AER Public Forum - 11th December 2014

Perspectives on the Transend Draft Determination

Hugh Grant

AER Consumer Challenge Panel Member

CONSUMER FEEDBACK

Consumer Feedback

- **Prices**

Suggestions that current prices are excessive and further reductions are justified

- **Return on Capital (WACC)**

Suggestions that the parameters in the *AER Rate of Return Guideline* have been set too high and concerns that the AER did not reduce those parameters in its draft determination

Suggestions that the AER needs to determine a WACC for Transend that is more reflective of its actual cost of capital

- **Regulatory Asset Base (RAB)**

Concerns regarding the current/proposed RAB levels, and suggestions that inefficient past investments are locking in excessive future prices

- **Capex**

Suggestions that the proposed levels of replacement capex are significantly above the underlying needs

Consumer Feedback

- **Opex**

Suggestions that Transend's proposed opex is inefficient and that further efficiency improvements should be derived from the Transend/Aurora merger

Suggestions that Transend's previous opex allowances were excessive

- **Reliability**

Concerns that consumers' feedback on price/reliability trade-offs have not been reflected in Transend's revenue proposal

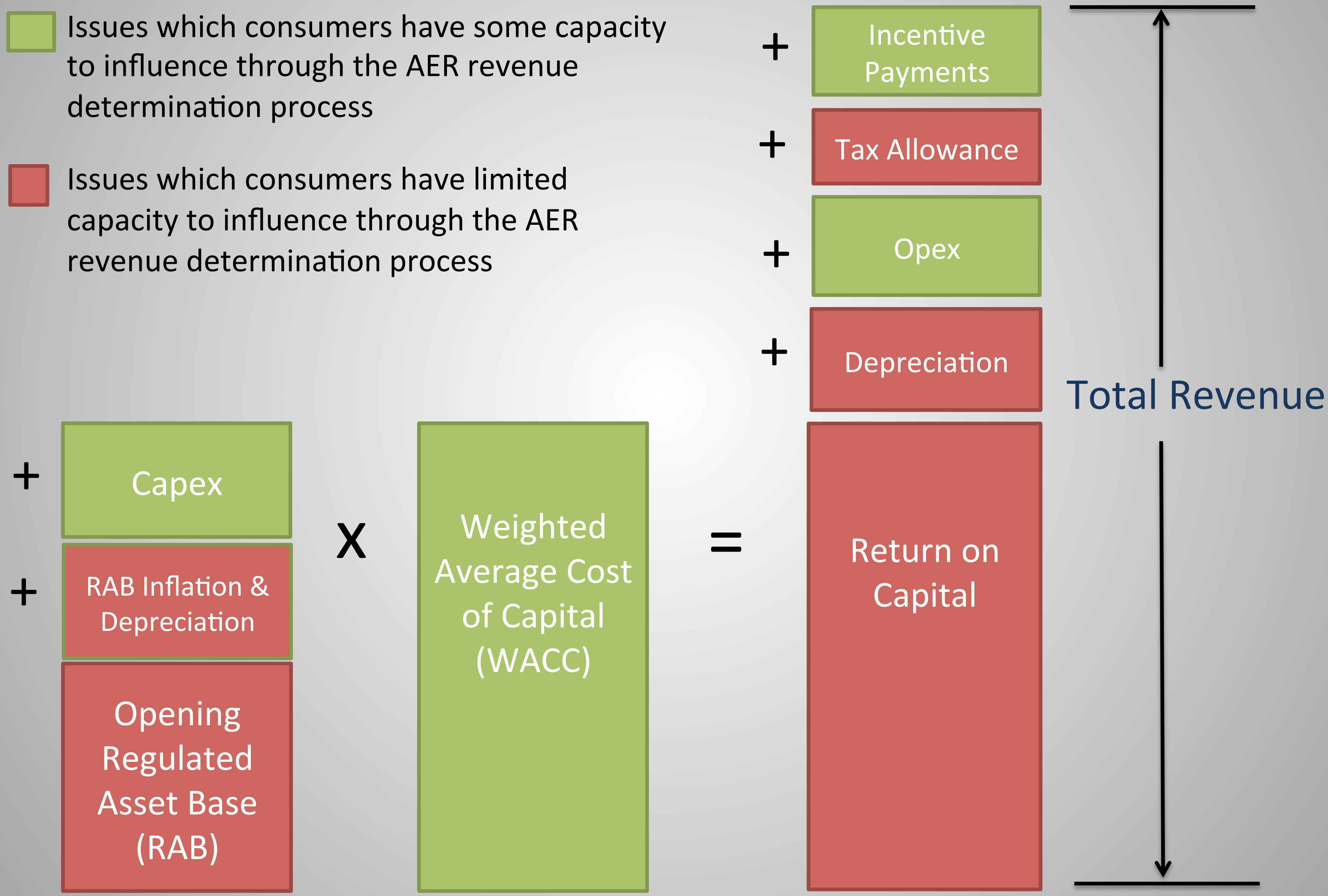
- **Consumer Engagement Program**

Concerns that the key issues raised during the consumer engagement programs have not influenced, or been reflected in, the revenue proposals

- **Regulatory Rules/AER**

Concerns with the AER's inability to challenge the efficiency/need of past investments

Building Block Revenue – Consumers' Capacity to Influence



REVENUE

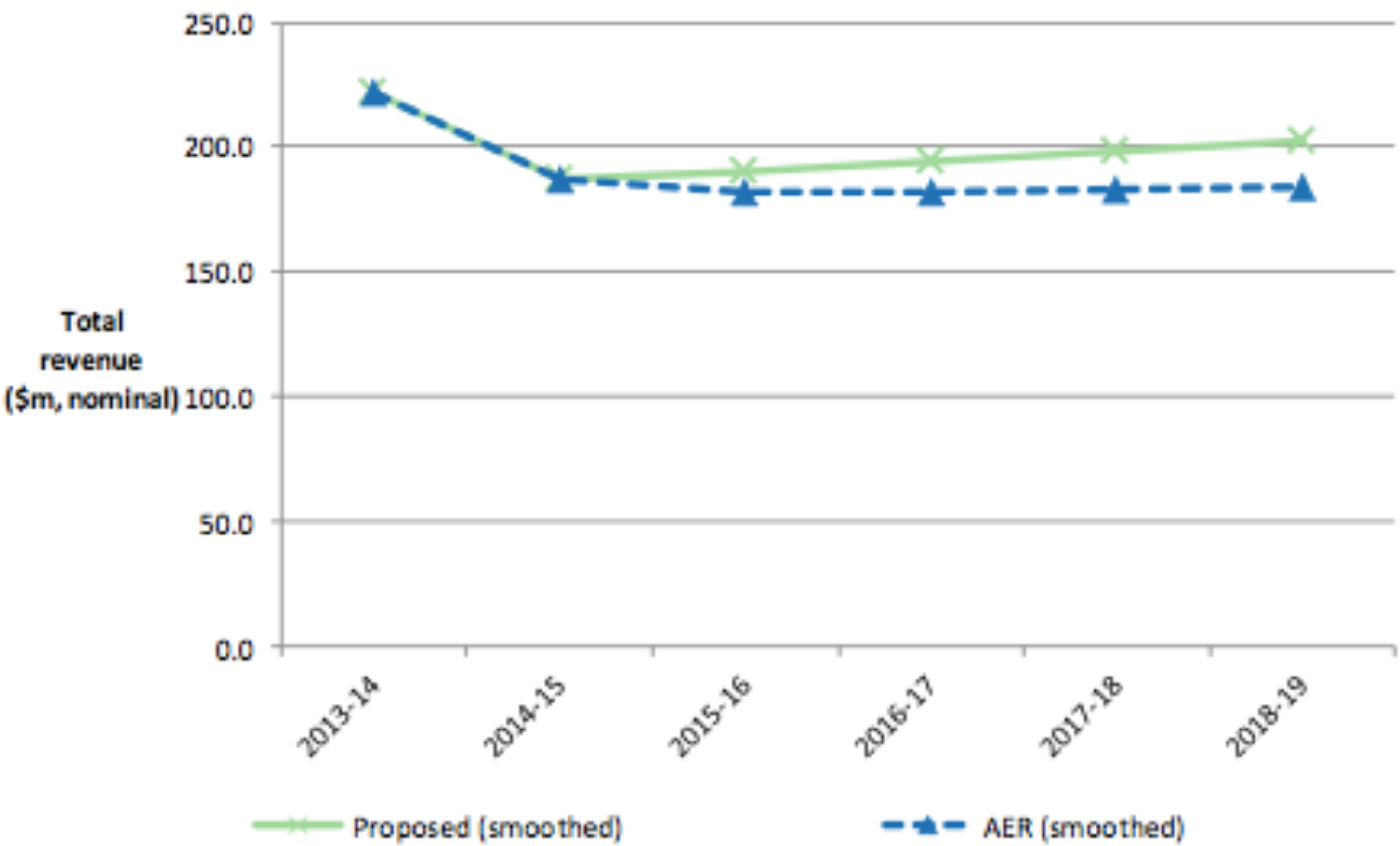
AER Draft Revenue Determination for Transend

Building Block Component	Transend Proposal	AER Draft Decision	Reduction
Return on Capital	$567 M	$511.8 M	9.7 %
Depreciation	$113 M	$115 M	(1.7) %
Opex	$235.4 M	$235.2 M	(0.1) %
Efficiency Payments	$34.1 M	$33.1 M	2.9 %
Tax Allowance	$23.3 M	$ 25.3 M	(8.6) %
Total Revenue (2014/15-18/19)	**$973 M**	**$ 920 M**	**5.4 %**

Source: AER Draft Decision (Nominal Dollars)

Transend Draft Decision - Estimated Price Impacts

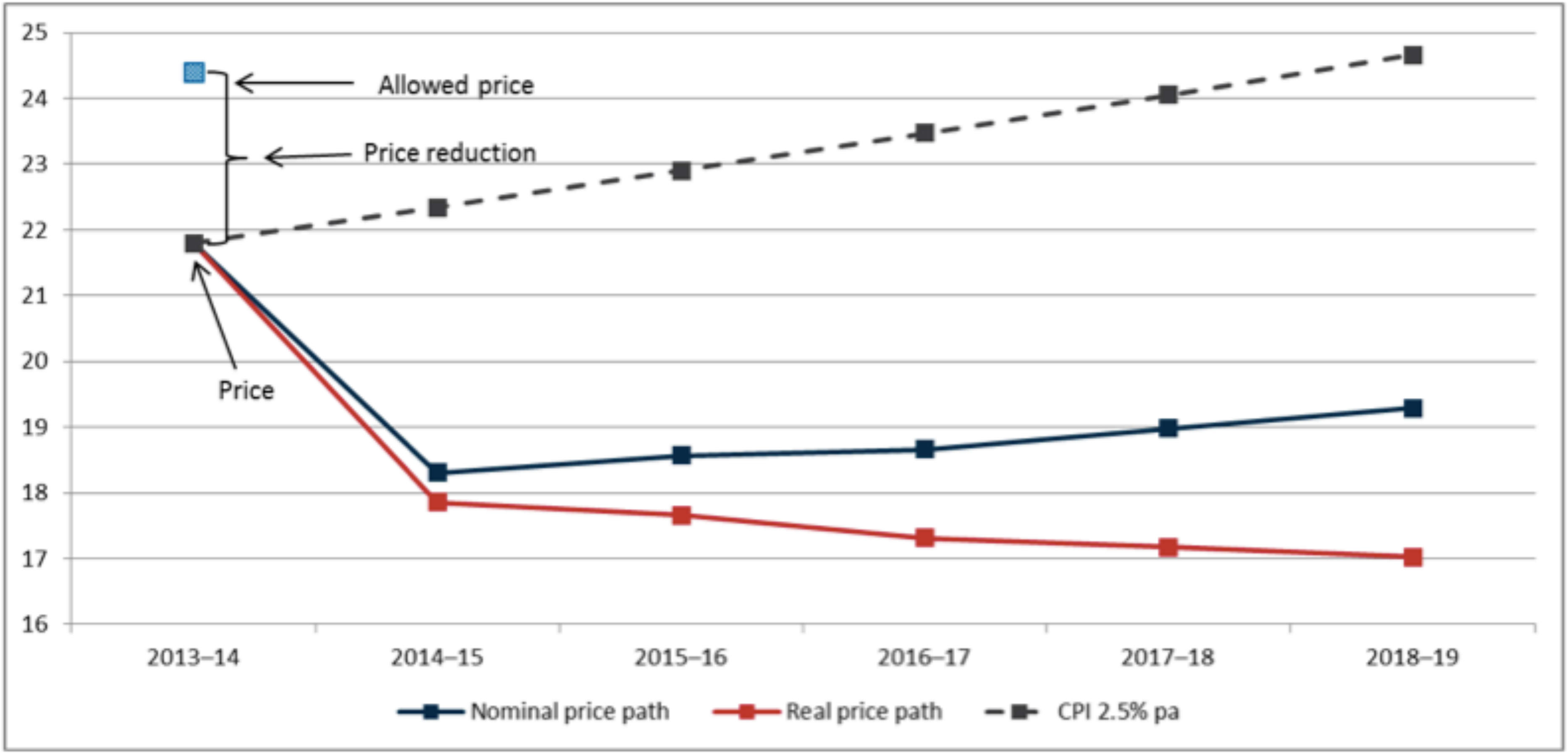
Figure 7-3 **AER's draft decision on MAR compared with TasNetworks' proposed MAR for 2014–19 ($ million, nominal)**



PRICE IMPACTS

Transend Proposal - Estimated Price Impacts

Figure E.5 Average price impact of Revenue Proposal ($/MWh)



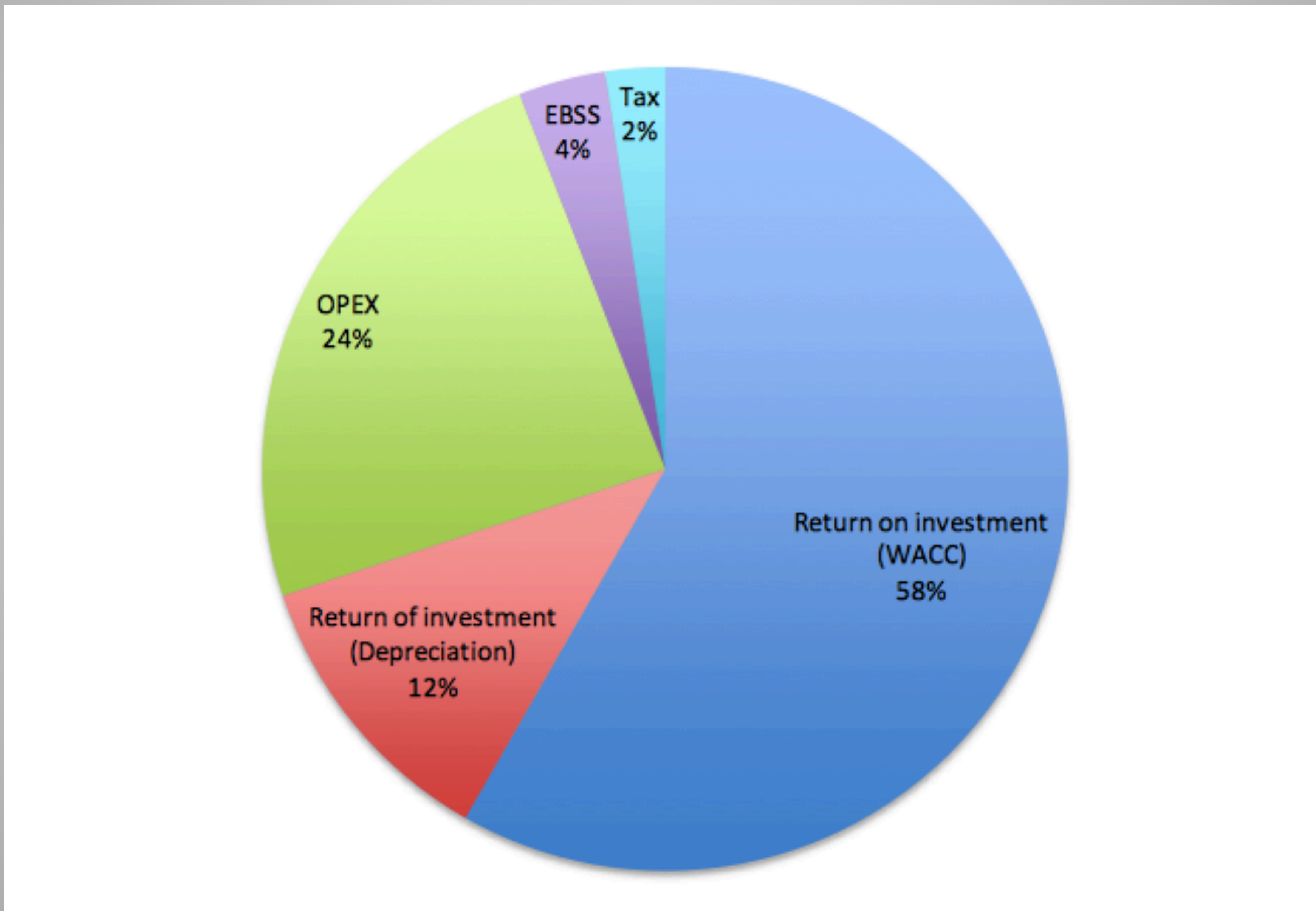
Source: Transend Revenue Proposal

Price Impacts for Large Energy Users?

- The AER's Draft Determination does not provide an estimate of the anticipated price impacts for large energy users
- Large consumers are concerned that Transend's approach to revenue recovery is resulting in inequitable prices for large energy consumers
- Large consumers expect Transend's pricing methodology to allocate costs to all tariffs on a cost reflective and equitable basis

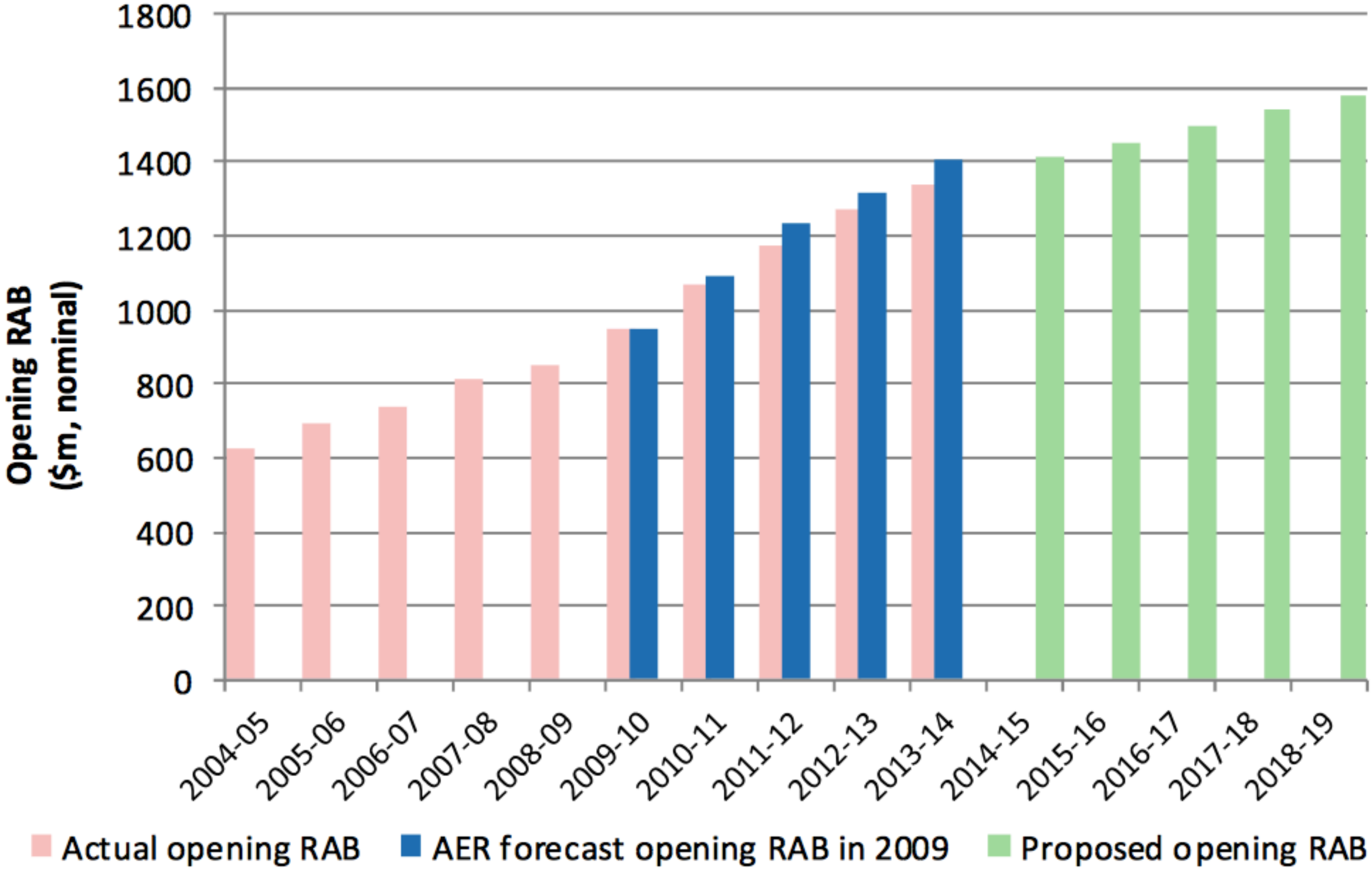
RETURN ON CAPITAL

Transend - Revenue Components



Transend RAB Growth

Figure 4 **TasNetworks - Regulatory Asset Base values ($ nominal)**

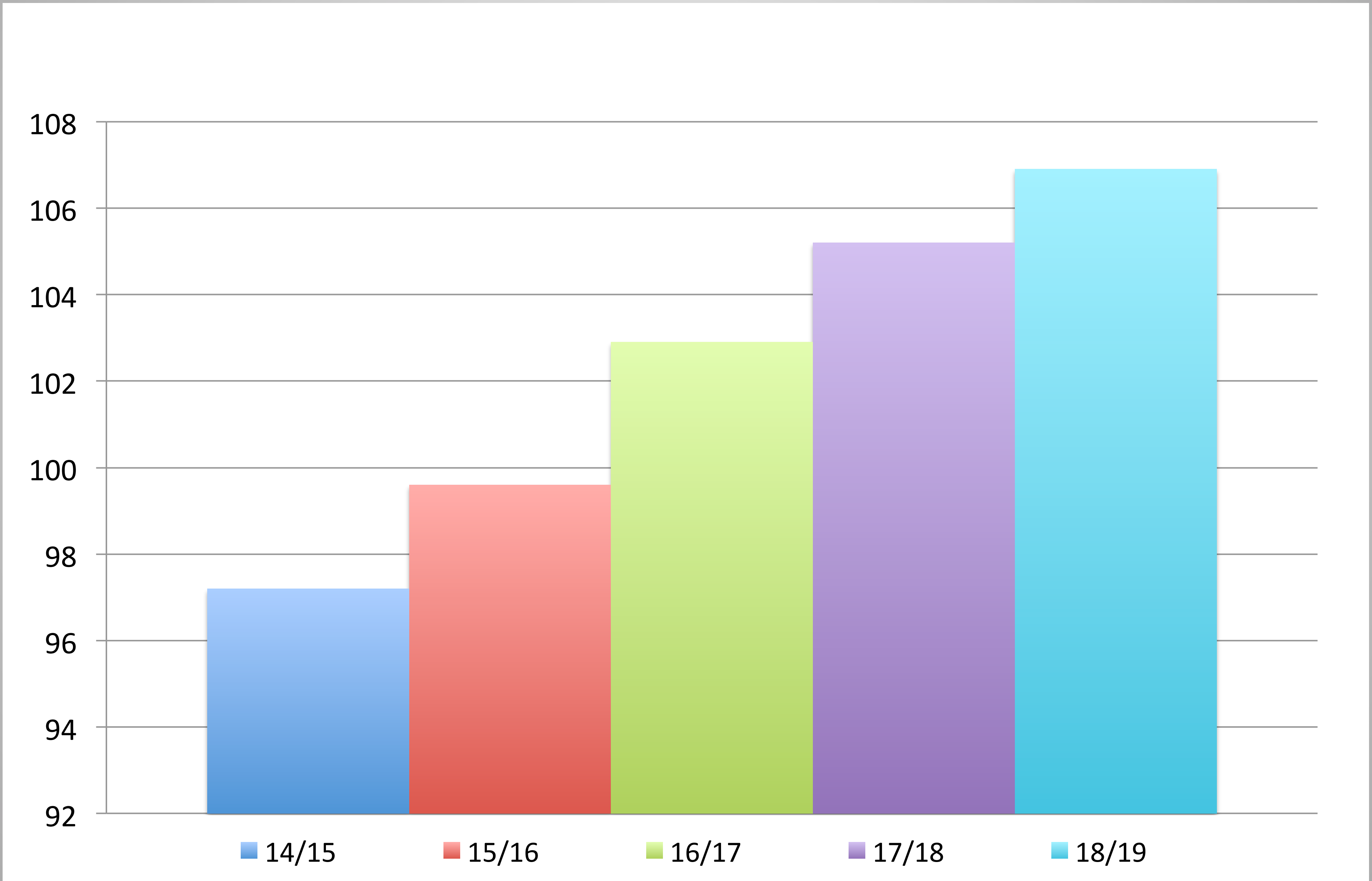


WACC – AER Draft Determination

WACC Component	Transend Revenue Proposal	AER Draft Decision
Cost of Equity		
Risk Free Rate	4.11%	3.55%
Market Risk Premium	6.5%	6.5%
Equity Beta	0.7	0.7
Total Cost of Equity	**8.7%**	**8.1%**
Cost of Debt	**6.84%**	**6.07%**
Total WACC	**7.58 %**	**6.88 %**

Source: AER Draft Determination

AER Draft Decision - Growth in 'Return on Capital'



Source: Transend Draft Decision

WACC Determinations - The AER's obligations Under the New Rules

- The new rule require the AER to:
  - Consider a range of factors when determining the allowed rate of return, **including relevant estimation methods, financial models, market data and other evidence**
  - Exercise its discretion in estimating the rate of return, by **adopting the approach it considers most appropriate** to achieve WACC outcomes in the long-term interests of consumers

"The amendments made ***will provide the Australian Energy Regulator (AER) with additional strength and flexibility*** *in setting revenues and prices for electricity and gas network service providers"*

"The Commission has provided high-level principles to guide the estimation ***and left the judgement as to the best approach to the regulator to make,*** *consistent with achieving the overall allowed rate of return objective"*

Source: AEMC Determination - National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012

Inappropriate Use of the AER's Discretion

- Consumers consider that the AER has inappropriately applied its discretion by setting the input parameters of the *AER Rate of Return Guideline* at the top of the possible ranges e.g:
  - For the 'equity beta' range of 0.4 to 0.7 - the AER has adopted 0.7
  - Whereas, the recent report by Professor Olan Henry suggests that an equity beta at the lower end of the range is more appropriate

- Consumers also consider that the AER's move from a gamma of 0.5 to 0.4 is not justified

- Consumers expect the AER to exercise its discretion in a more balanced manner in its Final Determination

Comparisons with WACC Decisions of Other Regulators

- Over the past decade, consumers have repeatedly expressed concerns regarding the AER's WACC determinations being higher than the determinations of other regulators in Australia and overseas

- Comparisons with Australian Regulators
  - The AER has consistently set higher WACCs compared to the determinations of the ACCC and state regulators

- Comparisons with International Regulators
  - The AER has consistently set higher WACCs compared to equivalent international regulators
  - For example, The UK regulator (Ofgem) recently outlined a 2015/16 WACC of 3.8% for five UK distribution entities, with further falls in the WACC projected in subsequent years

Rate of Return - Relevant Market Information

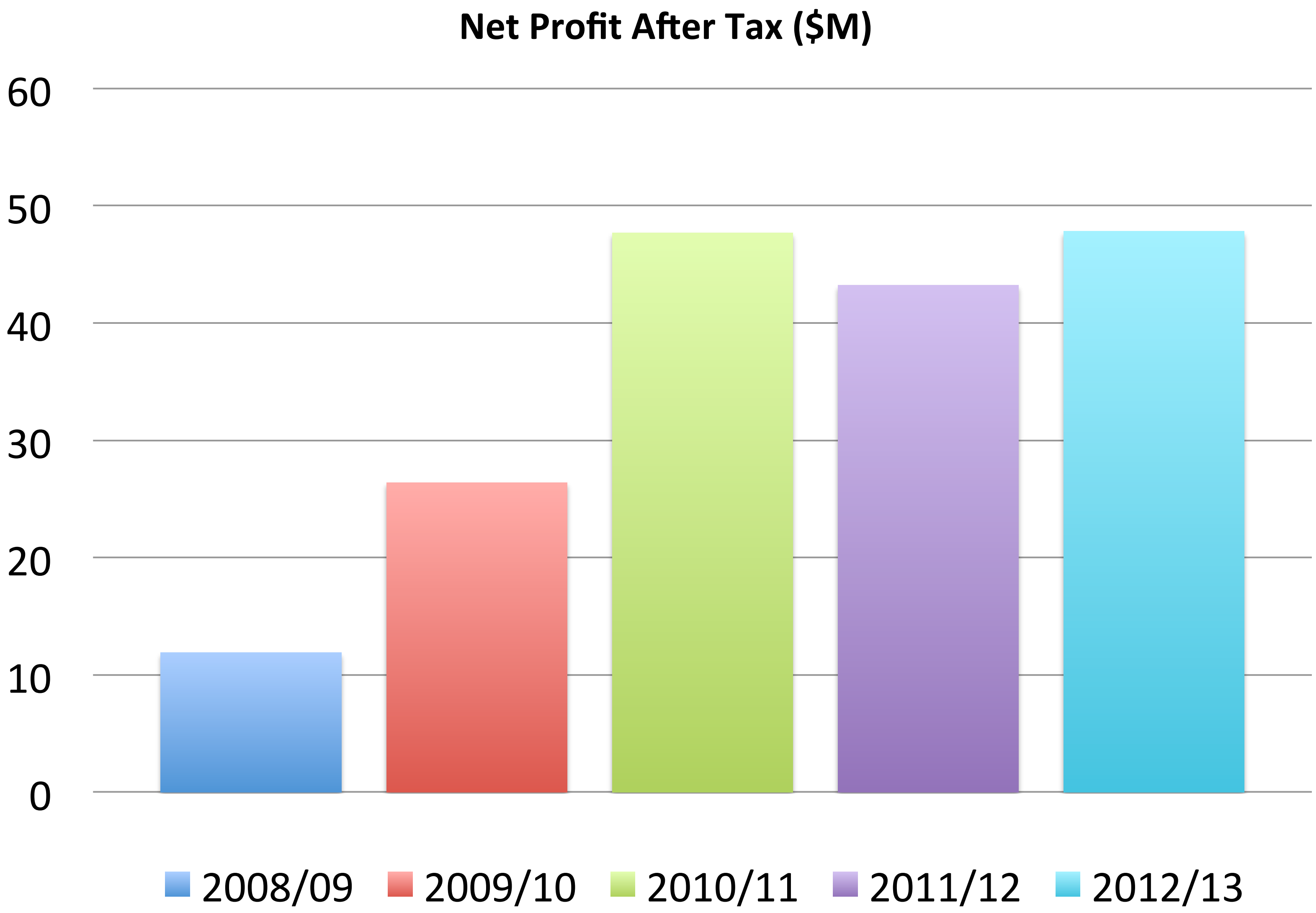
- The new rules require the AER to consider "market data and other evidence" when making its 'rate of return' determinations

- There is growing evidence that investors are paying substantial premiums above the Regulated Asset Base (RAB) when investing in Australian energy networks, e.g:
  - CKI's recent purchase of a stake in DUET has an implied RAB multiple of 128%
  - The recent offer by CKI for Envestra has an implied RAB multiple of over 150%

- The networks' profitability growth trends indicate that the industry is significantly more profitable than the regulatory framework assumes

- Consumers expect the AER to take account of this 'market information' when making its WACC determinations

Transend - Recent Profitability Growth



Source: Transend Annual Reports

Return on Capital (WACC)

- Refer to CCP Papers to the AER on the AER's approach to determining the Rate of Return
  http://www.aer.gov.au/sites/default/files/CCP%20Letter%20to%20the%20AER%20Board%20-%20Rate%20of%20Return%20Paper.PDF

  http://www.aer.gov.au/sites/default/files/CCP%20report%20prepared%20for%20AER%20Board%20-%20Rate%20of%20Return.pdf

- **Applying the CCPs' recommendations should result in an overall WACC of below 6%**

- That would still deliver generous returns to Transend and better reflect consumers' long term interest

CAPEX

Transend Draft Decision - Capex

	2009/10-2013/14	2014/15 - 2018/19	Change
Augmentation	$190 M	$1.6M	99% decrease
Connections	$69 M	$19 M	72% decrease
Renewal/ Enhancement	$245 M	$213 M	13% decrease
Non Network	$32M	$12.7 M	60% decrease
Other	$41 M	-	-
Total	**$577 Million**	**$246 Million**	**57 % decrease**

Source: Transend Revenue Proposal and AER Draft Determination (all figures in $2013-14)

AUGMENTATION AND CONNECTION CAPEX

Augmentation and Customer Connection CapEx

- The AER has accepted Transend's proposed $1.6M in augmentation capex
- The AER has accepted Transend's proposed $19M in 'customer connection' augmentation capex
- The CCP is interested in consumers' views on the 'customer connection' capex

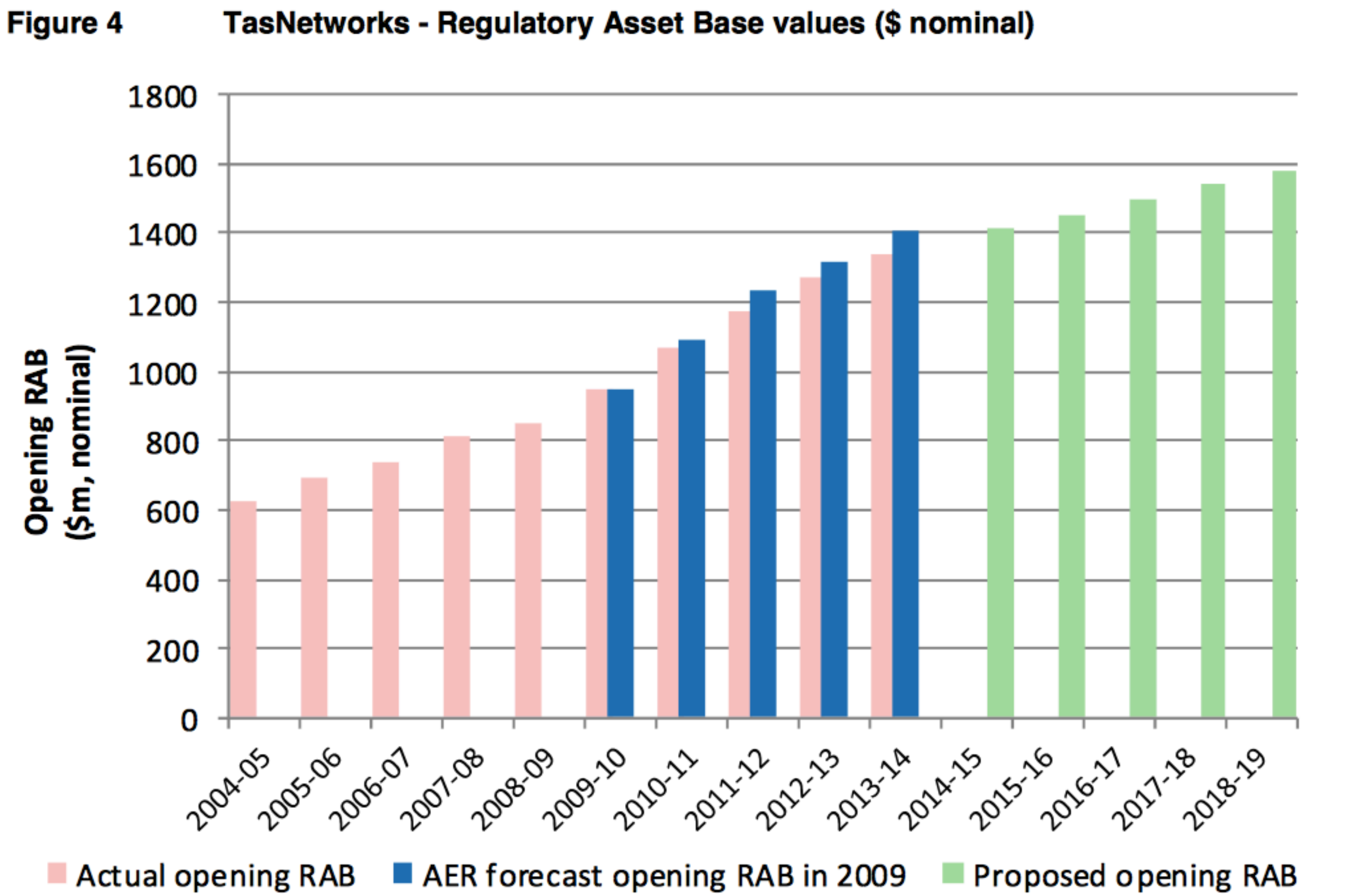
REPLACEMENT CAPEX

Transend – Replacement Capex During Current Period

Table 4.1 Allowed and actual capital expenditure by category ($m 2013–14)

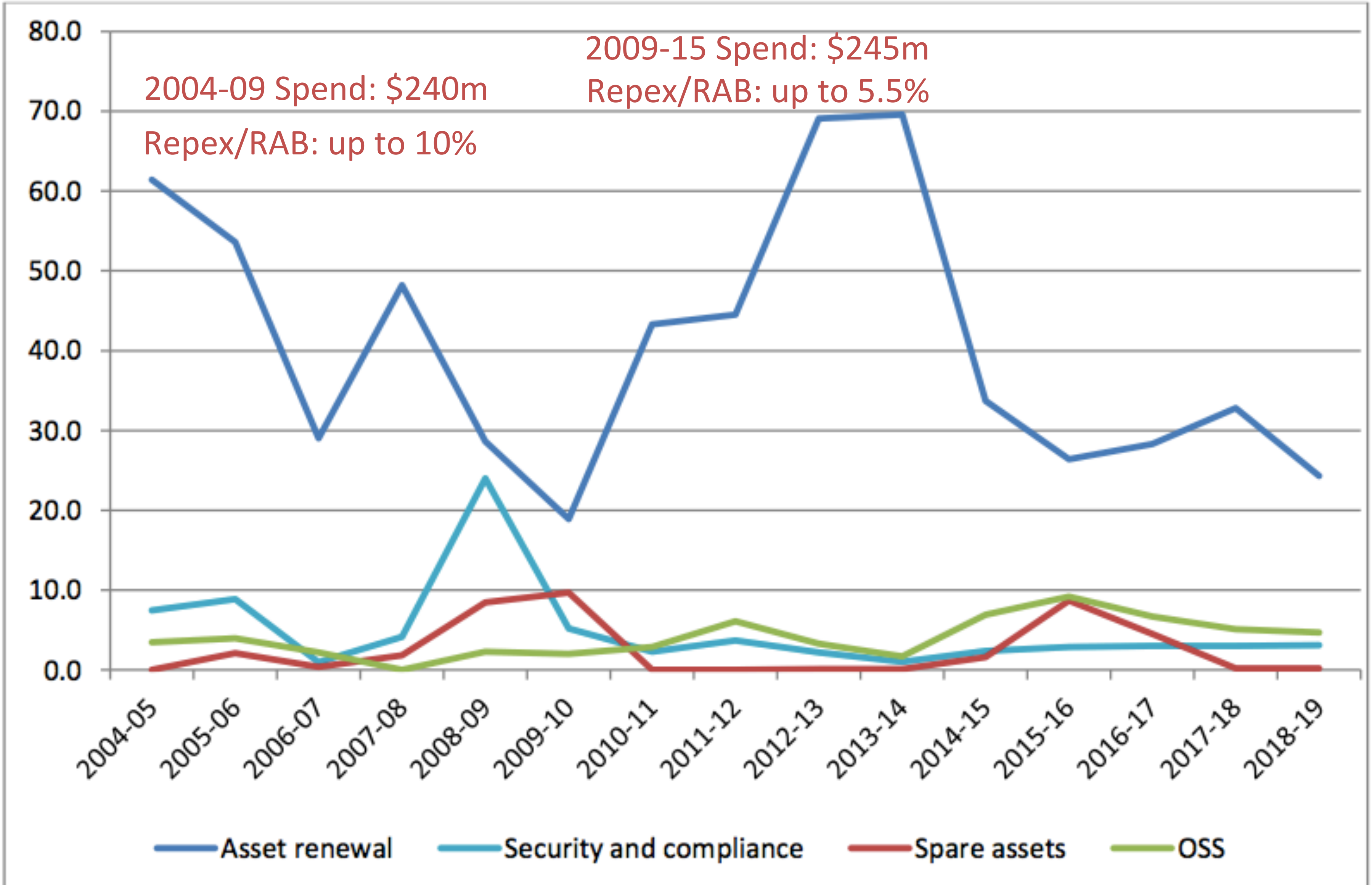
Category	2009–14 Allowance	Historical expenditure 2009–14	Variance
Augmentation	242.1	190.5	-51.5
Connection	126.0	68.9	-57.1
Land and easements	24.1	0.6	-23.5
Development capex	**392.2**	**260.1**	**-132.1**
Asset renewal/enhancement	203.7	245.2	41.6
Physical security/compliance	22.1	14.4	-7.7
Inventory/spares	12.1	9.9	-2.3
Operational support systems	23.9	15.9	-8.0
Renewal/enhancement capex	**261.7**	**285.4**	**23.7**
Information technology	19.1	6.4	-12.7
Business support	19.5	25.3	5.8
Support the business capex	**38.6**	**31.7**	**-6.9**
Total	**692.5**	**577.2**	**-115.3**

Transend: RAB Growth



Asset Renewal Capex Trends

Figure A-1 TasNetworks repex components (million $2013-14)



Source: TasNetworks proposal, AER analysis

Asset Renewal CapEx - Preliminary Comments

- The AER has fully accepted Transend's proposed replacement capex

- The AER's decision appears to be predominantly based on a comparison with Transend's previous repex - it does not appear to have reviewed Transend's capex governance processes

- The proposed allowance appears excessive, in light of:
  - Transend's major replacement capex programs over the past two regulatory periods
  - Transend's asset age and asset utilisation trends
  - Unsubstantiated justifications - e.g. demonstrated linkage to system performance

- The CCP is interested in engaging with consumers and Transend to review these issues and to inform the formal submission to the AER

AER Draft Determinations - Replacement Capex

	Proposed Replacement Capex	AER Draft Determinations 2014/15 - 2018/19	Reductions
Ausgrid	$3,113 Million	$1,901 Million	**39 %**
Essential Energy	$2,515 Million	$1,552 Million	**38.3%**
ActewAGL	$414 Million	$241 Million	**42%**

OTHER CAPEX

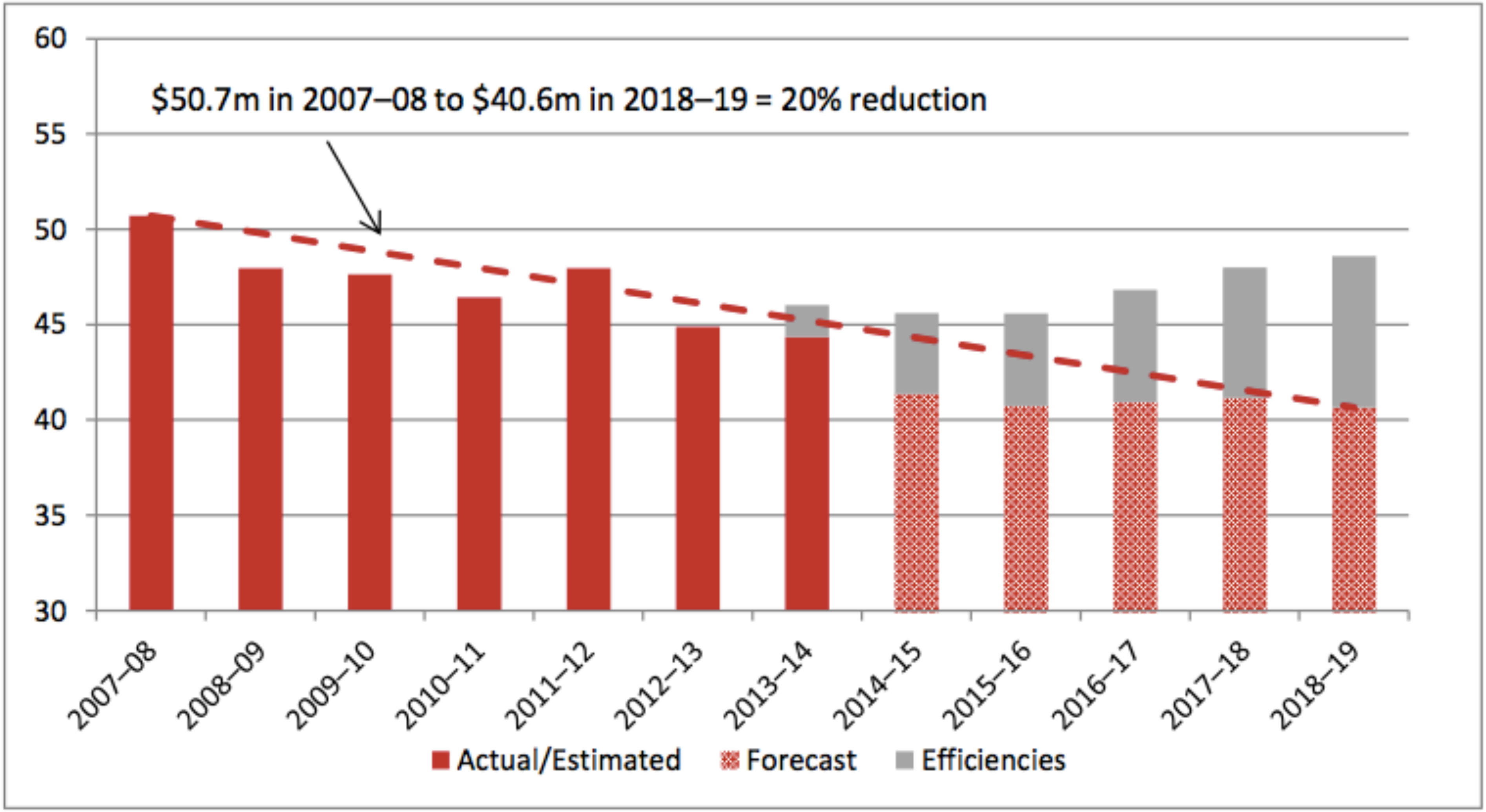
Other Capex

- The AER has accepted:
  - Transend's proposed $14.4 M for security & compliance capex
  - Transend's proposed $15.1 M for asset spare
  - Transend's proposed $32.5 M for operational support systems
  - Transend's proposed $12.7 M for Non-Network Capex
- The CCP will engage with consumers and Transend on these proposed allowances to inform the formal submission to the AER

OPEX

Transend Opex Trend

Figure 6.5 Controllable operating expenditure 2007–08 to 2018–19 ($m 2013–14)



Consumers' Perspectives on Transend's Opex

A number of the consumers challenged the efficiency of Transend's proposed opex:

- Asserting that Transend is "still not operating close to the efficiency frontier"
- Asserting that Transend's proposed efficiencies and overhead reductions from the Transend/Aurora merger are significantly lower than would be expected from a merger of this magnitude
- Identifying that the majority of Transend's proposed opex reductions arise in 2014/15 - predominantly due to the Transend/Aurora merger
- Asserting that Transend's proposed opex doesn't reflect the reduced opex that should arise from the operation of newer assets

The AER's Draft Decision on Transend's Opex

- The AER has accepted Transend's proposed opex of $235m
- This represents a reduction of around 12% compared to the previous period
- However, consumers expect the AER to determine the TNSPs' opex allowances based on benchmarking

BENCHMARKING

The AER's Lack of Benchmarking in Previous Determinations

- Consumers have advocated for many years that the AER should have applied benchmarking to its previous determinations, and that **the AER was required to under the previous Rules**

- Consumers believe that the data has been available, and that the AER had the information gathering powers under the previous Rules

- The AER does not appear to accepted those views, and **predominantly based its previous opex allowances on historical costs**

- Consumers are disappointed that **the AER has not applied benchmarking to date** - despite the overwhelming **evidence of major differences in efficiency between the networks**

- **Benchmarking is an accepted and proven technique in regulatory practice** - Ofgem (UK) has applied it effectively for over 20 years, and commenced it without a perfect data set

The AER's Obligations to Apply Benchmarking

- **Benchmarking was one of the major promises of the recent Rule changes**

- The new Rules formally require the AER to:
  - Undertake benchmarking to assess the relative efficiencies of network businesses
  - Apply the outcomes to determine efficient costs for the networks

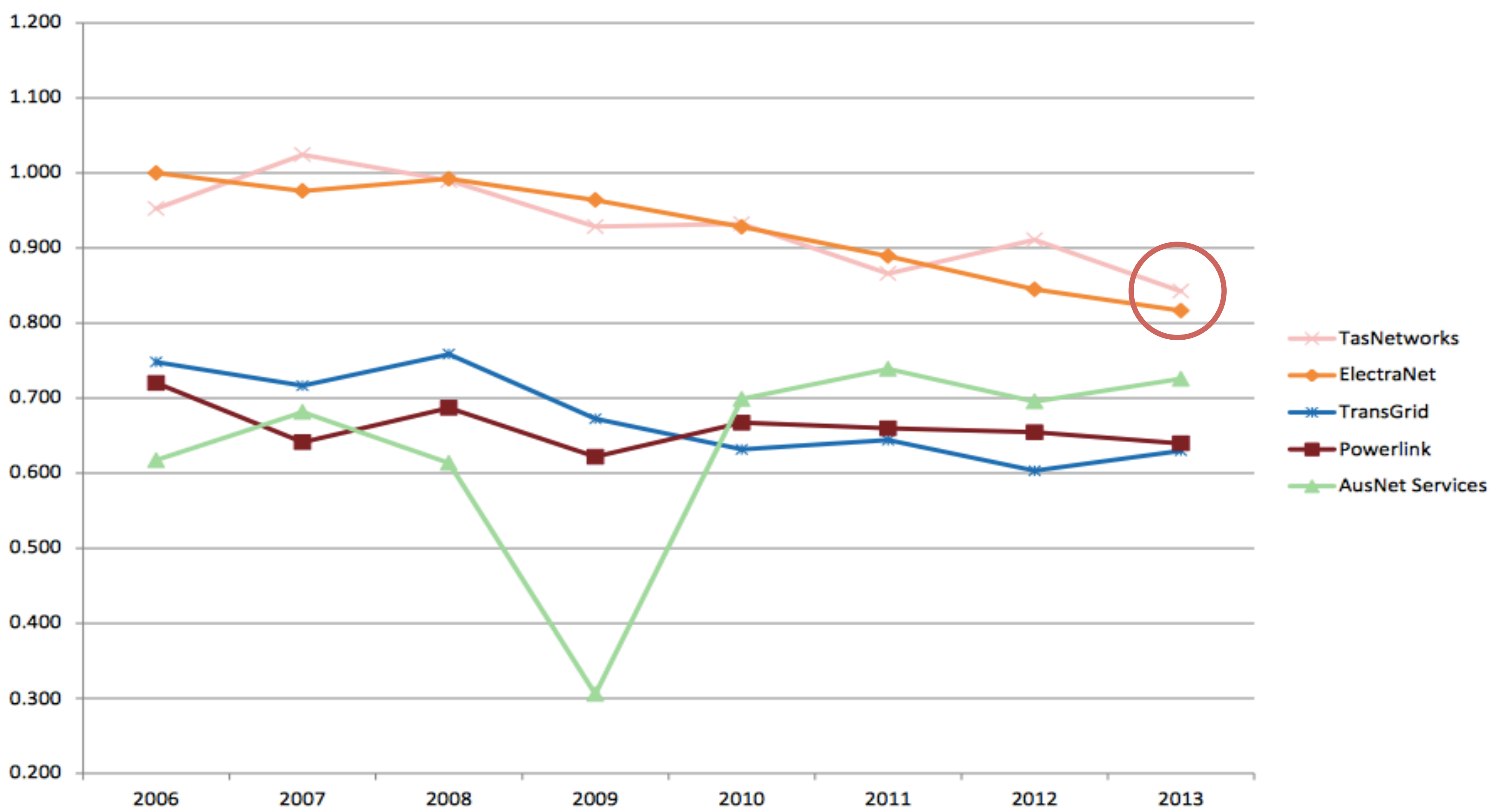
- The AER's first benchmarking reports were released in late November

- The AER has applied benchmarking to determine the opex allowances for the DNSPs - **but not for the TNSPs**

- **This is a major omission** in the AER's Draft Determinations

AER TNSP Benchmarking Report - MTFP

Figure 10 **Relative MTFP performance of transmission networks**



The Need to Apply Benchmarking to TNSPs' Opex Assessments

- The TNSPs have used benchmarking reports for many years to support their efficiency claims

- Transend's current revenue proposal referred to the *Huegen Transmission Benchmarking Study 2013 Report*

- TransGrid's current revenue proposal referred to the outcomes of 4 reports
  - International Transmission Operations and Maintenance Study (ITOMS)
  - International Transmission Asset Management Study (ITAMS)
  - Mercer Human Resource Effectiveness Monitor 2012
  - UMS Corporate Overheads High Level Comparative Assessment

- There are numerous other benchmarking reports that the AER could consider - e.g. the *EUAA's TNSP Benchmarking Report (October 2012)*

- Consumers urge the AER to seek out and apply the extensive information available to determine efficient opex allowances for Australia's TNSPs

AER Draft Determinations - Opex

	Proposal	AER Draft Determination 2014/15 - 2017/18	Reduction
TransGrid	**$836 Million**	**$702 Million**	**16 %**

	Proposal	AER Draft Determination 2014/15 - 2018/19	Reduction
Ausgrid	**$3,113 Million**	**$1,901 Million**	**39 %**
Essential Energy	**$2,515 Million**	**$1,552 Million**	**38.3%**
ActewAGL	**$414 Million**	**$241 Million**	**42%**

Source: AER Draft Determinations (Nominal Dollars)

PERFORMANCE INCENTIVE SCHEMES

Performance Incentive Schemes

- Efficiency Benefit Sharing Scheme (EBSS)
- Service Target Performance Incentive Scheme (STPIS)
- Demand Management Incentive Scheme (DMIS)
- Capital Expenditure Sharing Scheme (CESS)
- Network Capability Incentive Parameter Action Plan (NCIPAP)

Incentive Scheme Outcomes

- The outcomes of the AER's incentive schemes to date suggest that the AER is consistently setting allowances and targets above the efficient level
- The AER needs to negotiate targets that deliver genuine efficiency improvements and incentivise best practice

Concluding Comments

- The AER needs to apply reductions to Transend's proposed revenue
- Consumers expect the AER to exercise its discretion to determine a WACC that better reflects consumers interests
- Reductions in capex and opex also appear warranted - firm recommendations will be outlined in the CCP's formal submission to the AER in February
- Those reductions would still deliver generous returns to Transend and better reflect consumers' long term interest

Thank You

Hugh Grant

AER Consumer Challenge Panel Member