

19 January 2015

Transformation in the Electricity Distribution Network Industry

1.0 INTRODUCTION

This paper seeks to provide information as to the time required to undertake significant transformation activities in the NSW electricity distribution business (Ausgrid, Endeavour Energy and Essential Energy, collectively referred to as Networks NSW). While the information contained in this report is true of the NSW distributors specifically, it is also reflective of the Australian electricity distribution experience and of the distribution industry more broadly.

The current AER Draft Determination proposes unprecedented cuts to both capex and opex that are not consistent with the National Electricity Rules, or the national electricity objective. In addition these cuts are retrospective, do not reflect an understanding of the operating environment of an electricity network business, and therefore do not reflect the underlying cost base of the business nor do they reflect the necessary and efficient costs of making prudent change in the businesses.

Networks NSW believes this is inappropriate based on the fact that costs incurred in making change are a necessary cost of prudent business operations in this industry, and reflect the operating environment, legal obligations, and nature of infrastructure assets. Changes to business structures are a normal response to changes in investment cycles and technology change. The NSW DNSPs are transitioning from a significant period of investment in 2009 – 14 to a more stable level in 2014-19.

Networks NSW refutes the argument contained in the AER Draft Determination that resourcing decisions made in the 2009 – 2014 regulatory period were imprudent. But rather were a normal reaction to normal changes that businesses with long investment horizons face.

2.0 CHANGES IN THE OPERATING ENVIRONMENT

For the 2009-14 regulatory control period, the Networks NSW businesses were expected to undertake a significant capital program in response to more rigorous licence conditions and a rising peak demand forecast, all set against a backdrop of the resource boom competing for relevant labour resource.

This was understood and approved by both the AER and NSW State Government at the time.

The operating environment changed as a result of a number of factors not foreseen at the time of the AER's final determination. These factors include:-

- 1) **Declining consumption combined with relatively static peak demand.** For the first time since the 1960s, the NSW economy is consuming less electricity each consecutive year, than it did in the previous period. The combination of factors including legislated energy efficiency requirements, subsidised distributed local generation (i.e. PV), and a prolonged high dollar that impacted the volume of manufacturing and industrial production, all contributed to lower demand now, and a change in our expectations for the future.
- 2) **Revision of the NSW Licensing Conditions** that changed the reliability standards that NSW Distribution Network Service Providers (DNSPs) were required to meet.
- 3) **Customer concerns** about the rising price of electricity were heightened, particularly following the Global Financial Crisis.

Much of the criticism of the NSW Distributors contained within the AERs Draft Determination relies upon the inappropriate use of hindsight to support the conclusion that these businesses did not act prudently in the prior regulatory period when making resourcing decisions.

However, the AERs approval of the 2009 - 2014 Regulatory Determination supports the view that at the time the AER agreed, and ultimately approved the NSW Distributors assumptions about the future, which formed the basis of those resourcing decisions. The unprecedented,

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and therefore unforeseeable nature of the impacts to energy demand in NSW does not alter that these decisions were seen as prudent by both the AER and the businesses, and based on the best information available at the time. Both the AER and the NSW DNSPs underestimated the impact and speed of disruption of the NSW energy sector over the intervening 5 year period

3.0 WHAT IS CHANGING AT THE BUSINESSES

The NSW Network Reform Program was introduced in 2011/12 and is set to deliver substantial savings of \$5.7b in opex and capex against the 2010/11 Statement of Corporate Intent (SCI), a 5 year baseline projection for the businesses.

These substantial savings have been delivered in a way that is consistent with the principles outlined in section 4.0; safe and legal, affordable, and in a way that is sustainable for the future reliability of the network. By correctly balancing these critical factors, the savings are being delivered without any safety or reliability impact, with no significant disruptions from industrial action, and importantly, they have been delivered in the least cost manner. For more information on the Networks NSW reform program see the “*Delivering Efficiencies for our Customers*” paper contained in the business’ substantive regulatory proposal submitted in May 2014.

All major activity with the Network Reform Program is subject to a detailed process of development. The steps of this process are outlined below.

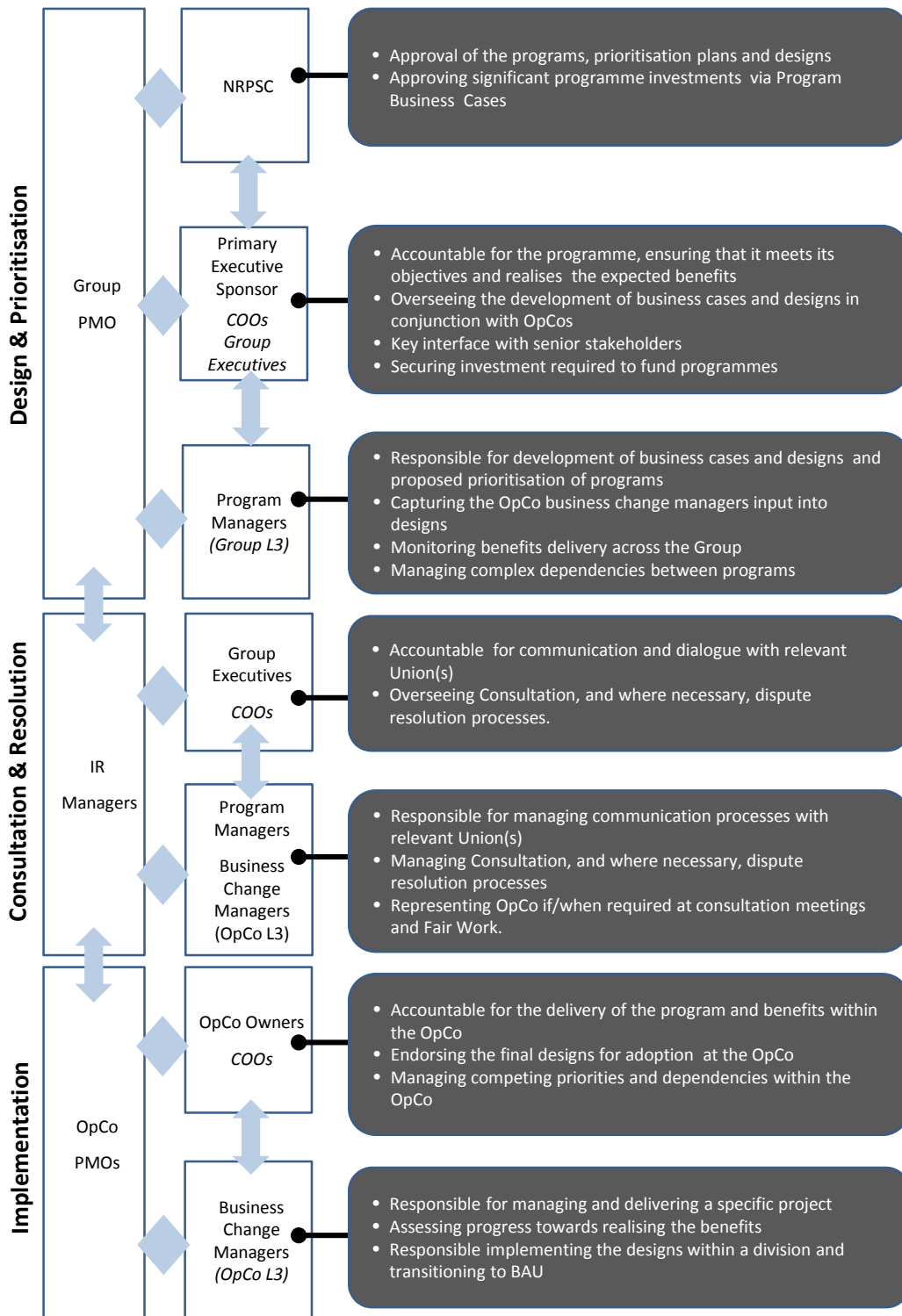
1. Design & Prioritisation
2. Consultation
3. Work Practice Change
4. Market Testing where relevant.
5. Disputes Procedure
6. Implementation
7. Monitoring and Reporting

Each of the components of this process ensures that the outcome is aligned with Networks NSW strategy and is consistent with the operating principles outlined in section 4.0.

Due to the inherent issues involved in distributing electricity noted below, Networks NSW has a rigorous program governance framework in place to ensure appropriate decision making and oversight is provided to programs that will impact the way we do business.

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Figure 1 Networks NSW Program Governance Diagram



The reforms, and the cost savings already made and those expected to be made through the ongoing reform program, are reflected in both our initial proposal and revised regulatory

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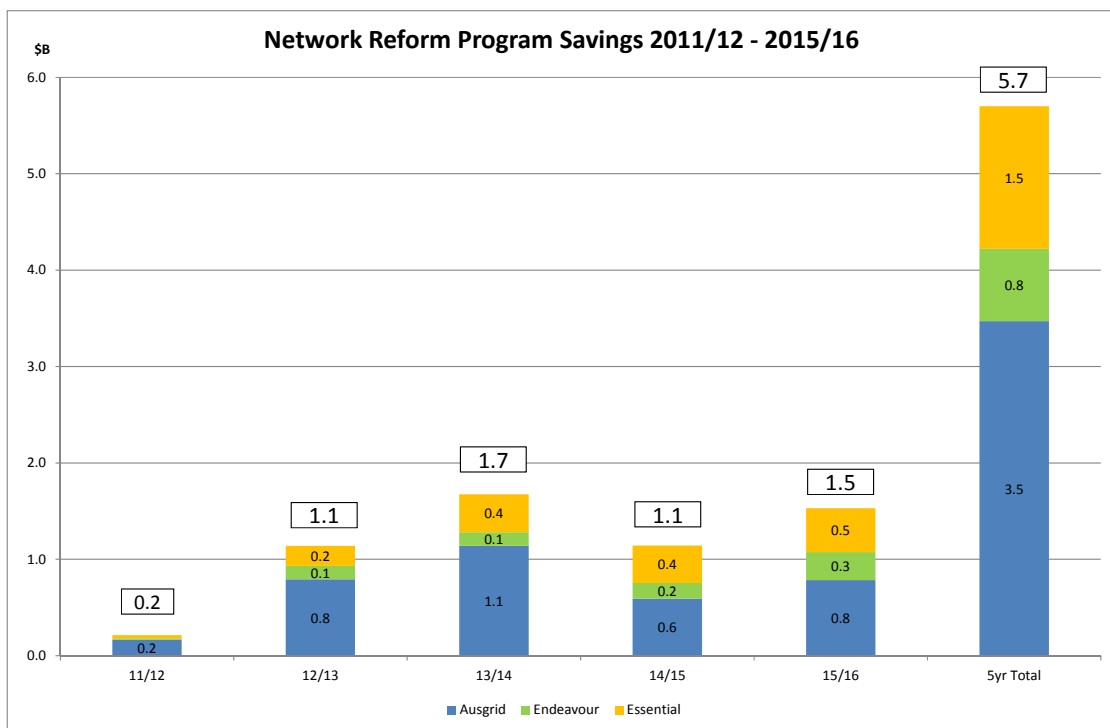
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proposal. Any difference between savings estimates simply reflects more up to date information for those programs.

Networks NSW has a proven track record of delivering substantial and rapid transformation, and is best placed to determine the maximum rate at which it can be achieved without compromising the principles outlined in section 4.0.

As can be seen in the savings profile of the Network Reform Program (Figure 2), it will take a full 5 years to realize the benefits of programs already underway. We note that less than a quarter of the savings occurring in the first 2 years of the program.

Figure 2 Network Reform Program Savings



The following 3 graphics (Figure 3, 4 & 5) provide a breakdown of the FTE reductions achieved in the most recent phase of the Network Reform Program (since 2013). This excludes the Transitional Service Arrangement (TSA) FTE departures driven by the sale of the retail businesses.

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Figure 3 Ausgrid FTE reductions

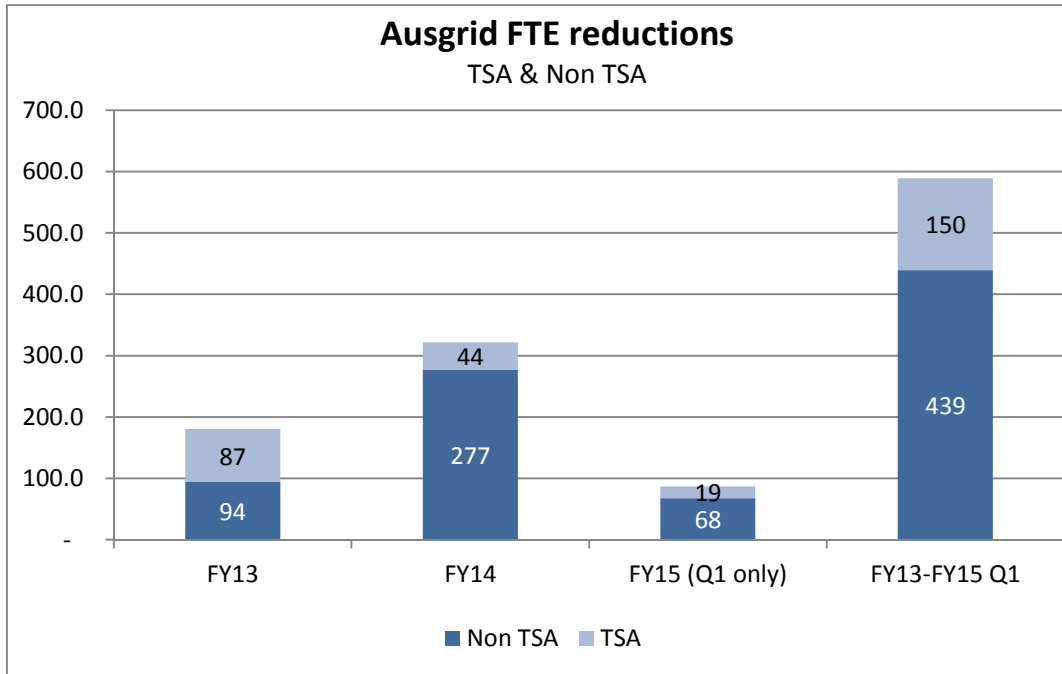


Figure 4 Endeavour FTE reductions

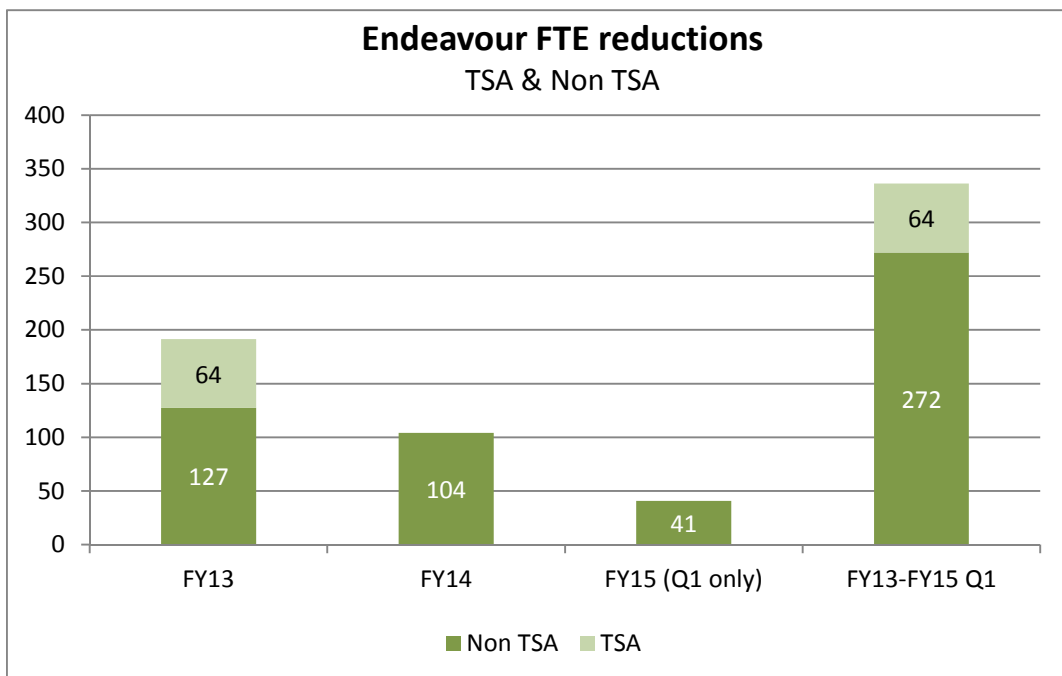
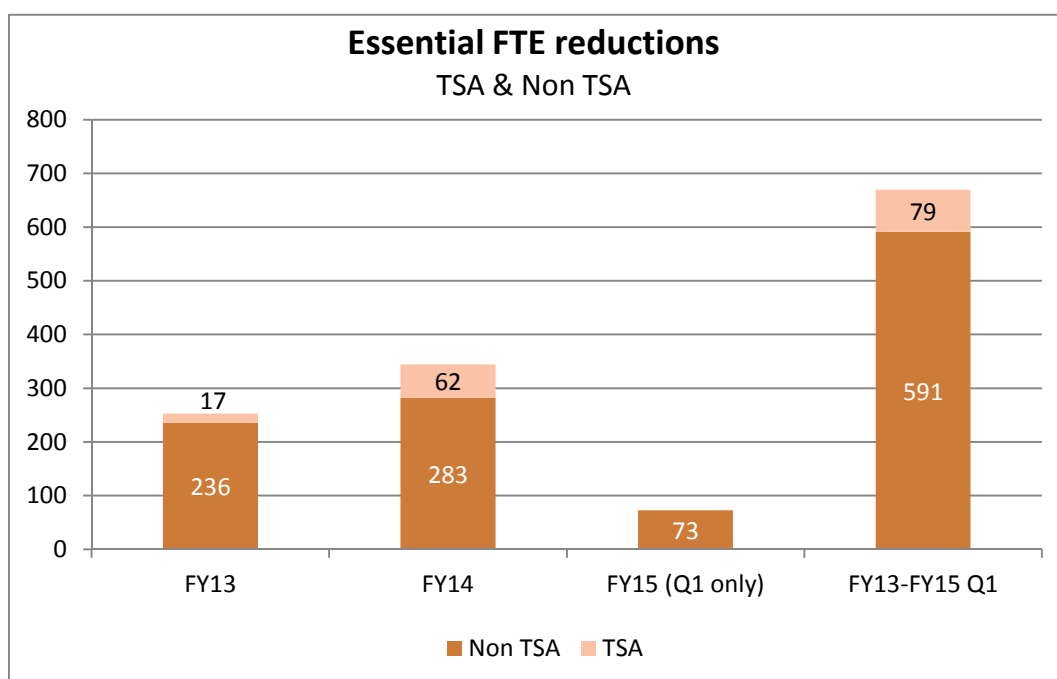


Figure 5 Essential FTE reductions

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4.0 THE DRIVERS OF THE TIMING OF CHANGE

The reforms outlined in section 3.0 require substantial commitments in resource and time to design, plan and execute well. Furthermore, reform must be as follows:-

- 1) **Safe & Legal.** We must operate our network in a way that provides a safe environment for our employees and the public recognising the inherent dangers of electricity and secondary risks such as bushfires. We must conduct business in a way consistent with the legal obligations imposed on us by licence conditions, legislation (including safety and industrial relations legislation) and other binding legal arrangements.
- 2) **Affordable.** We operate in a way that minimises the cost of change for the electricity consumers of NSW. We aim to minimise the cost of change to deliver the most efficient outcome for our customers.
- 3) **Reliable.** We must ensure we manage the distribution network sustainably, both for now, and in the future. This includes having regard for both the technical operation of our assets and our workforce.

NSW DNSPs will always fulfil their obligations to customers, the people of NSW, in a way that is consistent with these principles. We consider that it would be possible to inefficiently reduce costs faster by ignoring these principles. However history has proven that reform that is not designed, planned or executed well can have negative and often expensive consequences. i.e. public safety (see Black Saturday class action settlement¹), industrial action (see Citipower's 15 week industrial dispute²), or simply cost more financially than it should.

¹ SP Ausnet settled for \$378.6m, without admission of liability, a court action brought against it by victims of the Kilmore East-Kinglake bushfire, which started on February 7. The case came about after the Victorian Bushfires Royal Commission found the Kilmore East-Kinglake bushfire was caused by an ageing SP AusNet power line.

² In 1997 the ETU undertook industrial action against Citipower from 1 May to 21 August.

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The principles outlined represent good practice in implementing change. However, we recognise that there are also legal obligations in many instances that require our adherence to components of each step.

One such obligation is our ongoing legal requirement to adhere to the relevant Industrial Relations legislation, such as the Fair Work Act.

Our Industrial Relations obligations are particularly significant to Networks NSW given that more than 90% of the NSW DNSPs workforce is covered under Enterprise Bargaining Agreements (EBAs), which in turn are covered under the Federal Fair Work Act. In order to adhere to the obligations under this legislation, we must follow a stringent change management process which involves substantial investments in time, resource and expertise. At any point in the consultation process, should an issue arise in negotiations, we are obliged to use the dispute resolution processes mandated by the Fair Work Act. In some circumstances the Act provides for protected Industrial Action by Unions in circumstances where we are unable to achieve a mutually acceptable outcome during EBA renewal negotiations.

The successful implementation of the Networks NSW organisational design (known as the Networks NSW Operating Models) designed under the Network Reform Program, provide a good illustration of the time and resource commitment required to deliver change across the NSW electricity distribution businesses. The overall Operating Model work stream has been progressing for more than 2 years with 20 targeted programs defining our go-forward organisational structure across all functions. The mandatory industrial relations consultation process, has necessitated a substantial commitment in resource and time, with more than 374 Peak Reform Committee, sub-committee and employee consultative meetings.

Further, the various unions involved have subsequently raised a number of parallel disputes covering topics ranging from EBA scope coverage to vehicle policies. This has required an additional 45 hearings at the State Commission, Fair Work Commission and in formal Arbitration all of which demanded a significant resource commitment from Networks NSW. These disputes prolonged the process and delay the time taken to implement and realize savings. Networks NSW is also not always successful in achieving all of its targeted objectives through this process, as several recent dispute resolutions demonstrate. However, we are legally bound to the outcome by Federal legislation, even if the Fair Work findings are not in the interests of NSW customers or shareholders.

Given the constraint of having to operate under this time consuming, and resource intensive framework, care must be taken to ensure the results achieved are consistent with our strategic intent, and this often involves complex trade-offs between multiple strategic objectives. These trade-off decisions are made utilising relevant information available at the time, but also require assumptions about the uncertain future, as all prudent business decisions do. Using hindsight may inform us as to whether any other particular strategy would have been optimal, but it does not demonstrate that the original decision was not prudent, unless that information was known, with certainty, at the time the decision was taken.

5.0 THE AER'S DRAFT DETERMINATION POSES A RISK TO A PRUDENT AND EFFICIENT CHANGE PROGRAM

An AER determination that retrospectively cuts opex and capex to unprecedented levels will force the businesses into crisis management and unprecedented cost-cutting, which is unrealistic and reckless.

It is clear that transformation in the electricity distribution industry takes meaningful time to accomplish. As noted previously this is due to the inherent risks of electricity distribution, the

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long-lived and complex nature of the assets, the principles under which NSW DNSPs must operate and the constrained industrial relations environment in which the business is managed. All of these factors contribute to the measured rate at which prudent change can, and should, be implemented.

That is not to suggest that substantial change cannot be achieved, as the Network Reform Program has clearly demonstrated. With focused leadership, the correct strategy, and appropriate governance, Networks NSW has been able to deliver \$5.7b of savings, or 22% reduction in cost (opex and capex), over 5 years for the benefit of NSW electricity consumers. Further realistic cost efficiencies are set out in our initial and revised proposals.

The AER has ignored the informed judgment and proven capability of Networks NSW in managing the transition from the prior regulatory period in a manner that is consistent with the national electricity objective.

Networks NSW's experience has allowed, and will continue to allow, it to deliver change in the businesses and their processes and expenditure in the quickest, most prudent manner.

The financial forecasts for opex and capex included in the NSW DNSPs revised regulatory proposals, represent their informed view as to the most rapid and least-cost way to manage the transition from the prior regulatory period, in a manner that is consistent with the requirements of the law and in particular the requirements of the national electricity objective.