

# Networks NSW



Document tendered by

Mr. Vince Graham

Received by

Date: 11 / 5 / 2015

Resolved to publish Yes / No

## AER Final Determination Released 30 April 2015 Ausgrid – Endeavour - Essential

### PRESENTATION TO UNIONS

8 May  
2015

VINCE GRAHAM  
Chief Executive Officer, Ausgrid / Endeavour / Essential

## C ONTENTS

- 1 Background
- 2 **AER final decisions**
  - (a) Essential Energy
  - (b) Endeavour Energy
  - (c) Ausgrid
  - (d) AER criticisms of NSW Networks
- 3 NNSW issues of concern
- 4 Funding for jobs
- 5 Enterprise agreements
- 6 Next steps

# 1

## BACKGROUND

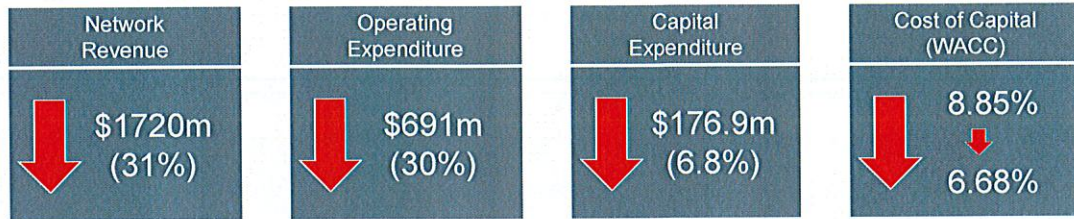
- The Australian Energy Regulator (AER) is the independent national regulator for electricity networks in Australia (*except WA and NT*)
- The AER, every five years, issues a regulatory determination for each network using a four step process:
  - **Initial Proposal** from the network;
  - A **Draft Determination** by the AER;
  - A **Revised Proposal** by the network;
  - A **Final Determination** by the AER.
- The AER's **Final Determination** is subject to legal appeals.
- Any decision on legal appeals must be lodged by 21 May 2015.

# 1

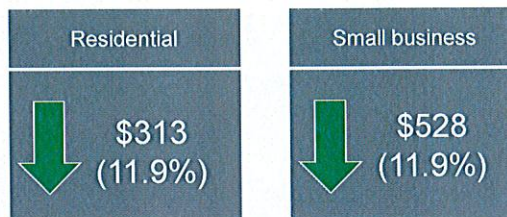
## BACKGROUND

- The AER, uses a “building block” model to calculate the “Total Revenue” networks can collect from customers. The building blocks are:
  - Approved operating costs;
  - Approved capital costs;
  - Return on capital and depreciation;
  - Efficiency schemes;
  - Income tax;
  - Alternative Control Services (eg: metering and street lighting).

DASHBOARD – compared to Essential Energy’s Revised Proposal

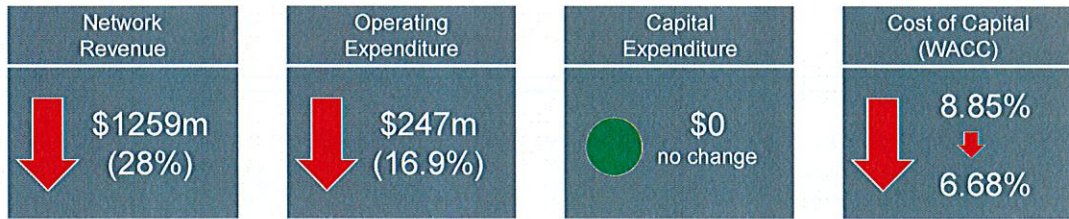


CUSTOMER BENEFITS – FY16 reduction in average electricity bills

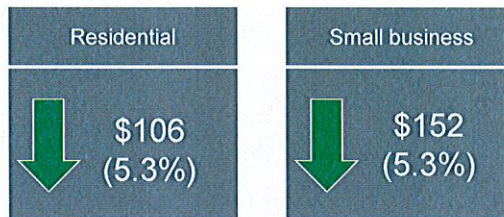


See Attachment A

**DASHBOARD** – compared to Endeavour Energy’s Revised Proposal

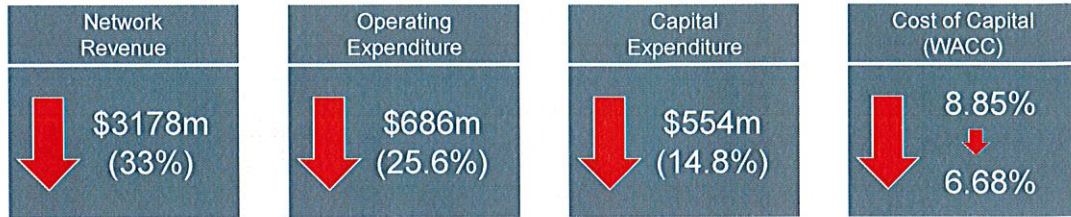


**CUSTOMER BENEFITS** – FY16 reduction in average electricity bills

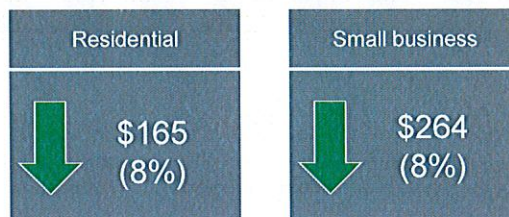


See Attachment B

## DASHBOARD – compared to Ausgrid's Revised Proposal



## CUSTOMER BENEFITS – FY16 reduction in average electricity bills



**Final decision: Ausgrid (distribution) 2015-19**

We have made a final decision on Ausgrid's distribution determination. Ausgrid is one of three electricity distributors in NSW. Our final decision allows Ausgrid to recover \$8576.4 million (nominal) from its customers over the 2015-19 regulatory control period.

**Overview**

The Australian Energy Regulator (AER) regulates Ausgrid by setting the annual revenue requirement & may receive from customers through distribution network charges. Our final decision allows Ausgrid to recover \$8576.4 million (nominal) from its customers over the 2015-19 regulatory control period. If we had accepted Ausgrid's proposal, it would have required \$9754.0 million (nominal) over the 2015-19 period. Our final decision is for 33 per cent less revenue than Ausgrid's proposal.

The figure below shows the difference between Ausgrid's proposed revenue, and what we have allowed for each year of the final decision. Ausgrid's past total revenue, proposed total revenue and AER final decision revenue allowance (\$ million, 2013-14).

**Estimated bill impact**

Based on the lower distribution charges from our final decision being passed through to customers, we expect average annual electricity bills for residential customers to reduce by \$165 (or 8 per cent) in 2015-16 and remain relatively stable over the rest of the period covered by this decision. For small business customers, we expect reductions of \$264 (or 8 per cent) in 2015-16, and relatively stable bills over the rest of the period covered by this decision. These are only estimates, and are based on the data we have about how much energy customers in NSW use. There are a number of other factors that also affect a customer's electricity bill, such as the wholesale price of electricity, how you can reduce your electricity usage, the energy prices on customers' bills, or our website: <http://www.ausgrid.com.au/energycustomers>.

**Key elements of our decision**

Our assessment of Ausgrid's proposed revenue is based on a number of components. These components include expenditure to maintain and operate the network, and the return to investors on their investment. Together, these determine the revenue Ausgrid may recover from its customers. Two components of our final decision drive most of the difference between Ausgrid's proposed revenue and our final decision rate of return and operating expenditure. We discuss each of these below.

**Rate of return**

Significant investment is required to build a distribution network. The return Ausgrid must pay lenders and investors is referred to as the rate of return. Even a small difference in the rate of return can have a big impact on revenues. Our final decision sets the allowed rate of return (or 'cost of capital') at 6.68 per cent in 2015-16. We have not accepted Ausgrid's proposal for a rate of return of 8.85 per cent.

**Capital expenditure**

Capital expenditure (capex) refers to the cost of building new facilities or replacing existing infrastructure. Factors that influence the required level of capex include the age and condition of existing assets. Capex is another key component of our final decision. We must be satisfied that the level of capex proposed by Ausgrid reflects the capex criteria: the costs that a prudent operator – with efficient costs and a realistic expectation of demand and cost inputs – would need to operate its network safely and comply with its obligations to service standards. We do not accept Ausgrid's proposed total forecast capex of \$3556 million (2013-14). Our final decision allows \$2012 million (2013-14), or 14.8 per cent lower than Ausgrid's proposal.

We did accept Ausgrid's proposal in respect of their revised augmentation capex (needed to build or upgrade its network), their customer connection capex and their capitalised overheads.

**AER final decision compared to Ausgrid's past and proposed capex (\$ million, 2013-14)**

The keys areas of difference between our substitute capex forecast and Ausgrid's revised proposal are lower expenditure on replacement capex and new network capex (such as buildings and property).

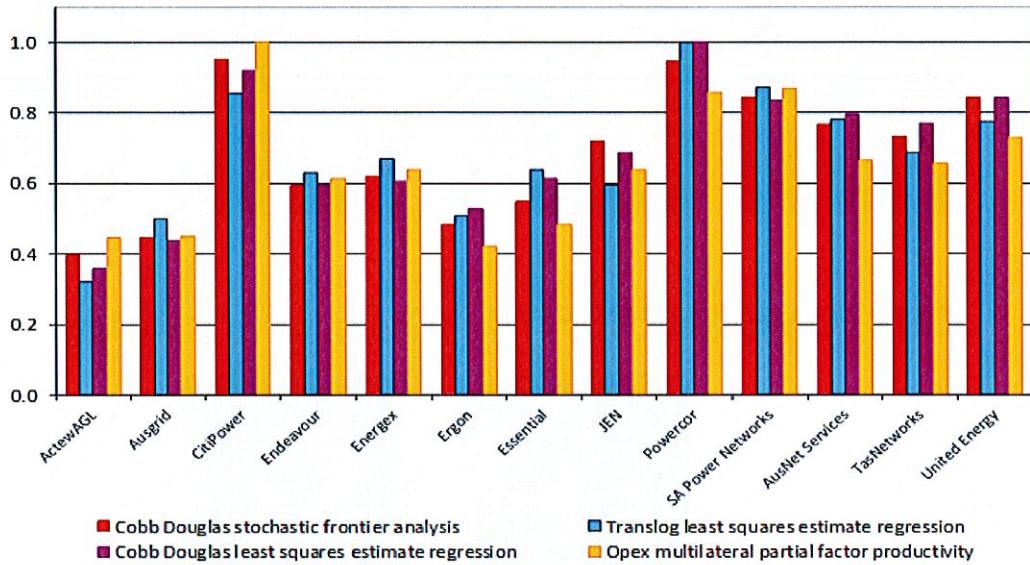
For more information: More information on our final decision can be found on our website: [www.aer.gov.au](http://www.aer.gov.au).

See Attachment C

## 2

### AER Final Decision – Benchmarking

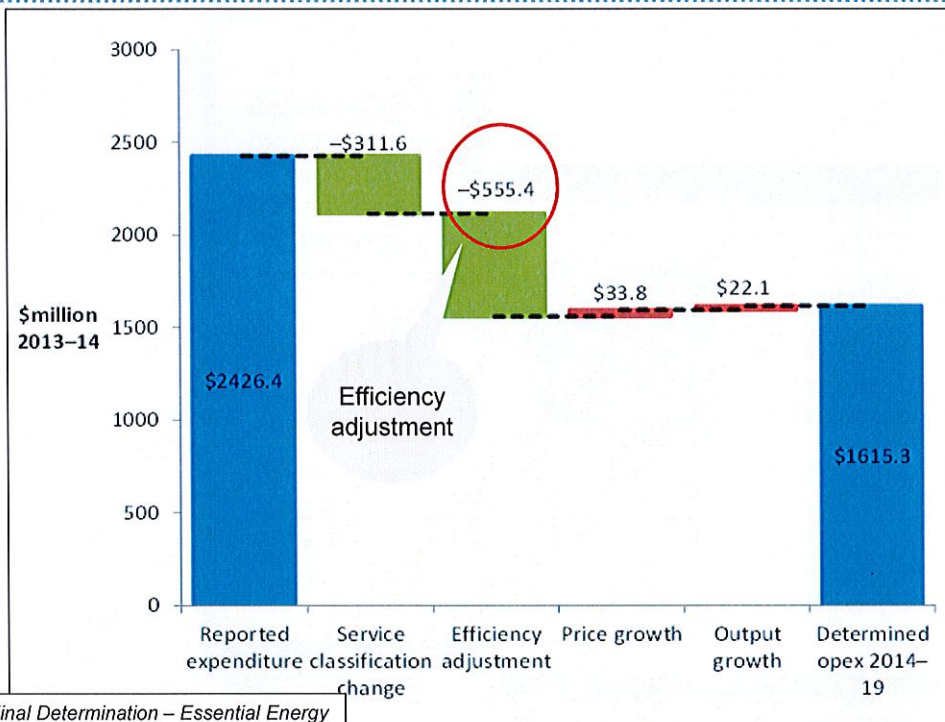
The AER applied four benchmarking models to each of the 13 distribution networks to assess relative operating cost efficiency for a base year (2012/13). CitiPower and Powercor were the most efficient.



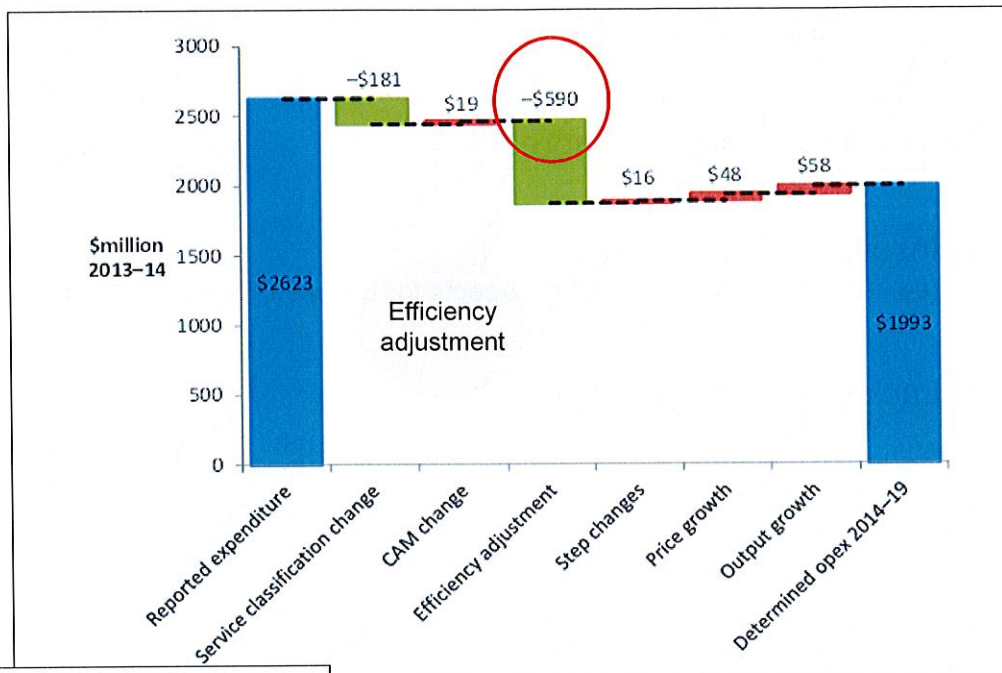
Source: Economic Insights, 2014.

## 2

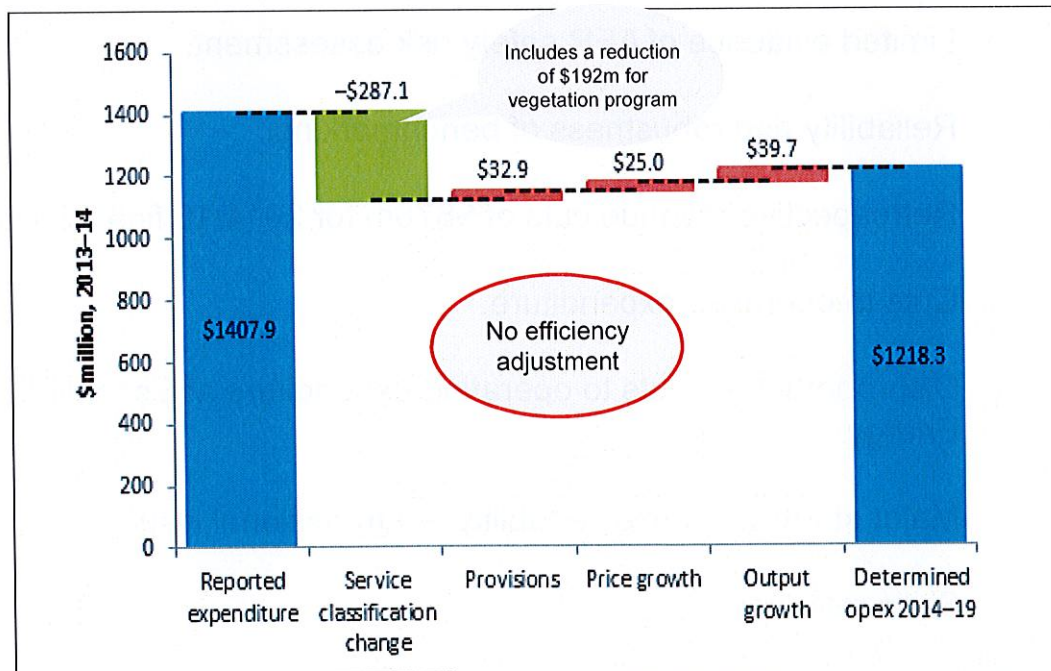
### AER Final Decision – Operating cost reduction



Source: AER Final Determination – Essential Energy



Source: AER Final Determination – Ausgrid



Source: AER Final Determination – Endeavour Energy

## 2

### AER final determination – AER criticisms of NSW networks

- Too many employees.
- Restrictive enterprise agreements.
- Insufficient outsourcing  
(eg: AER propose Local Service Agents for Essential Energy small depots).
- Lack of forced redundancy

(Reference: AER Essential Energy Overview p 41)

## 3

### AER final determination – NNSW issues of concern

- Limited evidence of AER safety risk assessment.
- Reliability and robustness of benchmarking.
- Retrospective revenue cuts of \$870m for 2014/15 financial year.
- Cuts to operating expenditure.
- Disproportionate cuts to operating expenditure at Essential Energy.
- Major storm response capability – a transitional issue.
- Skills retention.



# 4

## AER final determination – Funding for jobs

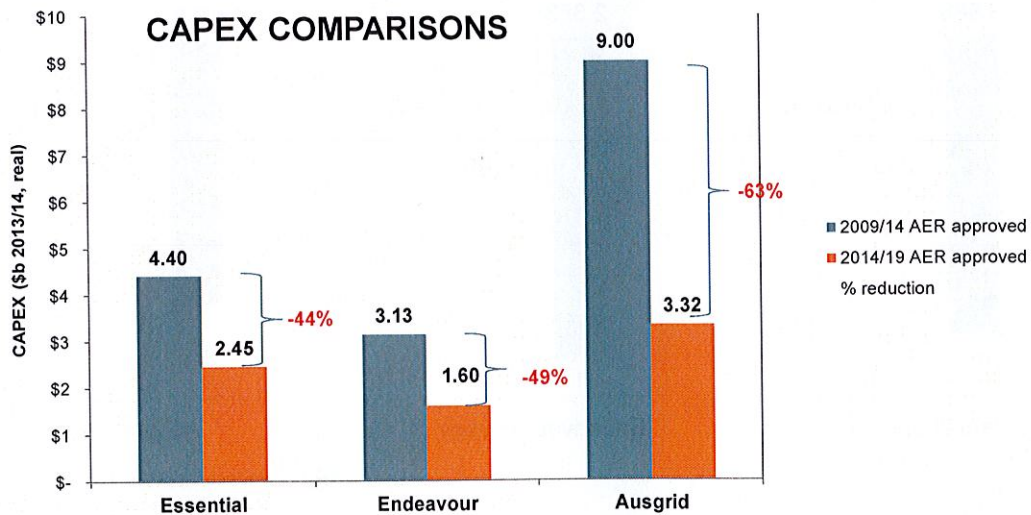
In our network businesses funding for jobs comes from four sources:

- AER (Final Determination)
  - AER approved operating program
  - AER approved capital program
    - Replacement capital (Repex)
    - New projects (Augex)
  - Alternative control services  
(includes metering, street lighting, disconnections and reconnections etc.)
- Non AER
  - Contestable metering, industry training

# 4

## AER final determination – Funding for jobs

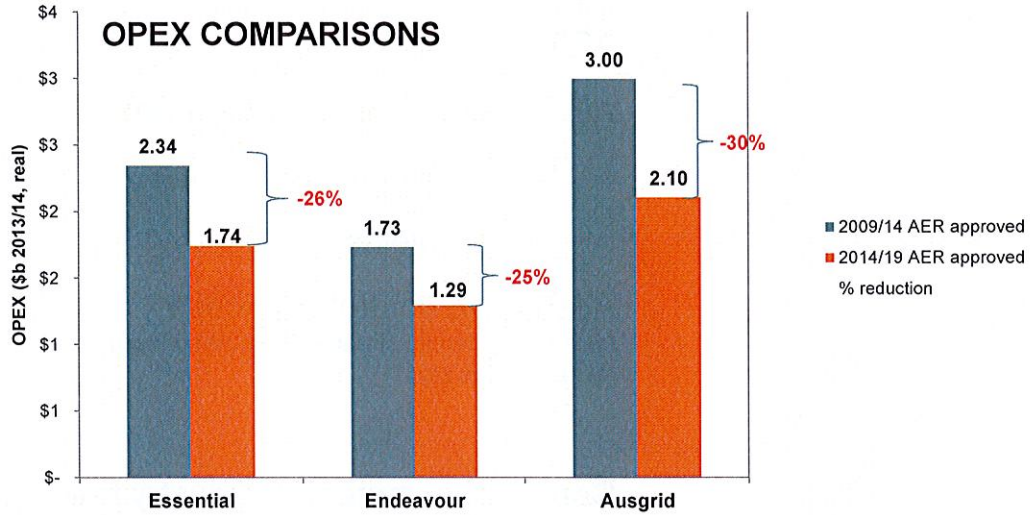
Changes in capital programs 2009/14 period v's 2014/19 period (\$2013/14):



# 4

## AER final determination – Funding for jobs

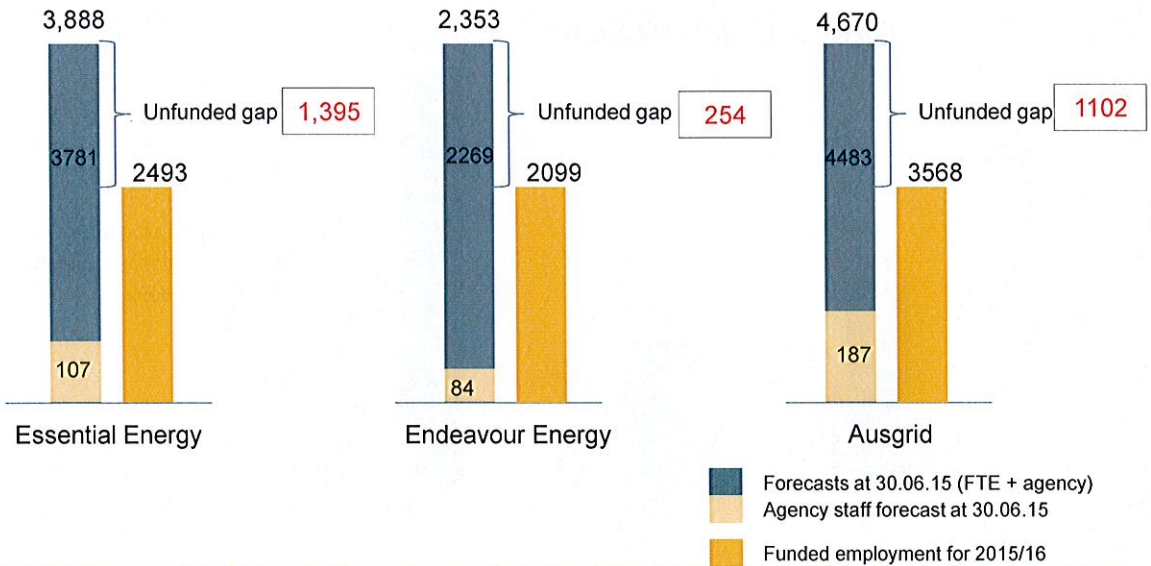
### Changes in operating programs 2009/14 period v's 2014/19 period (\$2013/14):



# 4

## AER final determination – Estimate of unfunded jobs for 2015/16

Note: 2015/16 numbers subject to change



## 4

## Unfunded jobs – 2015/16

	Essential	Endeavour	Ausgrid	Total
Forecast employees 30 June 2015 (FTE + Agency)*	3888	2353	4670	10911
Jobs funded by AER Final Determinations (sustainable jobs)	2493	2099	3568	8160
Unfunded jobs for 2015/16	1395	254	1102	2751

\*30 June forecasts assume 652 VRs (Ausgrid 446, Endeavour Energy 115 and Essential Energy 91) finalised by 30 June and a reduction in Agency Staff at Ausgrid by 50.

## 4

## Unfunded jobs – closing the gap

	Essential	Endeavour	Ausgrid	Total
Unfunded jobs for 2015/16	1395	254	1102	2751
Less wages freeze for all employees for two years	192	117	221	530
Less trade-offs for LSL, defined benefit super and maturing allowance (Endeavour Energy Only)	49	54	58	161
Remaining unfunded jobs for 2015/16	1154	83	823	2060

# 4

## Graduating Apprentices

A two year wage freeze for all employees will fund term contracts for suitable graduating apprentices in 2015 and 2016.

Graduating Year	Essential	Endeavour	Ausgrid	Total
2015	89	47	137	273
2016	114	43	79	236
<b>Subtotal</b>	<b>203</b>	<b>90</b>	<b>216</b>	<b>509</b>
2017	59	27	42	128
2018	30	18	41	89
<b>Total</b>	<b>292</b>	<b>135</b>	<b>299</b>	<b>726</b>
Jobs funding for two year wage freeze for all employees	192	117	221	530

# 5

## Objectives for new enterprise agreements

- Continue to maintain a safe, reliable and affordable network in the long term interest of NSW customers.
- Improve the productivity and competitiveness of current agreements.
- Align our future workforce with the funding provided by the AER final determination.
- Maintain skills and competencies.

## 5

### Proposals for enterprise bargaining

- A term to December 2017 (*Ausgrid and Endeavour Energy*)
- A term to June 2018 (*Essential Energy*)
- A wage freeze for the first two years of new enterprise agreements and NSW Wages Policy increase for the third year.
- Suitable graduating apprentices employed under fixed term award contracts for first two years of enterprise agreement funded by wage freeze. Location determined by employer.
- New redundancy and salary maintenance policy developed based on NSW Government's Managing Excess Employees Policy but maintaining existing redundancy payments for each network for the term of the agreement.
- Development and introduction of a retraining and redeployment model for placing excess employees into other organisations.

## 6

### Next Steps

- Unions to determine a position on NNSW proposal for the respective bargaining units.
- Management develops revised draft enterprise agreements including new redundancy policy for discussion in bargaining units.
- Management finalises decision on AER appeal by 21 May 2015.
- Management develops the redeployment and retraining model to better prepare excess employees for jobs in other organisations.





## Final decision: Essential Energy (distribution) 2015–19

We have made a final decision on Essential Energy's distribution determination. Essential Energy is one of three electricity distributors in NSW. Our final decision allows Essential Energy to recover \$3826.1 million (\$nominal) from its customers over the 2015–19 regulatory control period.<sup>1</sup>

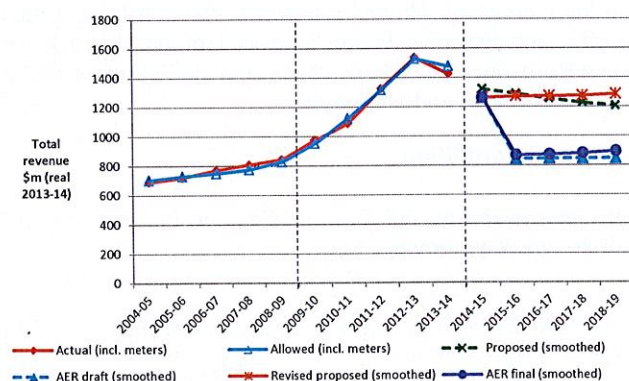
### Overview

The Australian Energy Regulator (AER) regulates Essential Energy by setting the annual revenue requirement it may recover from customers through distribution network charges.

Our final decision allows Essential Energy to recover \$3826.1 million (\$nominal) from its customers over the 2015–19 regulatory control period. If we had accepted Essential Energy's proposal, it would have recovered \$5545.7 million (\$nominal) over the 2015–19 regulatory control period. Our final decision is for 31 per cent less revenue than Essential Energy's proposal.

The figure below shows the difference between Essential Energy's proposed revenue, and what we have allowed for each year of the final decision.

**Essential Energy's past total revenue, proposed total revenue and AER final decision revenue allowance (\$ million, 2013–14)**



The revenue we determine affects the distribution component of a customer's electricity bill. Distribution charges make up about 43 per cent of the bill for one of Essential Energy's typical residential customers.

Other components in consumer bills include the cost of generation, transmission network charges, and retailer costs. The AER does not set retail prices.

### Estimated bill impact

Based on the lower distribution charges from our final decision being passed through to customers, we would expect average annual electricity bills for residential customers to reduce by \$313 (or 11.9 per cent) in 2015–16 and remain relatively stable over the rest of the period covered by this decision.

For small business customers, we estimate reductions of \$528 (or 11.9 per cent) in 2015–16 and relatively stable bills over the rest of the period covered by this decision.

These are only estimates, and are based on the data we have about how much energy customers in NSW use. There are a number of other factors that also affect a customer's electricity bill, such as the wholesale price of electricity. You can read more about what makes up the energy prices on customers' bills on our website: <http://www.aer.gov.au/Consumers>.

### Key elements of our decision

Our assessment of Essential Energy's proposed revenue is based on a number of components. These components include expenditure to maintain and operate the network, and the return to investors on their investment. Together, these determine the revenue Essential Energy may recover from its customers.

Two components of our final decision drive most of the difference between Essential Energy's proposed revenue and our final decision: rate of return and operating expenditure. We discuss each of these below.

### Rate of return

Significant investment is required to build a distribution network. The return Essential Energy must pay lenders and investors is referred to as the rate of return. Even a small difference in the rate of return can have a big impact on revenues.

Our final decision sets the allowed rate of return (or 'cost of capital') at 6.68 per cent in 2015–16. We have not accepted Essential Energy's proposal for a rate of return of 8.85 per

cent.<sup>ii</sup>

The investment environment has improved since our previous decision, which was made during the height of uncertainty surrounding the global financial crisis. This improved investment environment translates to lower financing costs necessary to attract efficient investment. We consider that Essential Energy has sought a rate of return that is higher than necessary given the current interest rate environment.

In our final decision we did not accept the methodology proposed by Essential Energy to set its rate of return. Instead, we have used our methodology developed with extensive consultation during our Better Regulation program in 2013. We consider that our approach provides for a rate of return that better reflects the allowed rate of return objective.

The lower rate of return in this decision will reduce Essential Energy's average annual revenue requirements compared to the past.

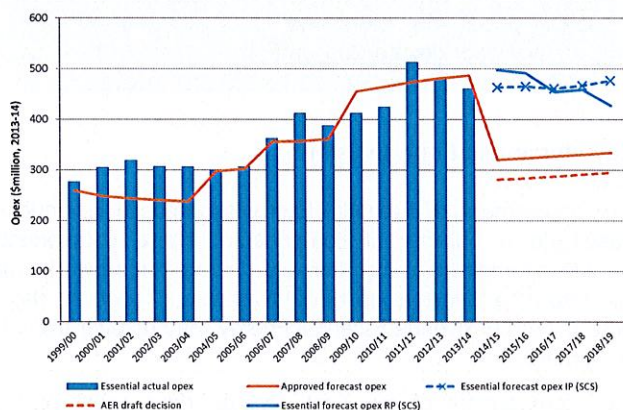
### Operating expenditure

Operating expenditure (opex) includes forecast operating, maintenance and other non-capital costs incurred in the provision of network services.

It includes labour costs, maintenance costs, and other non-capital costs that Essential Energy is likely to require during the 2014–19 period for the efficient operation of its network.

We did not accept Essential Energy's proposed \$2306.6 million (\$2013–14) opex forecast. Our final decision allows \$1615.3 million (\$2013–14). This is 30 per cent less than Essential Energy's proposal.

#### AER final decision compared to Essential Energy's past and proposed opex (\$million, 2013-14)



We must be satisfied that the level of opex reflects costs that a prudent operator—with efficient costs and a realistic expectation of demand and cost inputs—would need to operate its network safely and comply with its obligations and service standards.

Our evidence, including from benchmarking and detailed review of Essential Energy's historical expenditure, shows its costs are above what a prudent and efficient operator would incur in delivering services to Essential Energy's customers.

We assessed that Essential Energy's distribution services could be provided at a substantially lower cost while still maintaining safety and complying with reliability obligations.

### Capital expenditure

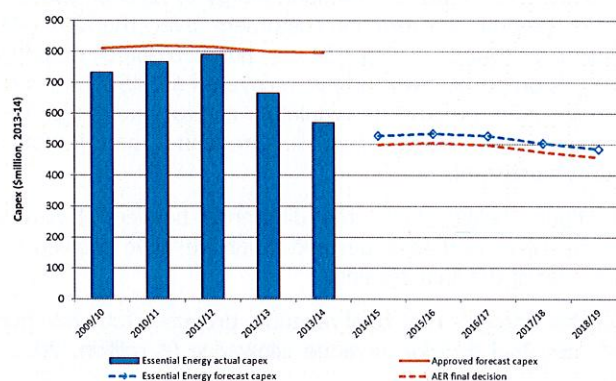
Capital expenditure (capex) refers to the cost of building new facilities or replacing existing infrastructure. Factors that influence the required level of capex include the age and condition of existing assets.

Capex is another key component of our final decision. We must be satisfied that the level of capex proposed by Essential Energy reflects the capex criteria: the costs that a prudent operator—with efficient costs and a realistic expectation of demand and cost inputs—would need to operate its network safely and comply with its obligations and service standards.

We did not accept Essential Energy's proposed total forecast capex of \$2577.9 million (\$2013–14). Our final decision allows \$2401.0 million (\$2013–14), or 6.8% lower than Essential Energy's proposal.

We did accept Essential Energy's proposal in respect of their revised augmentation capex (needed to build or upgrade its network), their customer connections capex and their capitalised overheads.

#### AER final decision compared to Essential Energy's past and proposed capex (\$million, 2013-14)



The keys areas of difference between our substitute capex forecast and Essential Energy's revised proposal are lower expenditure on replacement capex and non-network capex (such as buildings and property).

#### For more information:

More information on our final decision can be found on our website: [www.aer.gov.au](http://www.aer.gov.au).

<sup>i</sup> In November 2012 major changes were introduced to the regulation of distributors under the National Electricity Rules. Essential Energy's distribution determination was due to commence on 1 July 2014, and apply for a period of five years. So that the new rules could be applied to this decision, transitional rules required two regulatory control periods: a transitional regulatory control period from 1 July 2014 to 30 June 2015; and a subsequent regulatory control period commencing 1 July 2015. We made a fast-tracked placeholder determination for 2014-15. That determination has been adjusted (or 'trued up') in this final decision. Essential Energy's approved revenue for the combined 2014-19 period is \$5117.8 million (\$nominal).

<sup>ii</sup> The rate of return that Essential Energy included in its proposal is an indicative value. Its proposal includes provision for the AER to adjust this value based on updated information that was not available when Essential Energy submitted its revised proposal. More information on the rate of return can be found in our Rate of Return Fact Sheet.





## Final decision: Endeavour Energy (distribution) 2015–19

We have made a final decision on Endeavour Energy's distribution determination. Endeavour Energy is one of three electricity distributors in NSW. Our final decision allows Endeavour Energy to recover \$3182.8 million (\$nominal) from its customers over the 2015–19 regulatory control period.<sup>1</sup>

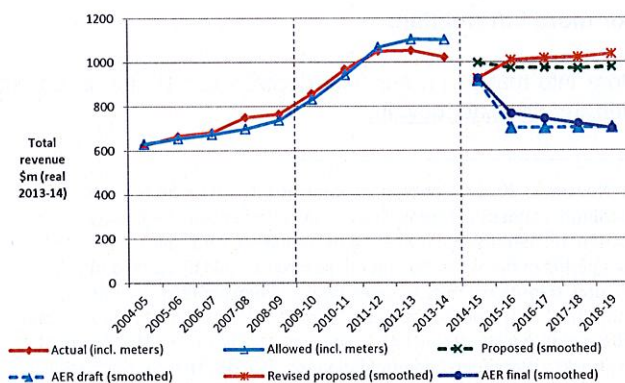
### Overview

The Australian Energy Regulator (AER) regulates Endeavour Energy by setting the annual revenue requirement it may recover from customers through distribution network charges.

Our final decision allows Endeavour Energy to recover \$3182.8 million (\$nominal) from its customers over the 2015–19 regulatory control period. If we had accepted Endeavour Energy's proposal, it would have recovered \$4441.3 million (\$ nominal) over the 2015–19 regulatory control period. Our final decision is for 28 per cent less revenue than Endeavour Energy's proposal.

The figure below shows the difference between Endeavour Energy's proposed revenue, and what we have allowed for each year of the final decision.

**Endeavour Energy's past total revenue, proposed total revenue and AER final decision revenue allowance (\$ million, 2013–14)**



The revenue we determine affects the distribution component of a customer's electricity bill. Distribution charges make up about 39 per cent of the bill for one of Endeavour Energy's typical residential customers.

Other components in consumer bills include the cost of generation, transmission network charges, and retailer costs. The AER does not set retail prices.

### Estimated bill impact

Based on the lower distribution charges from our final decision being passed through to customers, we expect average annual electricity bills for residential customers to reduce by \$106 (or 5.3 per cent) in 2015–16 and remain relatively stable over the rest of the period covered by this decision.

For small business customers, we expect reductions of \$152 (5.3 per cent) in 2015–16 and relatively stable bills over the rest of the period covered by this decision.

These are only estimates, and are based on the data we have about how much energy customers in NSW use. There are a number of other factors that also affect a customer's electricity bill, such as the wholesale price of electricity. You can read more about what makes up the energy prices on customers' bills on our website: <http://www.aer.gov.au/Consumers>.

### Key elements of our decision

Our assessment of Endeavour Energy's proposed revenue is based on a number of components. These components include expenditure to maintain and operate the network, and the return to investors on their investment. Together, these determine the revenue Endeavour Energy may recover from its customers.

Two components of our final decision drive most of the difference between Endeavour Energy's proposed revenue and our final decision: rate of return and operating expenditure. We discuss each of these below.

### Rate of return

Significant investment is required to build a distribution network. The return Endeavour Energy must pay lenders and investors is referred to as the rate of return. Even a small difference in the rate of return can have a big impact on revenues.

Our final decision sets the allowed rate of return (or 'cost of capital') at 6.68 per cent in 2015–16. We have not accepted

Endeavour Energy's proposal for a rate of return of 8.85 per cent.<sup>ii</sup>

The investment environment has improved since our previous decision, which was made during the height of uncertainty surrounding the global financial crisis. This improved investment environment translates to lower financing costs necessary to attract efficient investment. We consider that Endeavour Energy has sought a rate of return that is higher than necessary given the current investment environment.

In our final decision we did not accept the methodology proposed by Endeavour Energy to set its rate of return. Instead, we have used our methodology developed with extensive consultation during our Better Regulation program in 2013. We consider that our approach provides for a rate of return that better reflects the allowed rate of return objective.

The lower rate of return in this decision will reduce Endeavour Energy's average annual revenue requirements compared to the past.

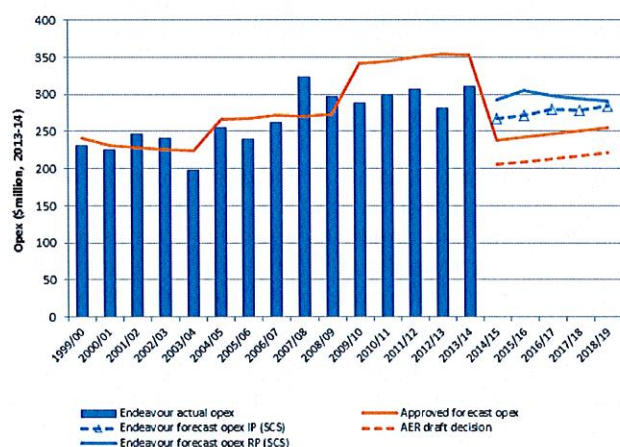
### Operating expenditure

Operating expenditure (opex) includes forecast operating, maintenance and other non-capital costs incurred in the provision of network services.

It includes labour costs, maintenance costs, and other non-capital costs that Endeavour Energy is likely to require during the 2014–19 period for the efficient operation of its network.

We did not accept Endeavour Energy's proposed \$1465.6 million (\$2013–14) opex forecast. Our final decision allows \$1218.3 million (\$2013–14). This is 16.9 per cent less than Endeavour Energy's proposal.

### AER final decision compared to Endeavour Energy's past and proposed opex (\$million, 2013–14)



We must be satisfied that the level of opex reflects costs that a prudent operator—with efficient costs and a realistic expectation of demand and cost inputs—would need to operate its network safely and comply with its obligations and service standards.

In our final decision we have relied on Endeavour Energy's revealed opex as a starting point for forecasting future opex. However, the key issue driving the difference between our final decision and Endeavour Energy's revised opex forecast is

our decision not to include a step change for increased vegetation management costs.

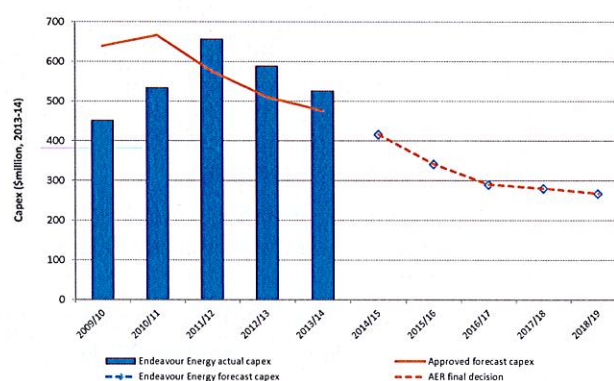
### Capital expenditure

Capital expenditure (capex) refers to the cost of building new facilities or replacing existing infrastructure. Factors that influence the required level of capex include the age and condition of existing assets.

Capex is another key component of our final decision. We must be satisfied that the level of capex proposed by Endeavour Energy reflects the capex criteria: the costs that a prudent operator—with efficient costs and a realistic expectation of demand and cost inputs—would need to operate its network safely and comply with its obligations and service standards.

We accept Endeavour Energy's proposed total forecast capex of \$1595.8 million (\$2013–14). We are satisfied that Endeavour Energy's revised total capex forecast reasonably reflects the capex criteria.

### AER final decision compared to Endeavour Energy's past and proposed capex (\$million, 2013–14)



### For more information:

More information on our final decision can be found on our website: [www.aer.gov.au](http://www.aer.gov.au).

<sup>i</sup> In November 2012 major changes were introduced to the regulation of distributors under the National Electricity Rules. Endeavour Energy's distribution determination was due to commence on 1 July 2014, and apply for a period of five years. So that the new rules could be applied to this decision, transitional rules required two regulatory control periods: a transitional regulatory control period from 1 July 2014 to 30 June 2015; and a subsequent regulatory control period commencing 1 July 2015. We made a fast-tracked placeholder determination for 2014-15. That determination has been adjusted (or 'trued up') in this final decision. Endeavour Energy's approved revenue for the combined 2014-19 period is \$4132.3 million (\$nominal).

<sup>ii</sup> The rate of return that Endeavour Energy included in its proposal is an indicative value. Its proposal includes provision for the AER to adjust this value based on updated information that was not available when Endeavour Energy submitted its revised proposal. More information on the rate of return can be found in our Rate of Return Fact Sheet.



## Final decision: Ausgrid (distribution) 2015–19

We have made a final decision on Ausgrid's distribution determination. Ausgrid is one of three electricity distributors in NSW. Our final decision allows Ausgrid to recover \$6576.4 million (\$nominal) from its customers over the 2015–19 regulatory control period.<sup>i</sup>

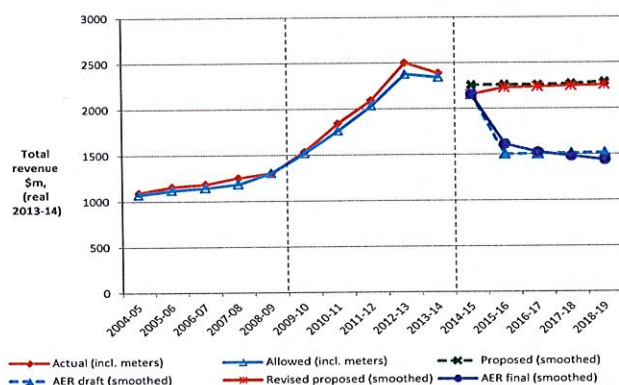
### Overview

The Australian Energy Regulator (AER) regulates Ausgrid by setting the annual revenue requirement it may recover from customers through distribution network charges.

Our final decision allows Ausgrid to recover \$6576.4 million (\$nominal) from its customers over the 2015–19 regulatory control period. If we had accepted Ausgrid's proposal, it would have recovered \$9754.0 million (\$nominal) over the 2015–19 period. Our final decision is for 33 per cent less revenue than Ausgrid's proposal.

The figure below shows the difference between Ausgrid's proposed revenue, and what we have allowed for each year of the final decision.

**Ausgrid's past total revenue, proposed total revenue and AER final decision revenue allowance (\$ million, 2013–14)**



The revenue we determine affects the distribution component of a customer's electricity bill. Distribution charges make up about 38 per cent of the bill for one of Ausgrid's typical residential customers.

Other components in consumer bills include the cost of generation, transmission network charges, and retailer costs. The AER does not set retail prices.

### Estimated bill impact

Based on the lower distribution charges from our final decision being passed through to customers, we expect average annual electricity bills for residential customers to reduce by \$165 (or 8 per cent) in 2015–16 and remain relatively stable over the rest of the period covered by this decision.

For small business customers, we expect reductions of \$264 (or 8 per cent) in 2015–16 and relatively stable bills over the rest of the period covered by this decision.

These are only estimates, and are based on the data we have about how much energy customers in NSW use. There are a number of other factors that also affect a customer's electricity bill, such as the wholesale price of electricity. You can read more about what makes up the energy prices on customers' bills on our website: <http://www.aer.gov.au/Consumers>.

### Key elements of our decision

Our assessment of Ausgrid's proposed revenue is based on a number of components. These components include expenditure to maintain and operate the network, and the return to investors on their investment. Together, these determine the revenue Ausgrid may recover from its customers.

Two components of our final decision drive most of the difference between Ausgrid's proposed revenue and our final decision: rate of return and operating expenditure. We discuss each of these below.

### Rate of return

Significant investment is required to build a distribution network. The return Ausgrid must pay lenders and investors is referred to as the rate of return. Even a small difference in the rate of return can have a big impact on revenues.

Our final decision sets the allowed rate of return (or 'cost of capital') at 6.68 per cent in 2015–16. We have not accepted Ausgrid's proposal for a rate of return of 8.85 per cent.<sup>ii</sup>

The investment environment has improved since our previous decision, which was made during the height of uncertainty surrounding the global financial crisis. This improved investment environment translates to lower financing costs necessary to attract efficient investment. We consider that Ausgrid has sought a rate of return that is higher than necessary given the current investment environment.

In our final decision we did not accept the methodology proposed by Ausgrid to set its rate of return. Instead, we have used our methodology developed with extensive consultation during our Better Regulation program in 2013. We consider that our approach provides for a rate of return that better reflects the allowed rate of return objective.

The lower rate of return in this decision will reduce Ausgrid's average annual revenue requirements compared to the past.

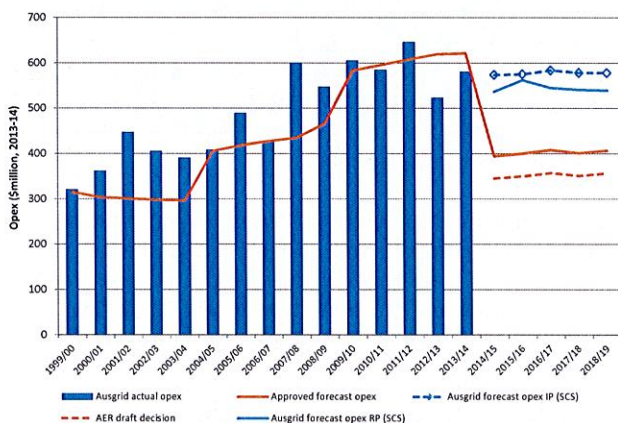
### Operating expenditure

Operating expenditure (opex) includes forecast operating, maintenance and other non-capital costs incurred in the provision of network services.

It includes labour costs, maintenance costs, and other non-capital costs that Ausgrid is likely to require during the 2014–19 period for the efficient operation of its network.

We did not accept Ausgrid's proposed \$2679.3 million (\$2013–14) opex forecast. Our final decision allows \$1992.9 million (\$2013–14). This 25.6 per cent less than Ausgrid's proposal.

#### AER final decision compared to Ausgrid's past and proposed opex (\$million, 2013-14)



We must be satisfied that the level of opex reflects costs that a prudent operator—with efficient costs and a realistic expectation of demand and cost inputs—would need to operate its network safely and comply with its obligations and service standards.

Our evidence, including from benchmarking and detailed review of Ausgrid's historical expenditure, shows its costs are above what a prudent and efficient operator would incur in delivering services to Ausgrid's customers.

We assessed that Ausgrid's distribution services could be provided at a substantially lower cost while still maintaining safety and complying with reliability obligations.

### Capital expenditure

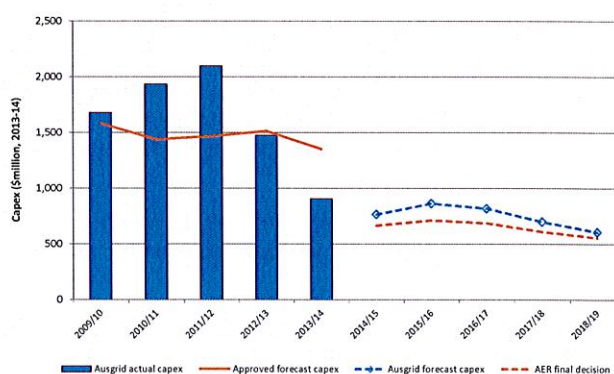
Capital expenditure (capex) refers to the cost of building new facilities or replacing existing infrastructure. Factors that influence the required level of capex include the age and condition of existing assets.

Capex is another key component of our final decision. We must be satisfied that the level of capex proposed by Ausgrid reflects the capex criteria: the costs that a prudent operator—with efficient costs and a realistic expectation of demand and cost inputs—would need to operate its network safely and comply with its obligations and service standards.

We did not accept Ausgrid's proposed total forecast capex of \$3755.6 million (\$2013–14). Our final decision allows \$3201.2 million (\$2013–14), or 14.8 per cent lower than Ausgrid's proposal.

We did accept Ausgrid's proposal in respect of their revised augmentation capex (needed to build or upgrade its network), their customer connections capex and their capitalised overheads.

#### AER final decision compared to Ausgrid's past and proposed capex (\$million, 2013-14)



The keys areas of difference between our substitute capex forecast and Ausgrid's revised proposal are lower expenditure on replacement capex and non-network capex (such as buildings and property).

#### For more information:

More information on our final decision can be found on our website: [www.aer.gov.au](http://www.aer.gov.au).

<sup>i</sup> In November 2012 major changes were introduced to the regulation of distributors under the National Electricity Rules. Ausgrid's distribution determination was due to commence on 1 July 2014, and apply for a period of five years. So that the new rules could be applied to this decision, transitional rules required two regulatory control periods: a transitional regulatory control period from 1 July 2014 to 30 June 2015; and a subsequent regulatory control period commencing 1 July 2015. We made a fast-tracked placeholder determination for 2014-15. That determination has been adjusted (or 'trued up') in this final decision. Ausgrid's approved revenue for the combined 2014-19 period is \$8785.2 million (\$nominal).

<sup>ii</sup> The rate of return that Ausgrid included in its proposal is an indicative value. Its proposal includes provision for the AER to adjust this value based on updated information that was not available when Ausgrid submitted its revised proposal. More information on the rate of return can be found in our Rate of Return Fact Sheet.