AUSTRALIAN ENERGY REGULATOR

Draft decision

Powerlink transmission

1 July 2012 to 30 June 2017

Mr Andrew Reeves

Chairman

14 December 2011

Agenda

9:00 am	Introduction, Mr Warwick Anderson
9:30 am	Presentation by Andrew Reeves Chair AER
10:30 am	Presentation by Bob Lim, Energy Consumers Group operating in Queensland
11:00 am	Questions
11:30 am	Conference close

Housekeeping

- Please sign the attendance sheet
- A record of this meeting will be made
- Morning tea will be served after the presentations

Framework

- The AER is responsible for the economic regulation of transmission services. The AER draft decision for transmission under the National Electricity Rules (NER) chapter 6A has four elements:

  <u>Prescribed services</u>
  - revenue decision
  - pricing methodology

  <u>Negotiated services</u>
  - negotiating framework
  - negotiated Transmission Services Criteria (NTSC)

- Other chapter 6A rules concerned with contingent projects, service standards, the pricing policy and the negotiating framework all operate in a similar fashion

Specialist advice

- Energy Market Consulting associates
  - demand forecasting review
  - forecast capital expenditure (capex) and service targets
- Deloitte
  - forecast labour cost growth
  - productivity measures to adjust labour price index and average weekly ordinary time earnings
- CHC Associates
  - Kogan Creek assets

Indicative prices

- Transmission charges represent approximately 10 per cent of end user electricity charges in Queensland

- Impact of draft decision on indicative average:

  <u>transmission charges</u>

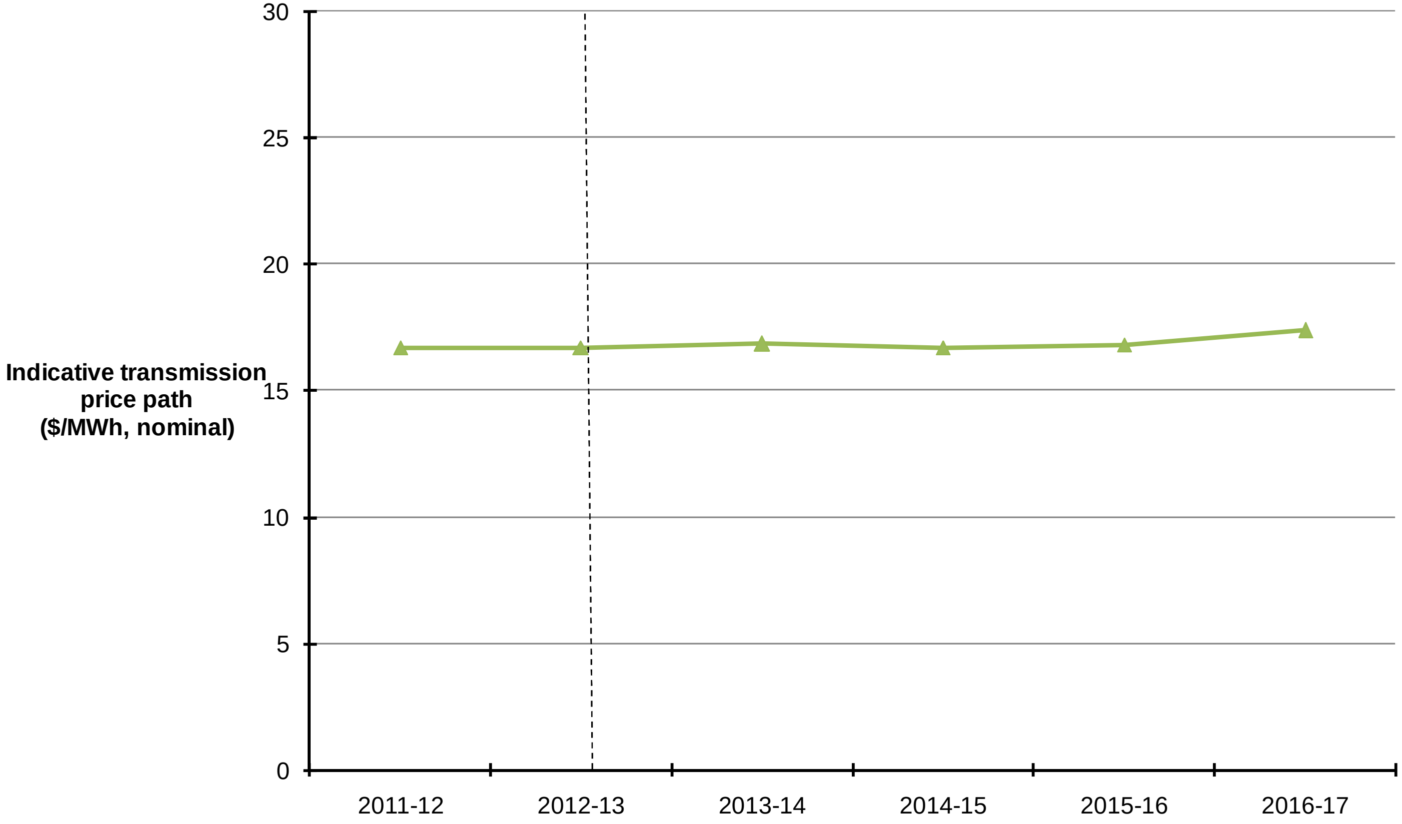
  – increase of 0.8 per cent per annum (nominal) from 2011-12 to 2016-17

  <u>residential retail prices</u>

  – typical residential customer's annual bill of $1655 may increase by about $1.40 per annum

- Final Determination impacts will take account of Powerlink response and financial market conditions closer to the time of the decision.

Indicative price path



Revenue

- The revenue forecast is a summation of the following components:
  - return on previous capital investment
  - depreciation allowance
  - operating expenditure (opex)
  - corporate income tax

- The AER does not accept all elements of Powerlink's revenue proposal and has determined lower revenues than those proposed

- The main reductions relate to reduced forecast demand, capex and opex and the proposed WACC

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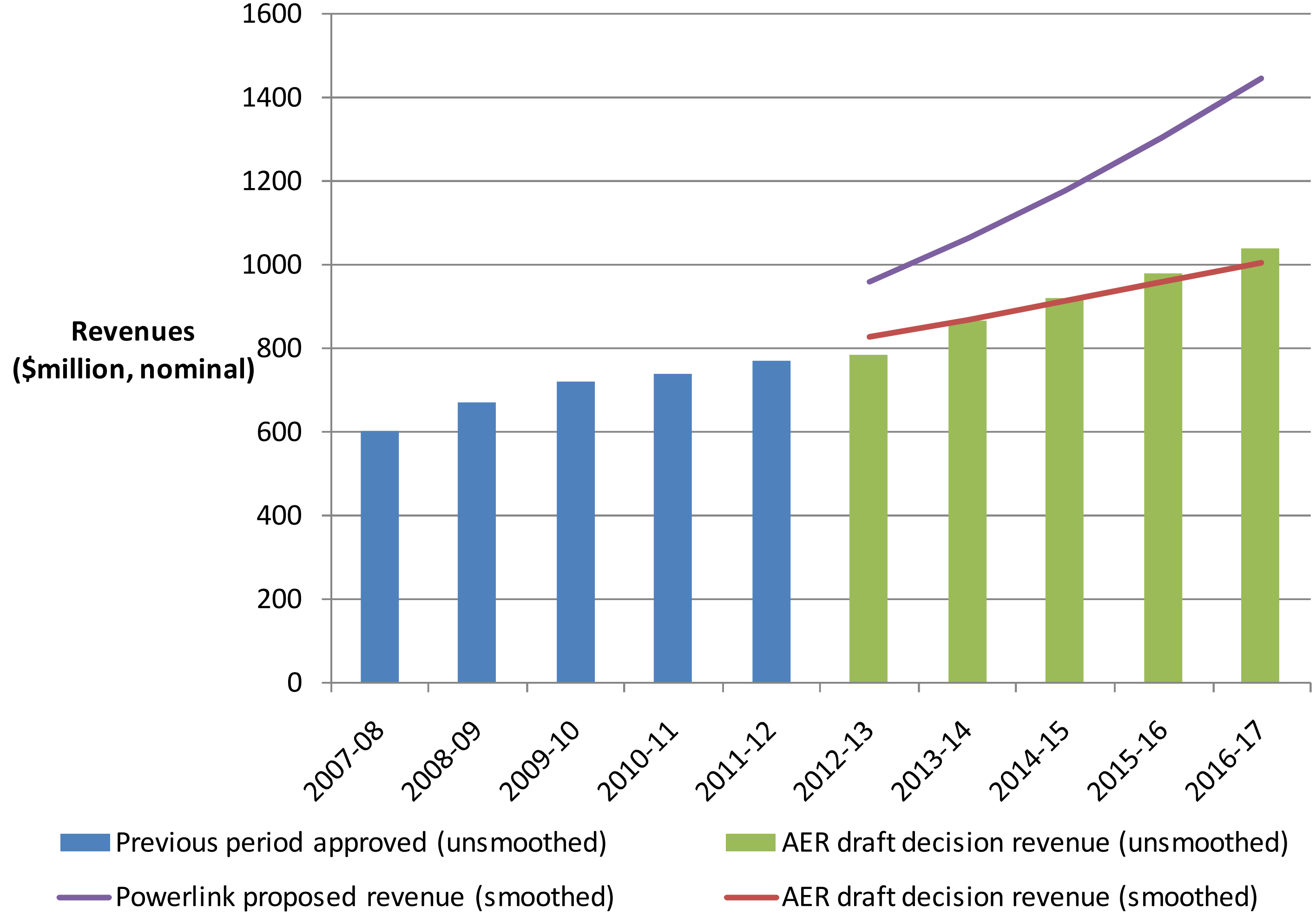
Revenue

- The 2012-13 to 2016-17 total smoothed revenue allowance for Powerlink is $4563 million ($nominal)
  - 36 per cent increase (real) on current period
  - 23 per cent below Powerlink's proposal ($5954 million ($nominal))

Revenue



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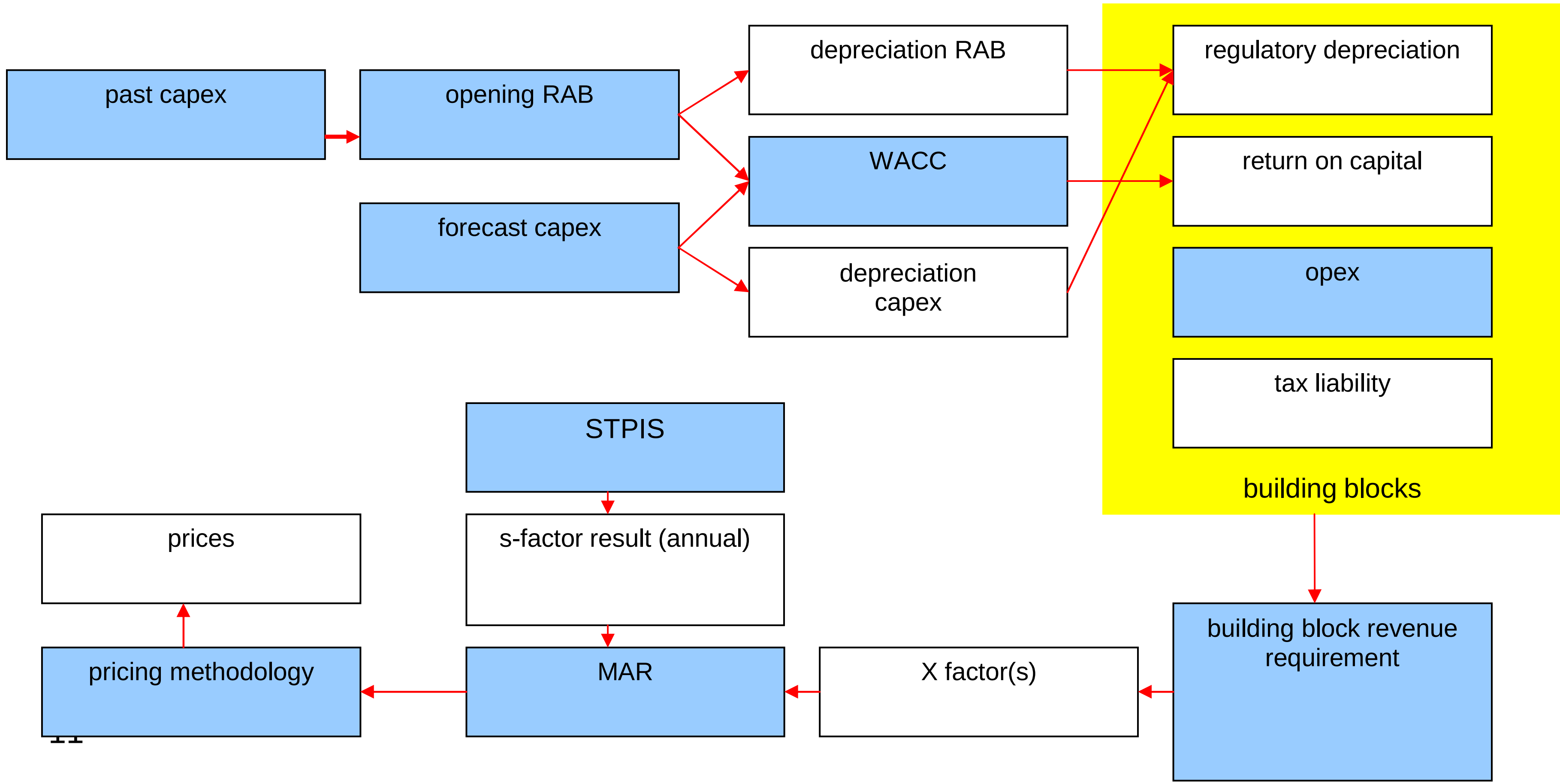
Revenue

- The revenue allowance is calculated from the following components



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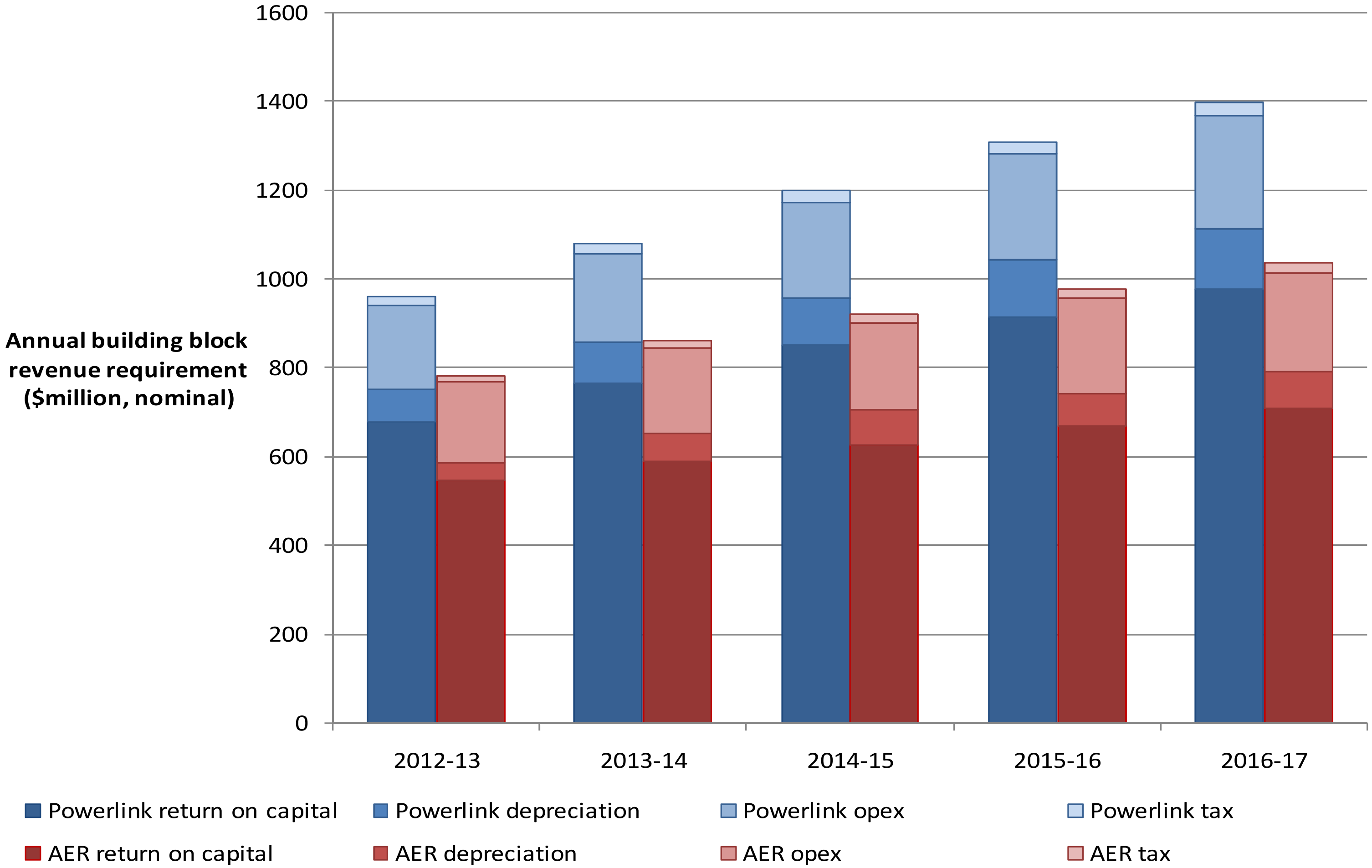
Annual building block revenue



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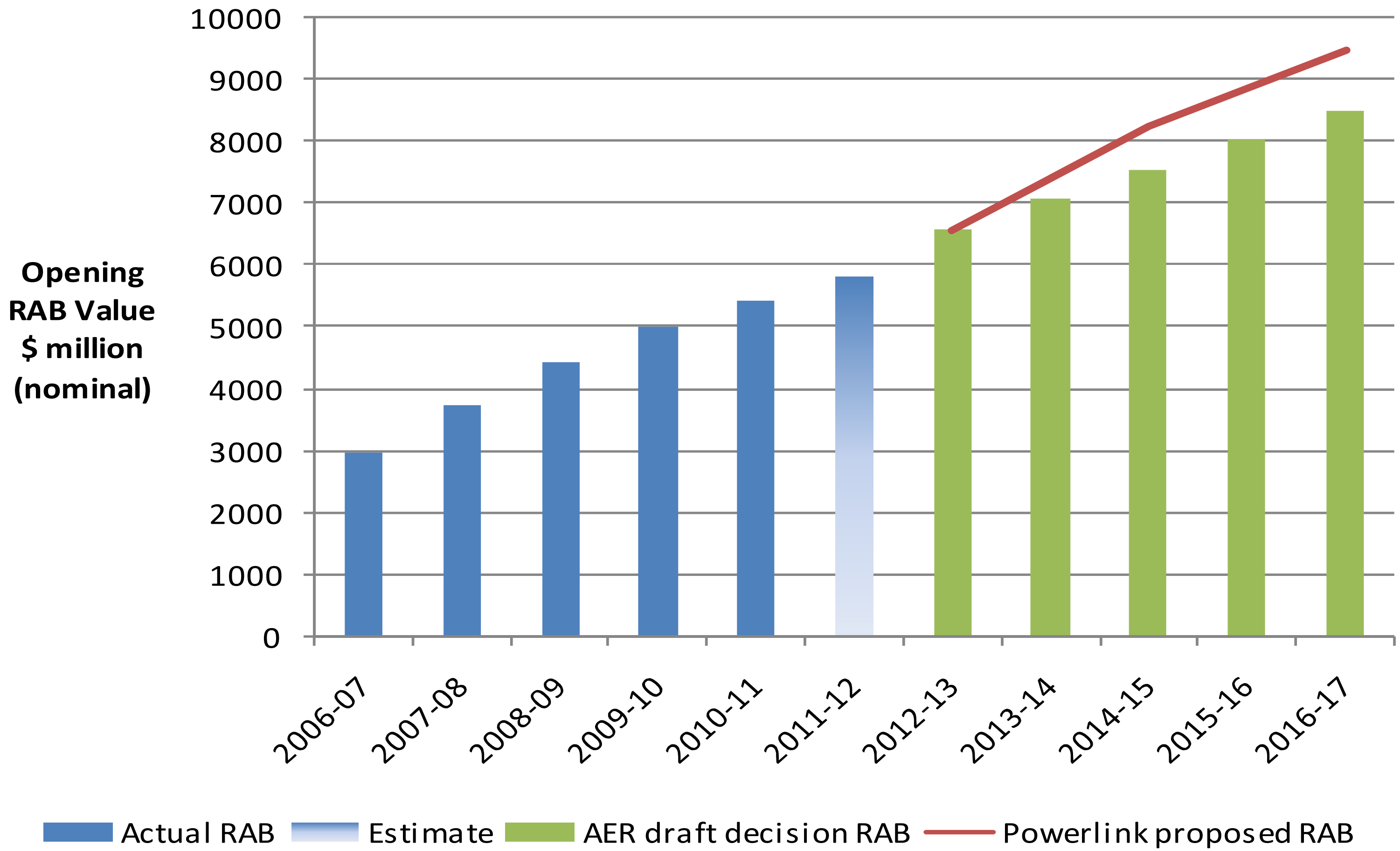
Regulatory asset base



Regulatory asset base

Powerlink proposal

- opening $6576 million
- closing $9982 million
- 52 per cent increase during the regulatory period

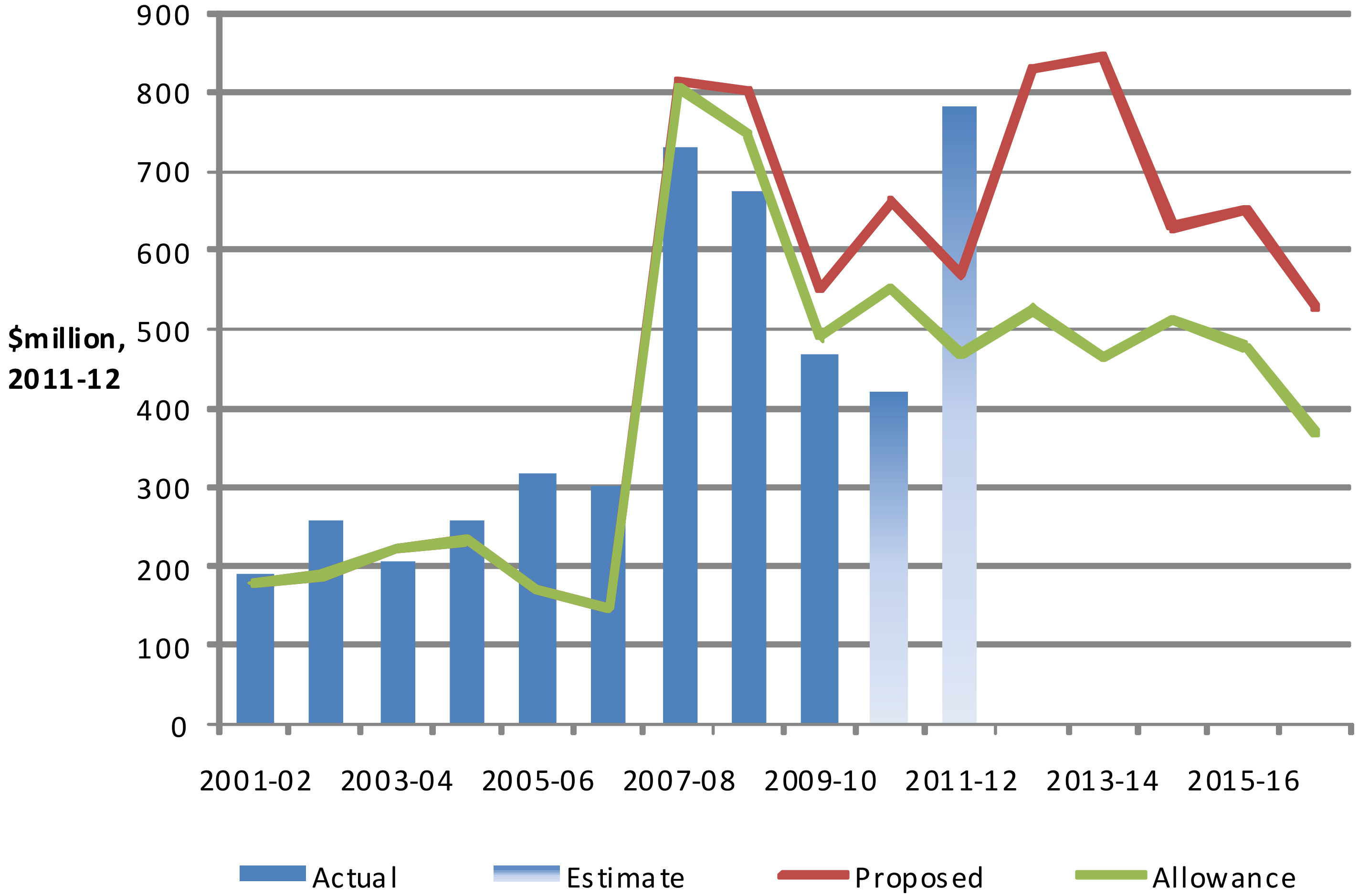
AER draft decision

- opening $6576 million
- closing $8877 million
- 35 per cent increase during the regulatory period

Reasons

- lower inflation forecast for the next regulatory control period
- reduced forecast capex
- forecast depreciation: AER does not accept the retrospective application of a new asset class (transmission line refit) to the roll forward calculations during the current regulatory control period

Capex allowance



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Capex allowance

Powerlink proposal

- $3488 million ($2011-12)

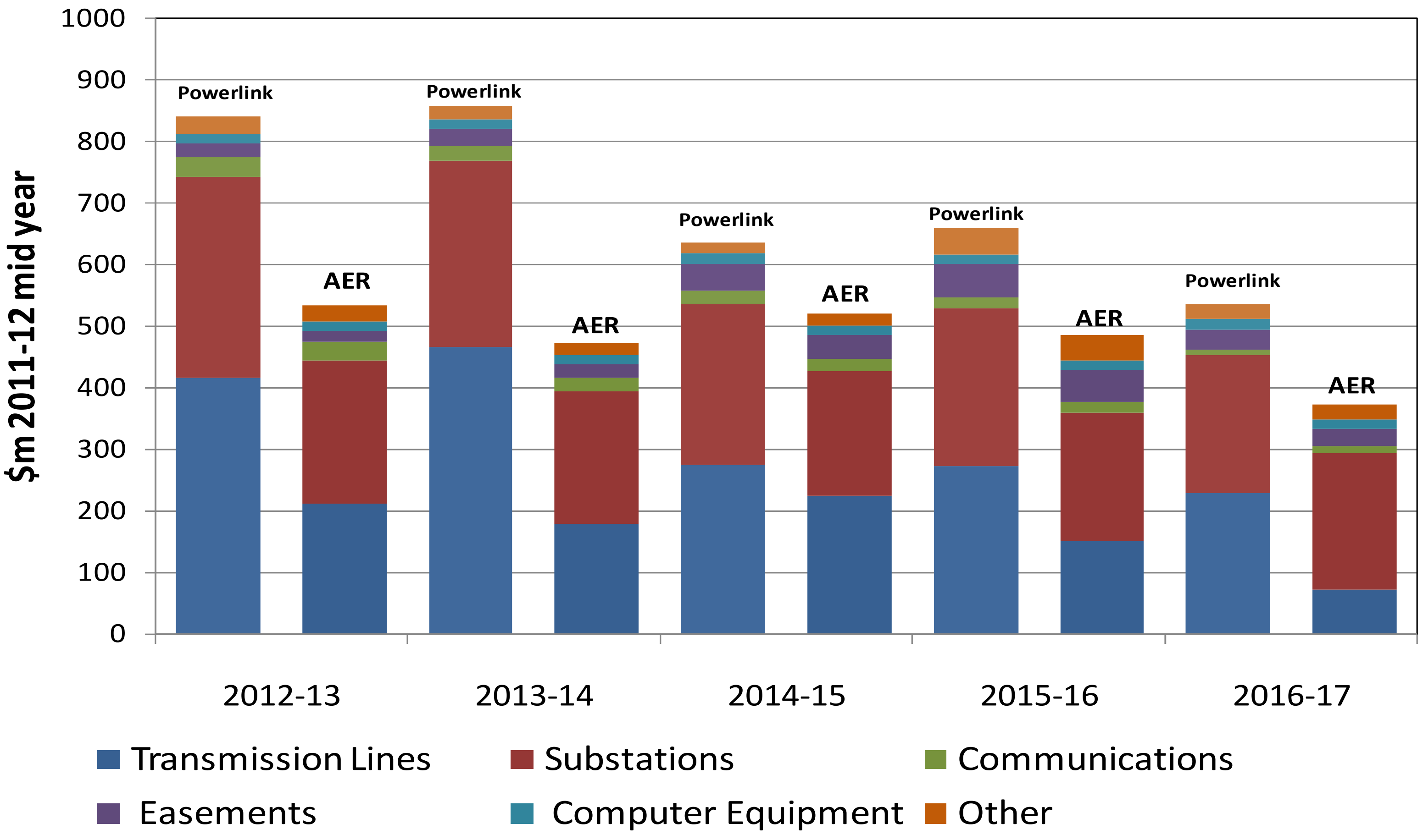
AER draft decision

- $2360 million ($2011-12)
- decrease of 23 per cent

Reasons

- reduced demand forecast
- 500kV projects
- carbon price trajectory
- cost estimation risk factor
- efficiency program
- equity raising costs
- cost escalation

Capex allowance



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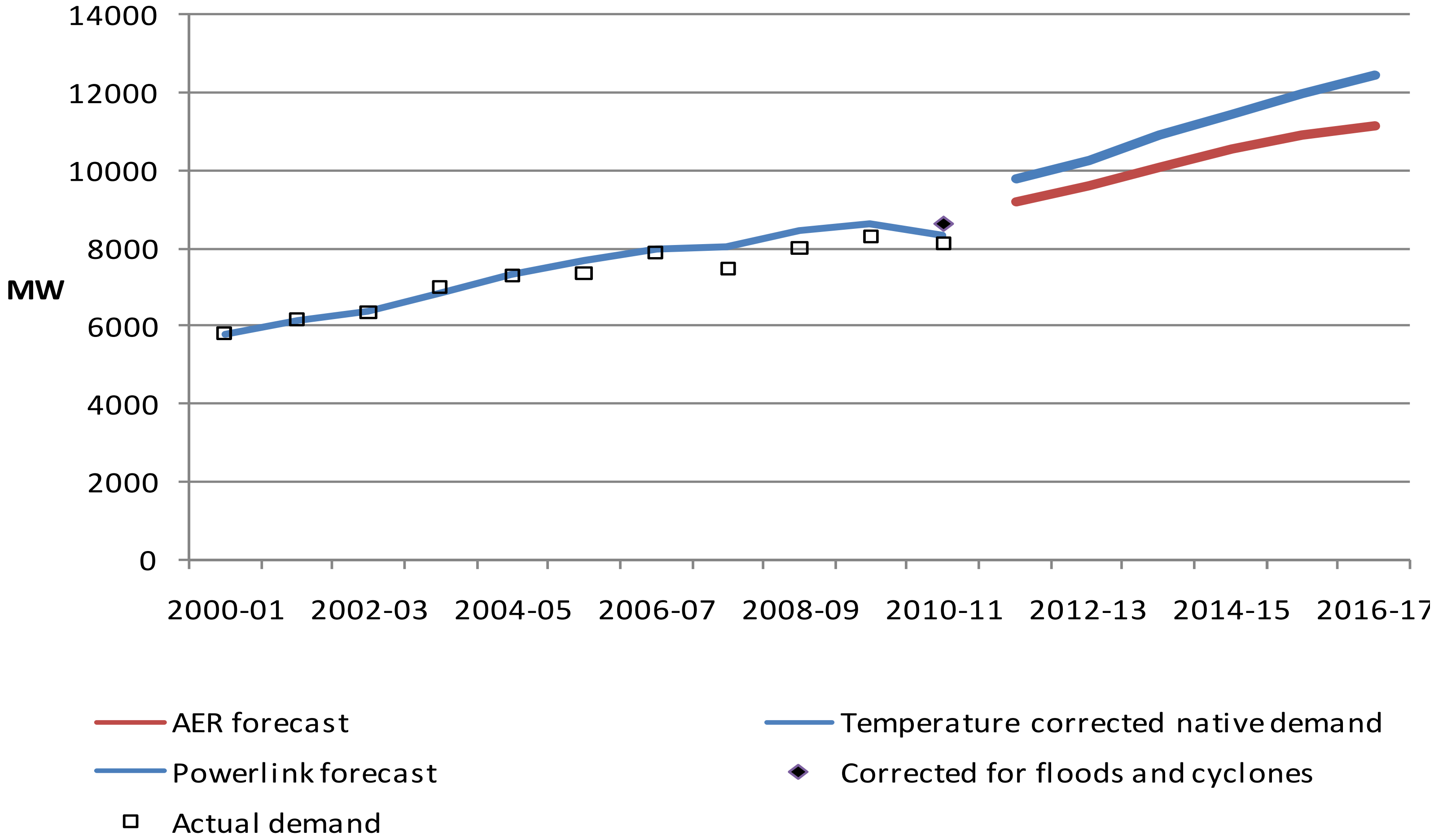
Demand forecasts (10 per cent PoE)



Demand forecasts

Powerlink proposal

- 10252 MW (2012-13) to 12437 MW (2016-17)

AER draft decision

- 9632 MW (2012-13) to 11146 MW(2016-17)
- Strong growth is expected in Queensland, however the AER's demand forecast is lower by
  620 MW (2012-13) to
  1291 MW (2016-17)

Reasons

- temperature correction method
- assumptions and inputs to models
  - population forecasts
  - electricity prices
  - energy sector assumptions
  - energy and demand trends

Cost of capital

- The NER requires the AER to determine an appropriate return on Powerlink's investment in transmission assets
- The rate of return is the Weighted Average Cost of Capital (WACC)

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Cost of capital

Powerlink proposal

- 10.30 per cent
- $4185 million (nominal)

AER draft decision

- 8.31 per cent
- $3142 million (nominal)
- parameters to be updated at final decision

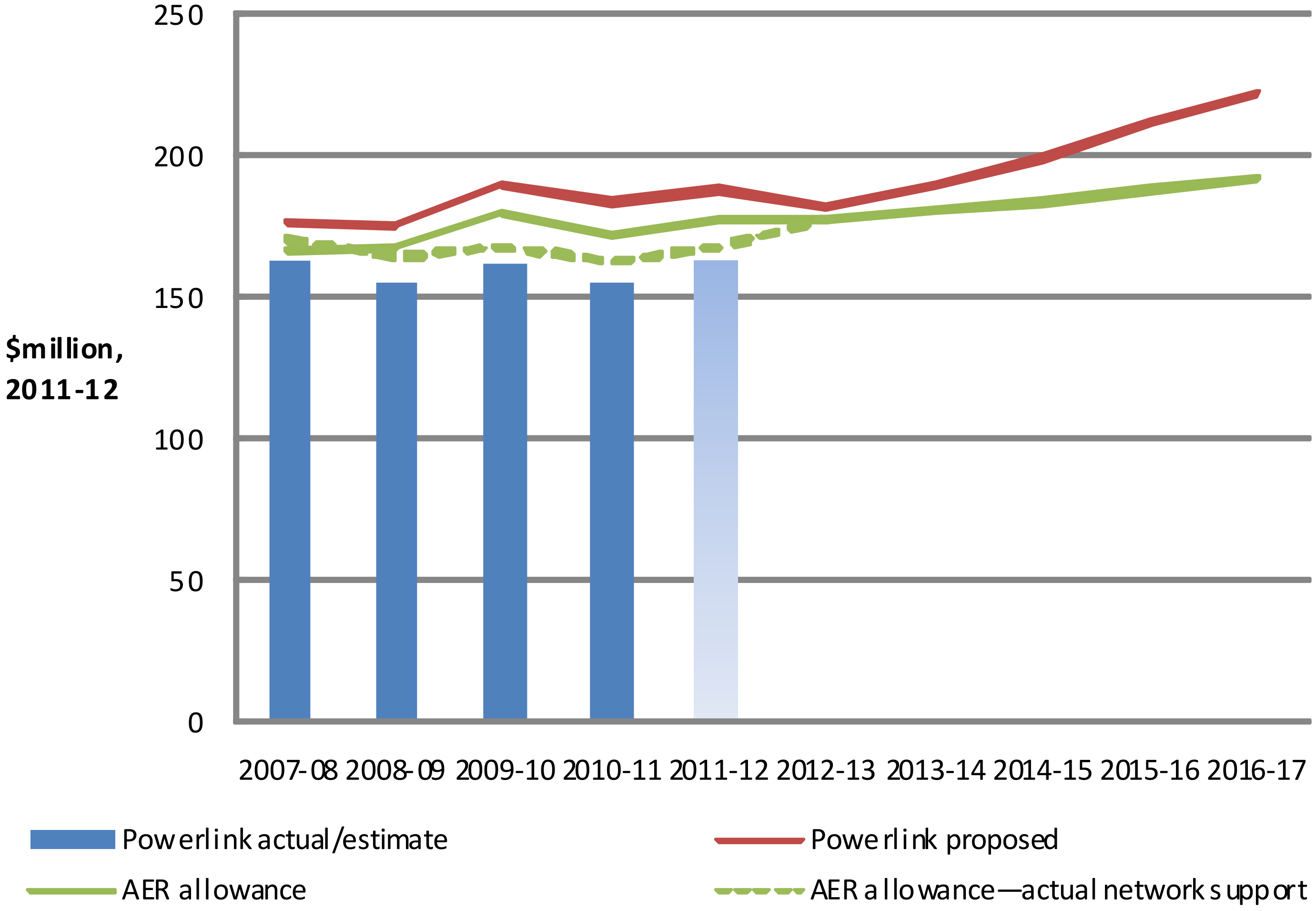
Reasons

- AER adjustment: $1043 million (nominal)
- AER does not accept: debt risk premium, nominal risk free rate, cost of equity and cost of debt
- AER accepts Powerlink's other proposed WACC parameters including: averaging period for nominal risk free rate, equity beta, gamma, MRP and gearing level

Cost of capital

WACC parameters	Powerlink's proposal	AER's draft decision
Nominal risk free rate (per cent)	5.62	4.32
Equity beta	0.8	0.8
Market risk premium (per cent)	6.5	6.5
Gearing level (debt/debt plus equity) (per cent)	60	60
Debt risk premium (per cent)	4.34	3.19
Assumed utilisation of imputation credits (gamma)	0.65	0.65
Inflation forecast (per cent)	2.50	2.62
Cost of equity (per cent)	9.96	9.52
Cost of debt (per cent)	10.82	7.51
Nominal vanilla WACC (per cent)	**10.30**	**8.31**

Opex allowance



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Opex allowance

Powerlink proposal

- $1002 million ($2011-12)

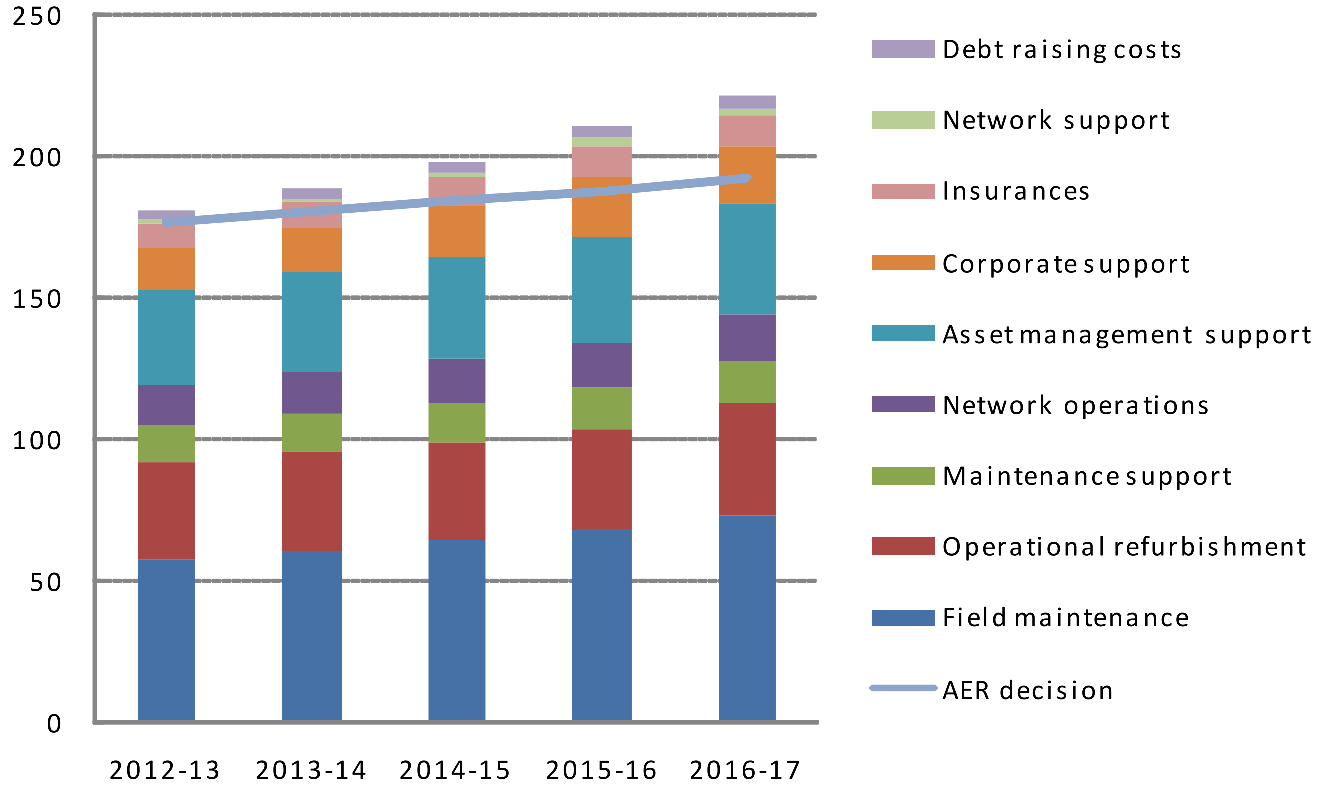
AER draft decision

- $920 million ($2011-12)
- 15.2 per cent increase (real) on current

Reasons

- real cost escalators
- network growth escalators
- step changes
- network support costs
- debt raising costs
- insurance costs

Opex allowance



Service target performance incentive scheme (STPIS)

Service component

- financial incentive to maintain and improve performance
- limited to 1 per cent of maximum allowed revenue (MAR)
- financial penalty for under performance

Market component

- financial rewards for improvements in performance
- additional revenue increment of up to two per cent of MAR
- no financial penalty for underperformance

Service target performance incentive scheme (STPIS)

AER draft decision

- aspects of Powerlink's proposal do not comply with requirements and were recalculated:

  Service component
  - caps and collars for the transmission line and transformer availability
  - most recent five years performance data used by AER
  - different weightings

  Market component
  - lower target parameter (1442 compared with 1953)

Pricing methodology

- A pricing methodology is the methodology used to:
  - – allocate the aggregate annual revenue requirement to categories of prescribed transmission services and transmission network connection points
  - – determine tariff structure

AER draft decision

- The AER approves Powerlink's proposed pricing methodology

Negotiated services

- Key elements to the negotiated transmission service regime:
  - negotiated transmission service principles
  - negotiating framework
  - negotiated transmission service criteria (NTSC)

- Light-handed approach – minimum prescription, reliance on commercial negotiation between able counter parties
  - not subject to direct revenue control
  - commercial arbitration available if necessary

Negotiated services

AER draft decision

- AER does not approve Powerlink's proposed negotiating framework
- Powerlink required to amend framework by including additional clauses

Reasons

- Powerlink's proposed negotiating framework does not make provision for the service applicant to request additional commercial information or clarification of commercial information provided
  - this may limit the applicant's ability to effectively engage in supply negotiations

Process – next steps

16 January 2012	Powerlink revised revenue proposal
20 February 2012	Submissions on revised proposal and draft decision
	Submissions to: AERInquiry@aer,gov,au
30 April 2012	AER final decision
1 July 2012	Start of regulatory control period

Questions and comments