

**Responds to Question 4 of the AER's issues paper**

The AER's Issues Paper asks how our proposed sharing of the costs and benefits of the transition to a lower level of opex is consistent with the Revenue and Pricing Principles and the National Electricity Objective (NEO).

As noted by the Tribunal, the long-term interests of consumers – the focal point of the NEO – are served through the promotion of efficient investment in, and efficient operation and use of, electricity services. This in turn requires that service providers have a reasonable opportunity to recover the efficient cost of delivering services and complying with their regulatory obligations.

Ausgrid's transition to a lower cost base is demonstrably in the long-term interests of consumers. Our investment in the transformation program is on track to reduce substantially the cost of operating our network. Once this transition is complete, Ausgrid will be able to deliver services at a lower cost to customers, while maintaining the high levels of reliability that our customers value.

Moreover, the manner in which Ausgrid has undertaken this transition is efficient and in the best interests of consumers. The costs that have been (and continue to be) incurred by Ausgrid in transitioning to the lower level of opex reflect only the efficient costs of making the transition. As discussed in our response to question 1 of the AER's Issues Paper, we have had no clarity over what if any of our transition costs would be recoverable following a remade 2014-19 determination so we have reduced our opex in the quickest and lowest cost manner possible.

In these circumstances, the NEO and the RPP require that Ausgrid be provided with a reasonable opportunity to recover the cost of transitioning to a lower level of opex. If Ausgrid were forced to bear these costs, this would damage incentives for businesses to invest in cost reduction programs that are in the long-term interests of consumers. This would also be in direct conflict with the Revenue and Pricing Principles, which require Ausgrid to be given an opportunity to recover at least its efficient costs in providing network services.



We propose to pass through the savings to customers immediately, but to recognise that these gains required us to invest in “right-sizing” our operations. This investment has driven material improvements in consumer affordability that will continue into the 2019-24 period and beyond. This is unambiguously in the long-term interest of consumers. It is appropriate that we fully recover all efficient costs of the program that delivers these customer benefits, especially where the opex savings benefits is fully passed through to customers.

## **Interactions between operating and capital expenditure allowances**

### **Respond to Question 6 of the AER’s issues paper**

The Issues Paper asks for comments from stakeholders on how any actual underspend on capex should be treated given the relevant interrelationships between capex and opex.

During the 2014-19 period, we continue to comply with our approved cost allocation methodology (CAM). A feature of our CAM is that it allocates corporate support costs to both opex and capex. That said, allocated corporate support costs are a component of our capex costs that may have changed as a result of our lower level of capex (i.e. some more overheads may have been allocated to opex than initially anticipated and were part of our proposed capex program).

However, the precise impact of allocated corporate support costs is difficult to ascertain as it depends on a range of factors, including Ausgrid’s:

- approved CAM;
- improved efficiency of overheads in 2014-19
- forecast levels of opex and capex in each year of the 2014-19 period; and
- actual levels of opex and capex in each year of the 2014-19 period.

In the event that the AER makes an adjustment through the remittal process to adjust for the inter-relationships between opex and capex, and it applies a full cost recovery model for opex, a cost recovery model for capital expenditure may be a sensible approach to deal with the complexity of interactions between businesses’ incentives to spend opex and capex.

Yours sincerely,



**Rob Amphlett Lewis**  
Executive General Manager - Strategy & Regulation