

**AER Public Forum**

**15<sup>th</sup> March 2016**

**Preliminary Perspectives**

**Powerlink's 2018-22 Revenue Proposal**

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# OBSERVATIONS OF CURRENT REGULATORY PERIOD (2013-17) OUTCOMES

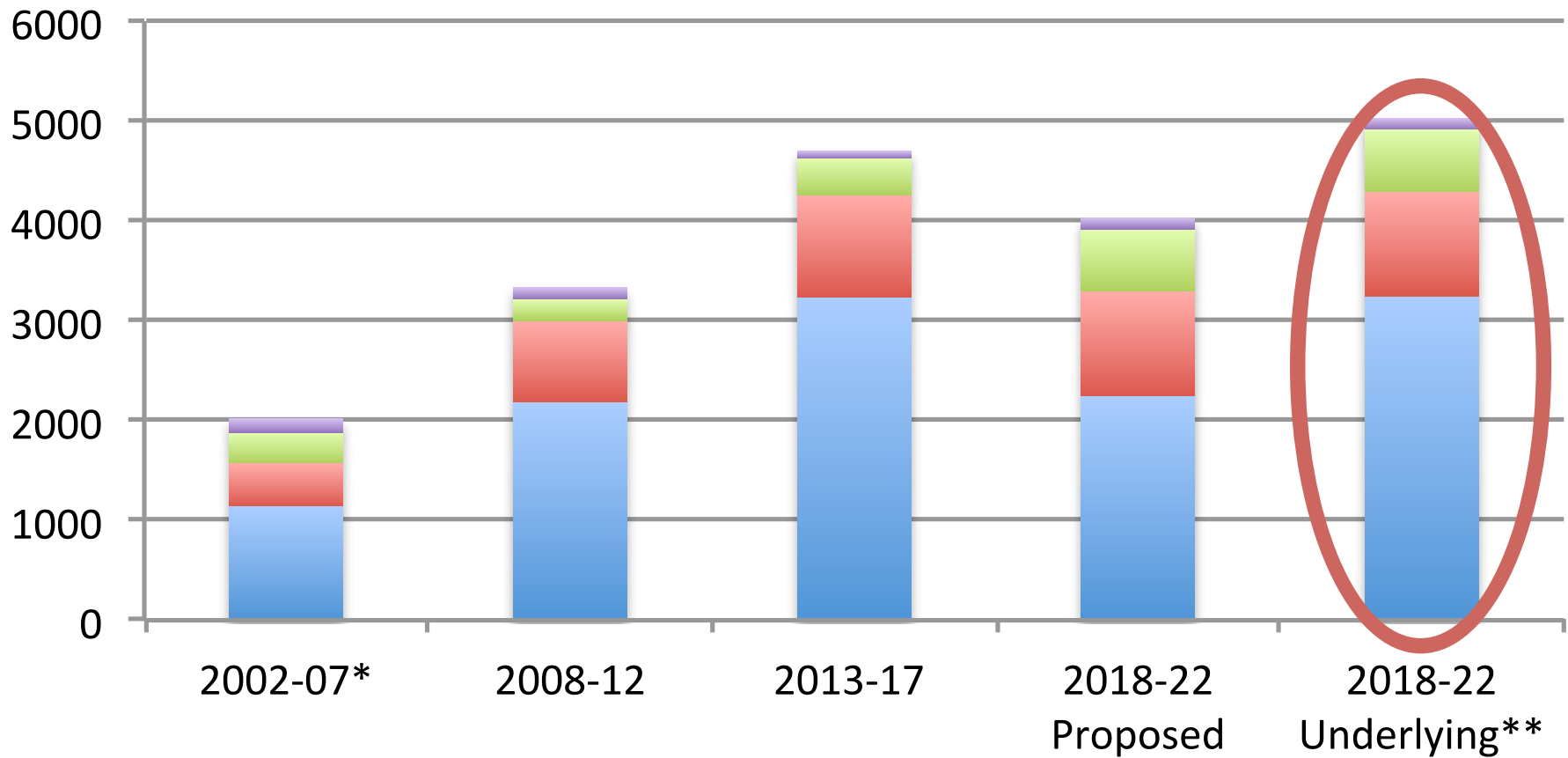
# Observations on Current Regulatory Period Outcomes

- Powerlink is achieving return on equity levels much higher than the AER's assumed return on equity
- Powerlink will achieve a total of around \$300 million in 'windfall gains' over the current period, due to its revenue allowances being based on capex that it did not require
- Many of the consumers' criticisms of Powerlink's 2013-17 revenue determination have been proven to be correct
- Powerlink has continued to receive very high bonuses from the AER's *Service Target Performance Incentive Scheme (STPIS)*
- Returns on RAB drive Powerlink's prices to a greater extent than all other Australian networks - accounting for 77% of Powerlink's revenue

# PROPOSED REVENUE

# Powerlink Revenue Building Block Trends

Return on Capital Opex Depreciation Tax




\* 2002-07 figures pro-rated to 5 years (rather than 6 years) for comparison purposes


\*\* Based on the average interest rates that applied in the previous 3 regulatory periods

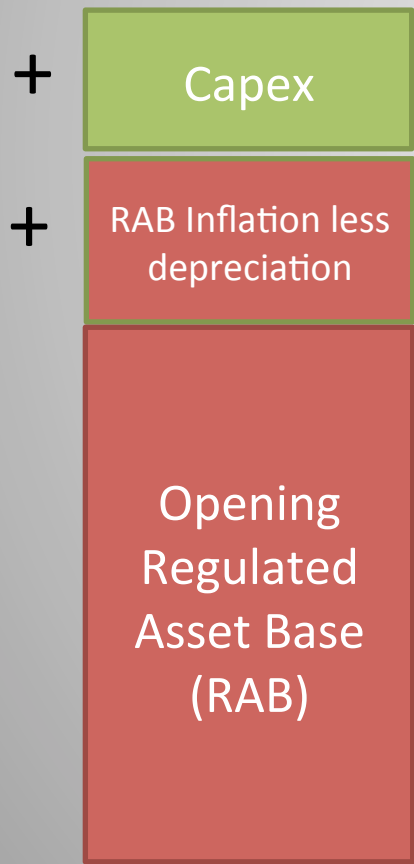
# High Level Observations on Powerlink's Proposed Revenue

- Powerlink is continuing to propose very high opex levels
- Powerlink is proposing a 68% increase in depreciation allowance compared to the current period
- If interest rates had remained at the same level as the previous regulatory periods, Powerlink's proposed revenue and prices would be around 25% higher
- Returns on past investments will continue to drive Powerlink's future prices - accounting for 71% of Powerlink's proposed 2018-22 revenue

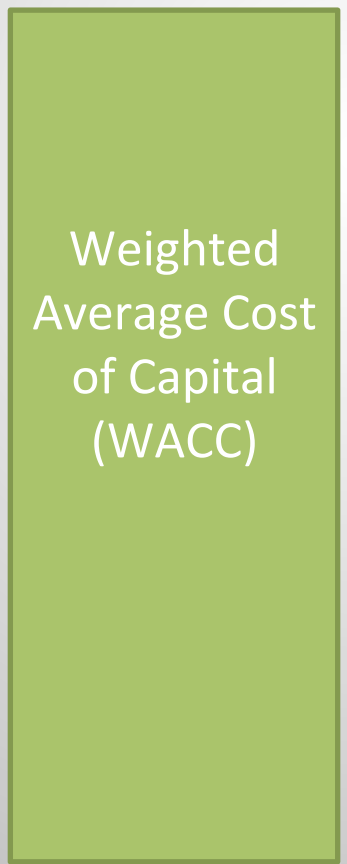
# Building Block Revenue Components: The AER's Ability to Influence

 Issues over which the AER has strong discretion under the current rules

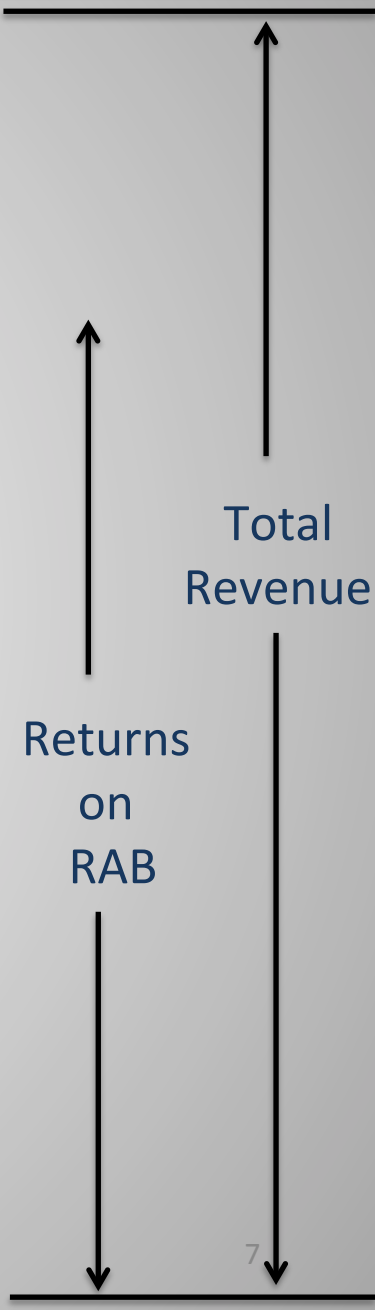
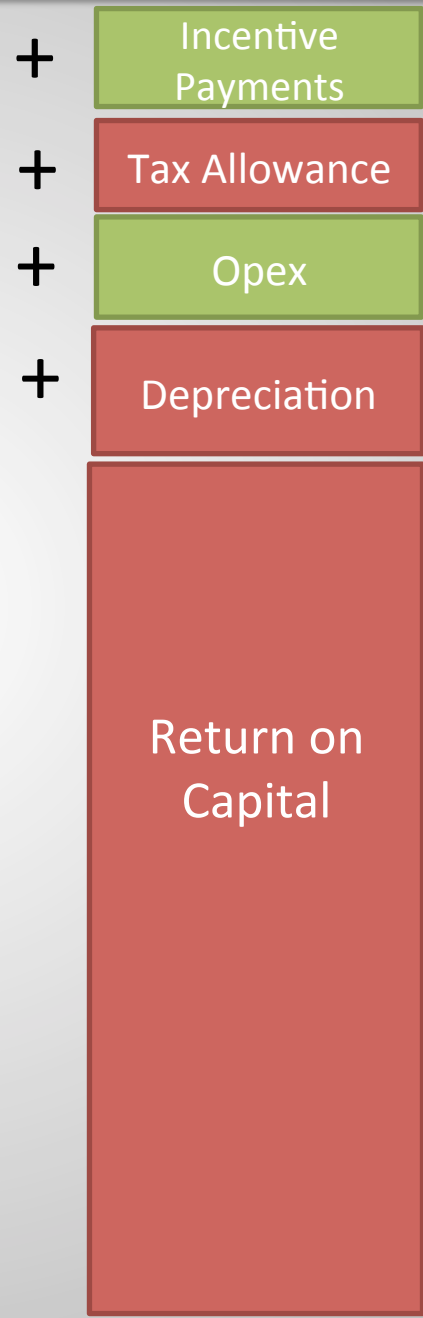
 Issues over which the AER has limited discretion under the current rules



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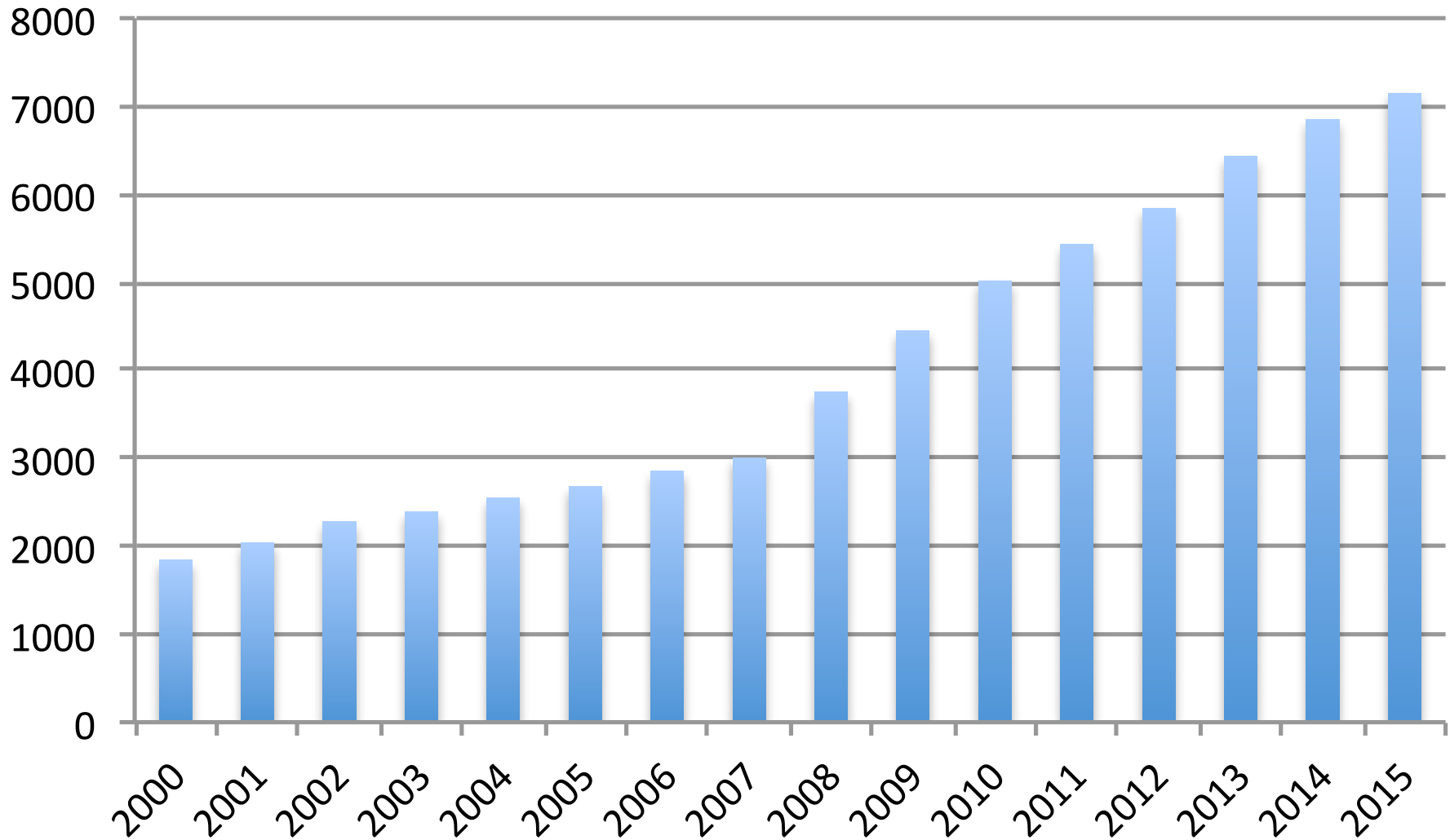
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# RAB GROWTH



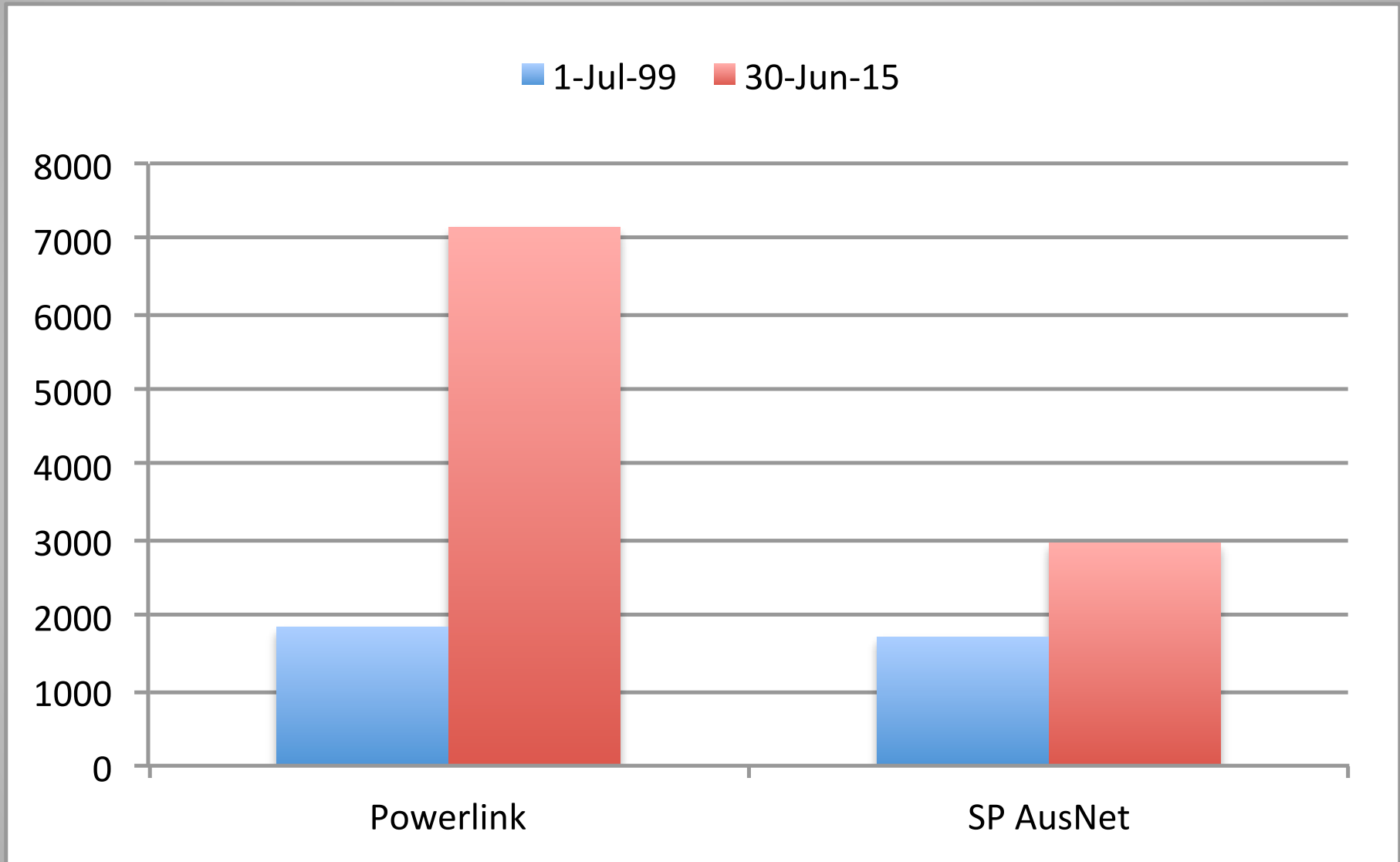
# Powerlink: RAB Growth



Sources: AER Roll Forward model and Powerlink's 2018-22 Revenue Proposal

Powerlink's 2015 RAB is assumed to be \$7.149 billion as stated in Powerlink's 2018-22 revenue proposal, rather than \$7.64bn assumed in the AER's 2013-17 Revenue Determination

# Comparison with SP AusNet's RAB Growth



Powerlink's 2015 RAB is assumed to be \$7.149 billion as stated in Powerlink's 2018-22 revenue proposal, rather than \$7.64bn assumed in the AER's 2013-17 Revenue determination

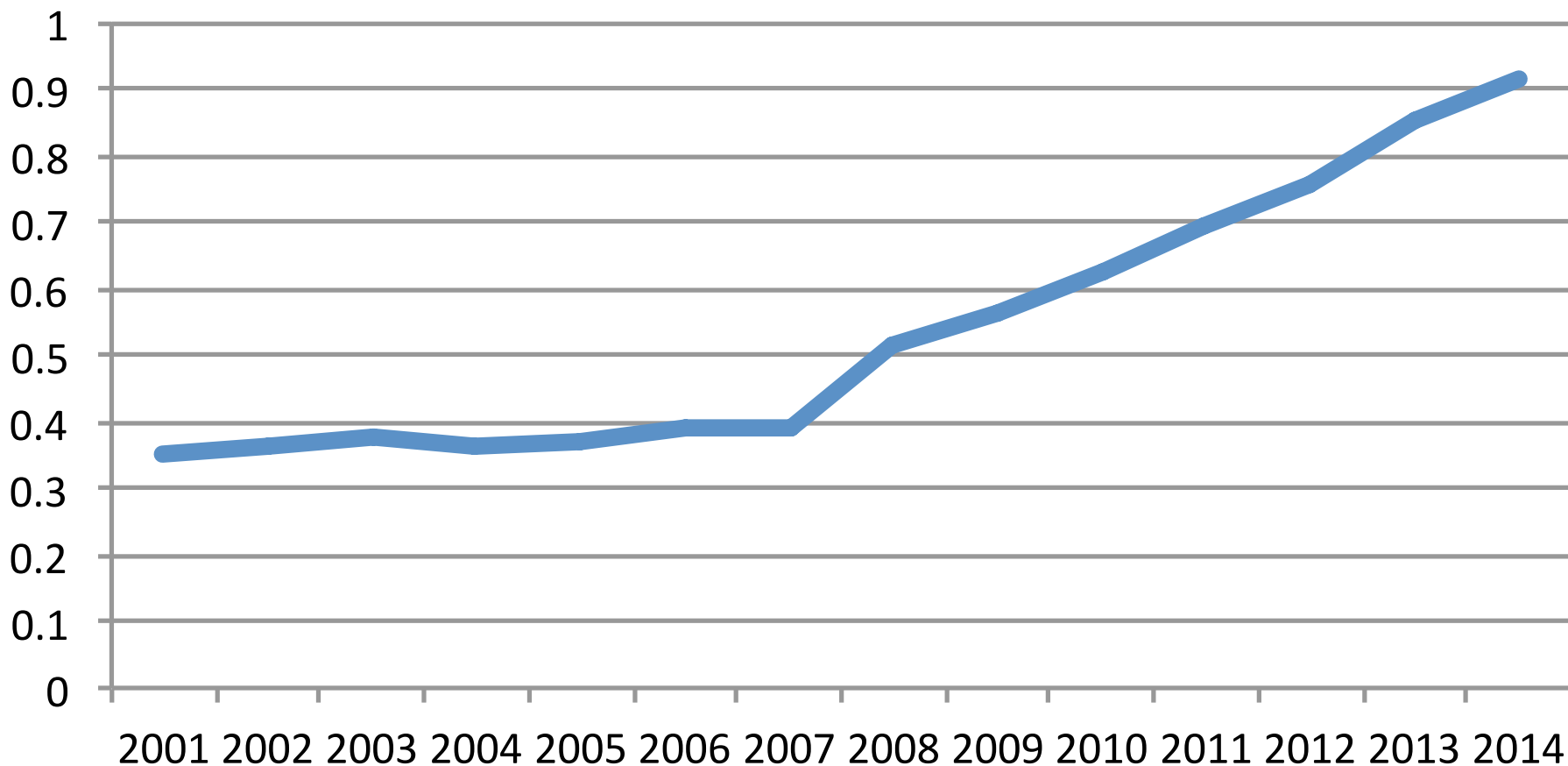
# Powerlink's Extraordinary RAB Growth

Over the past 16 years:

- Powerlink's RAB increased to around 4 times its 1999 value
- By comparison, SP AusNet's RAB grew to around 1.7 times its 1999 value

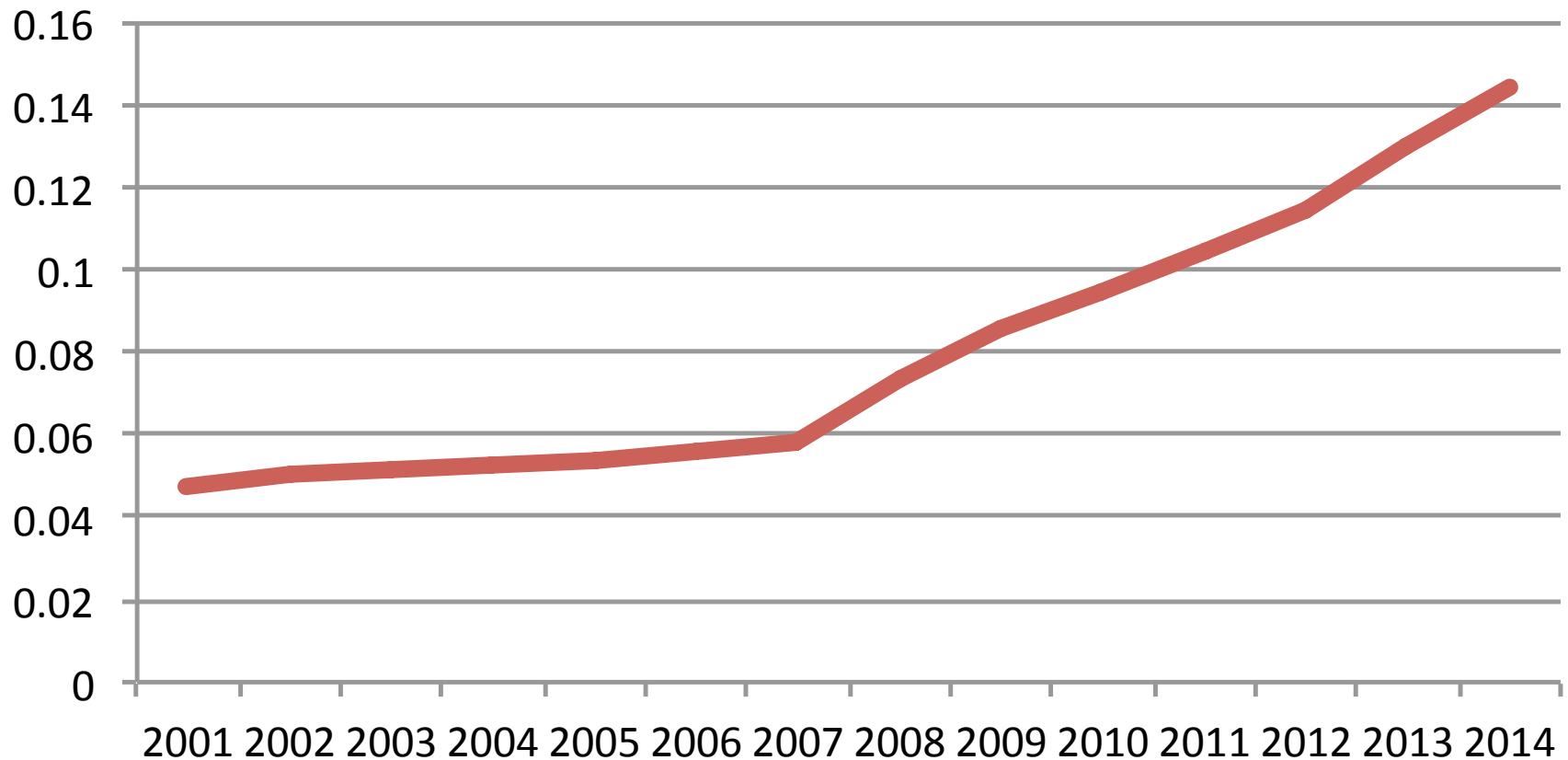
# Powerlink RAB: Normalised for Peak Demand

## Powerlink RAB/Pk Demand



# Powerlink RAB: Normalised for Energy Delivered

## Powerlink RAB/Energy Delivered



# Exogenous Factors Do Not Explain Powerlink's Higher Investment Levels

- In 2012, the EUAA performed a study into the Australian transmission networks' different investment levels
- That study concluded that Powerlink's higher investment levels can not be explained by exogenous factors (e.g. differences in customer density, demand growth, reliability standards or ageing assets)
- It concluded that Powerlink's investment levels were much higher than the other transmission networks - both in absolute terms, and after normalisation for growth in network outputs such as peak demand and energy delivered

Source: A comparison of outcomes delivered by electricity transmission network service providers in the National Electricity Market, EUAA 2012

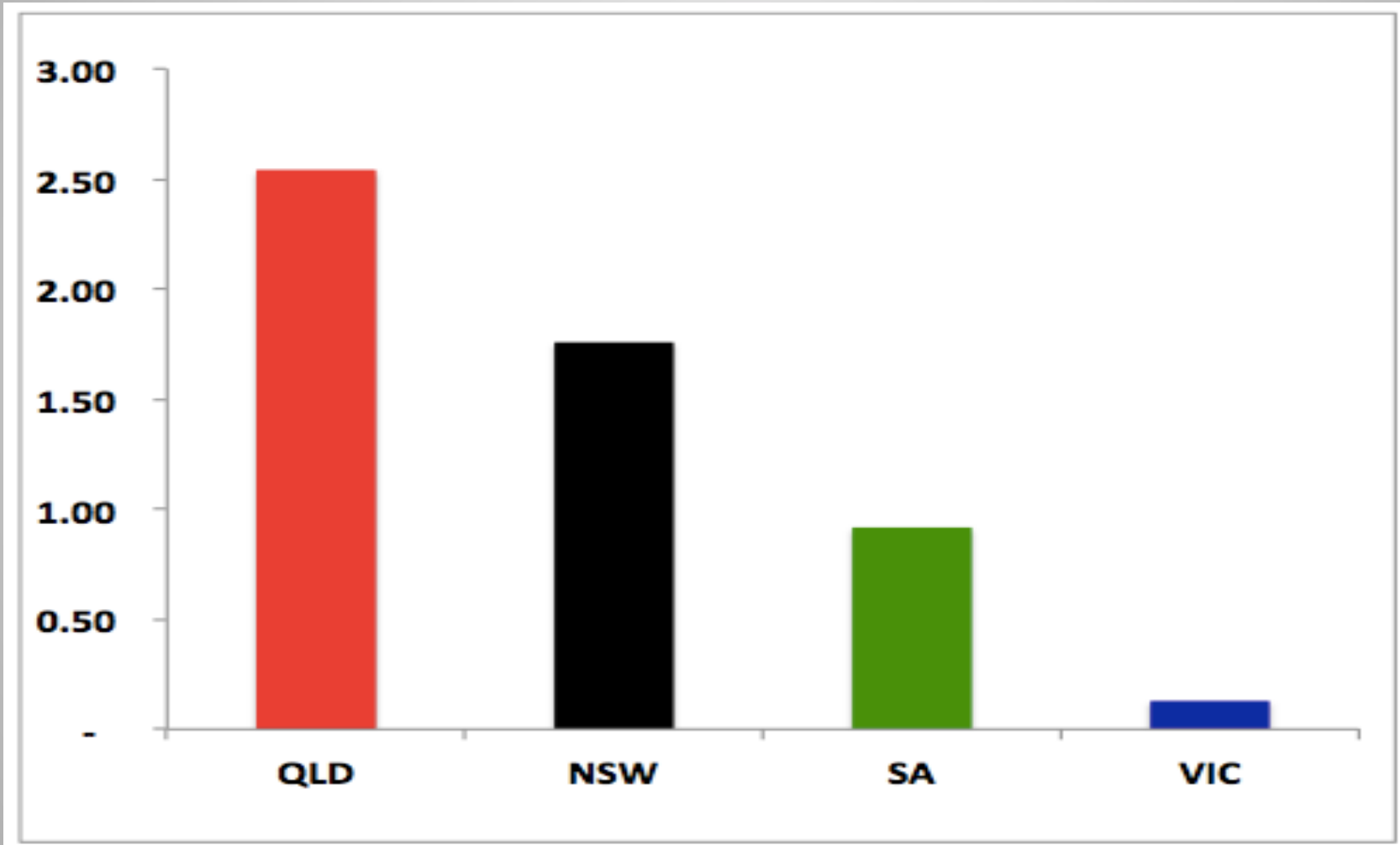
*“An industry engineering **culture biased toward expanding the network infrastructure and enlarging the capital base of the NSPs - driving inefficient expenditure**”*

*“A **deficient commercial model** in that there was **no rigorous capital rationing** by the Government, as shareholder and provider of capital, to guide investment decisions”*

*“A **regulatory model that does not allow** the Australian Energy Regulator (AER) to drive **the networks to deliver efficient capital and operating programs**”*

# Prudency/Efficiency of Load Growth Capex

**Average Annual Load-Driven Capex Divided by Average Annual Demand Growth for Australia's Transmission Networks**



Source: A comparison of outcomes delivered by electricity transmission network service providers in the National Electricity Market, EUAA 2012



# Over-Estimation of Demand

*“Another factor contributing to the escalation in capital programs has been the **consistent over- estimation of demand by the NSPs**”*

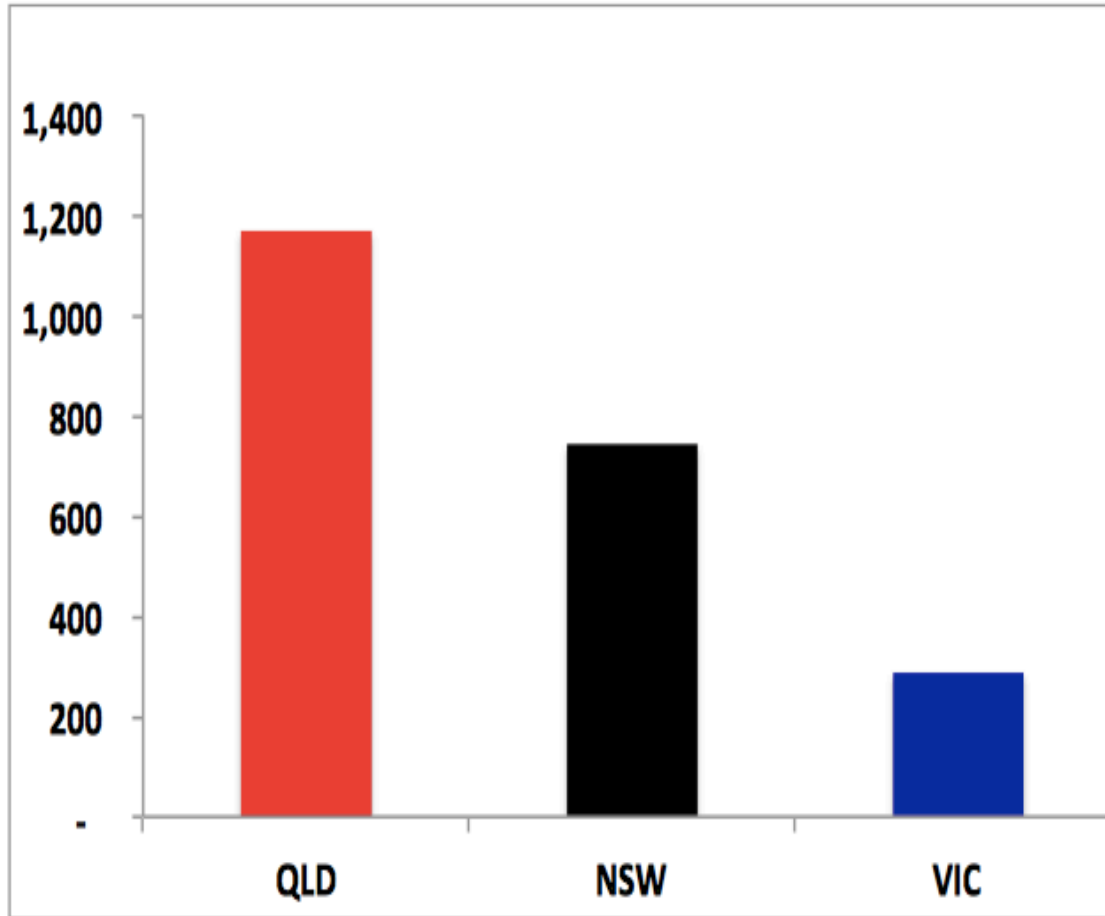
*“ The Panel also notes that the current **revenue cap control mechanism places volume risk on customers**”*

*“Where demand is over-estimated, capital programs will be excess to requirements and **network tariffs to customers will increase during the regulatory control period to ensure the NSPs are able to recover the allowable revenue**”*

Source: Queensland Government Independent Review Panel (IRP) on Network Costs

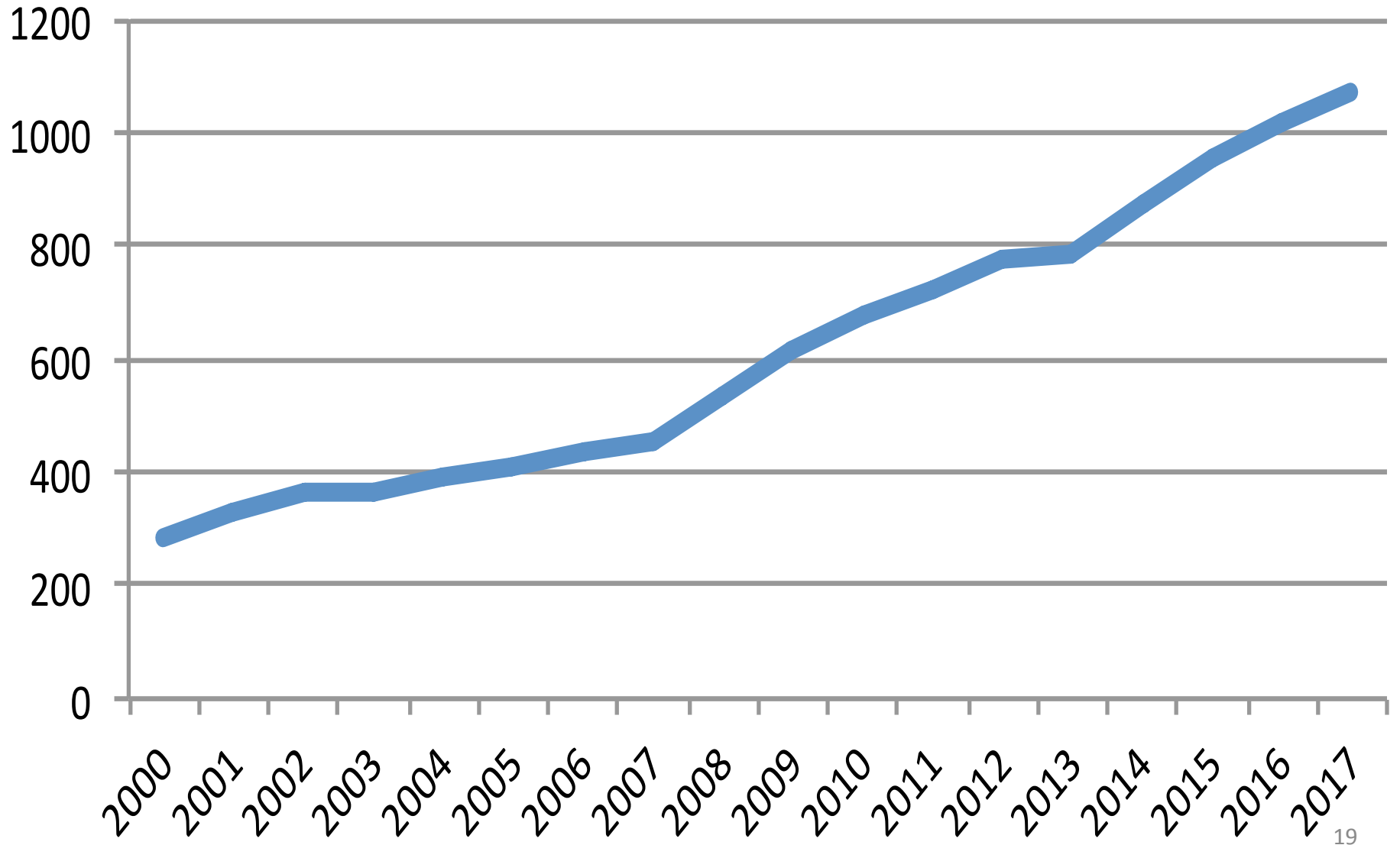
# Excessive Allowances Due to Demand Forecasting Errors

Figure 17. Average annual difference between projected and actual peak demand (MW) over the period from 2006/2007 to 2011/2012



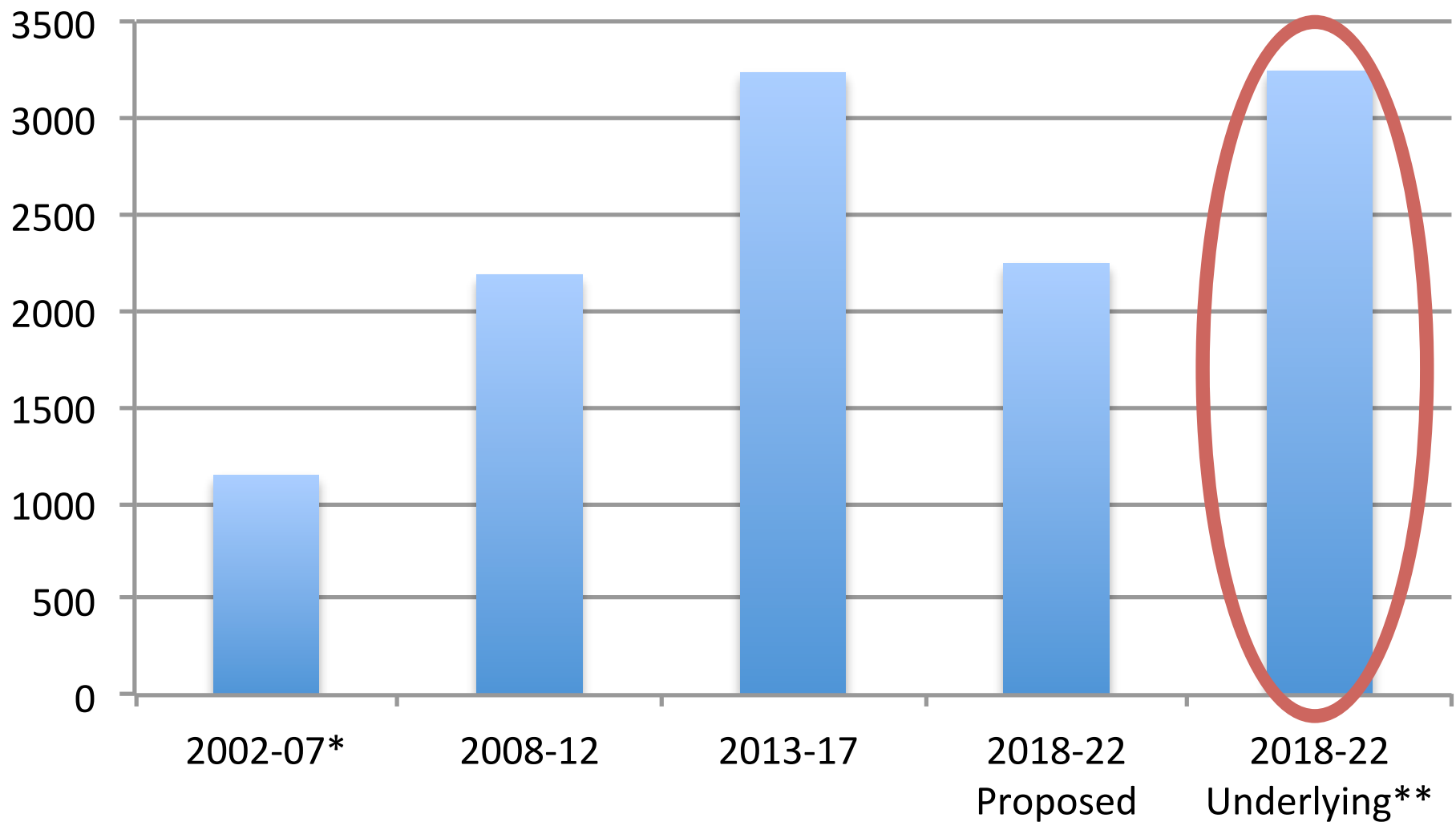
Source: A comparison of outcomes delivered by electricity transmission network service providers in the National Electricity Market, EUAA 2012

# Powerlink Revenue Growth



# RETURN ON CAPITAL

# Powerlink: Return on Capital Trend



\* 2002-07 figures pro-rated to 5 years (rather than 6 years) for comparison purposes

\*\* Based on the average interest rates that applied in the previous 3 regulatory periods

# The AER's Methodology for Determining Return on Capital Allowances

- Australia's electricity networks are extraordinarily profitable
- Many stakeholders have repeatedly criticised the AER for applying excessive WACCs when calculating the networks' 'return on capital' allowances
- However, excessive WACCs are only part of the problem
- A key driver of the networks' extraordinary profitability levels is deficiencies with the approach to determining the networks' 'return on capital' allowances
- In essence, the AER's methodology for determining its % WACCs is **inconsistent** with the capital base it applies its WACCs to
- This is particularly an issue for the AER's return on equity allowances

## **Determination Of The Percentage Return On Equity (ROE)**

The AER estimates the percentage return on equity that it considers investors require to invest in businesses with similar risk profiles to the electricity networks

## **Multiplying The Percentage Return On Equity To A Theoretical Equity Base**

The AER then calculates the network's 'return on equity' allowances by multiplying the percentage ROE to a theoretical equity base - which the AER assumes amounts to 40% of the network's RAB value

# The AER's Approach To Determining 'Return on Debt' Allowances

## Determination Of The Percentage 'Return On Debt'

- The AER estimates the percentage return on debt that it considers reflects the interest rates that the networks pay when they borrow money to invest in the business
- This is intended to reflect the interest rates that debt providers charge businesses with similar risk profiles to the electricity networks

## Multiplying the Percentage 'Cost of Debt' To A Theoretical Debt Base

- The AER then calculates its 'return on debt' allowances by multiplying the percentage interest rate to a theoretical debt base - which the AER assumes amounts to 60% of the network's RAB value



# The Networks' Actual Investment Levels Are Much Lower

- The networks' actual investment levels are much lower than the AER's assumptions
- This results in the AER providing return on capital allowances much higher than the required levels
- This is particularly an issue for the networks' *return on equity* allowances

# Powerlink's Actual Capital Bases Compared to Theoretical Bases

## Powerlink Queensland Investment Levels (30 June 2014)

	The AER's Assumed Investment Bases		Powerlink Queensland's Actual Investment Bases			Difference
	Value (\$bn)	% of RAB	Value (\$bn)	% of Total Investment	% of RAB	
<b>Equity</b>	3.056	40%	0.791	16%	10.4%	The AER's assumed equity level is 3.9 times Powerlink's actual equity investment
<b>Debt</b>	4.585	60%	4.154	84%	54.4%	The AER's assumed debt level is 10.4% higher than Powerlink's actual debt level
<b>Total</b>	<b>\$7.641 billion</b>		<b>\$4.945 billion</b>			The AER's assumed total investment is 1.55 times Powerlink's actual investment

# Powerlink - Theoretical vs Actual Investment Levels

## Total Investment

- Powerlink's RAB valuation is 1.55 times its actual total investment
- This is predominantly due to the RAB inflation – i.e. Powerlink's RAB value includes 'artificial capital' that it has not invested

## Equity Investment

- The AER's assumed equity investment for Powerlink is 3.9 times its actual equity investment

## Debt Investment

- The AER's assumed debt level for Powerlink is over 10% higher than its actual debt level

# Theoretical vs Actual Debt/Equity Ratios

## **As a percentage of its actual investment:**

- Powerlink funded 16% of its investment from equity
- Powerlink funded 84% of its investment from debt

## **As a percentage of RAB:**

- Powerlink's equity investment amounts to 10.4 % of RAB, rather than 40 % assumed by the AER
- Powerlink's debt amounts to 54.4 % of RAB, rather than 60 % assumed by the AER

# Outcomes

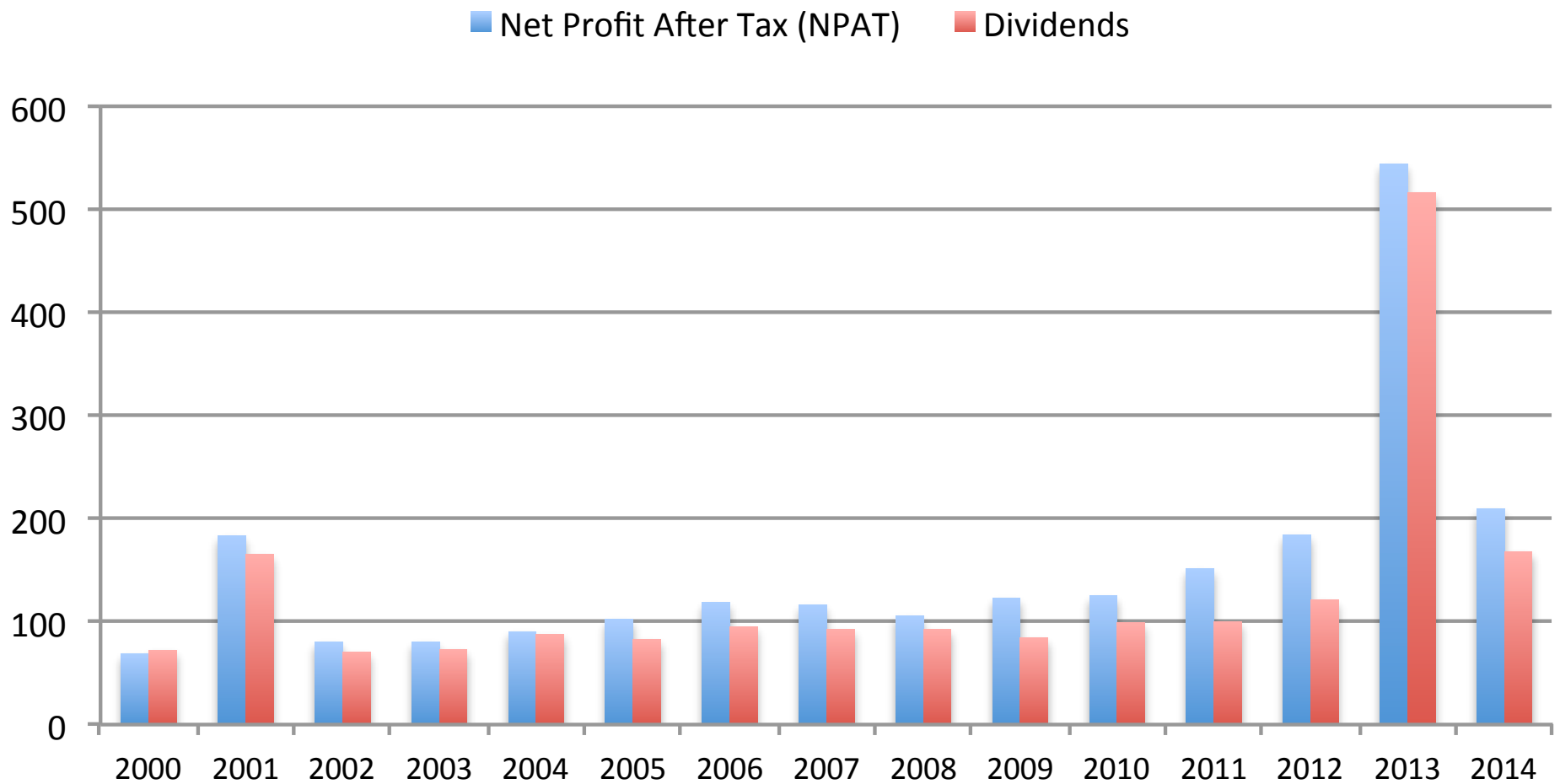
- The AER is providing 'return on equity' allowances to Powerlink of at least 3.9 times the required level
- The AER is providing 'return on debt' allowances to Powerlink of over 10% above the required level

# Powerlink's Actual Return on Equity

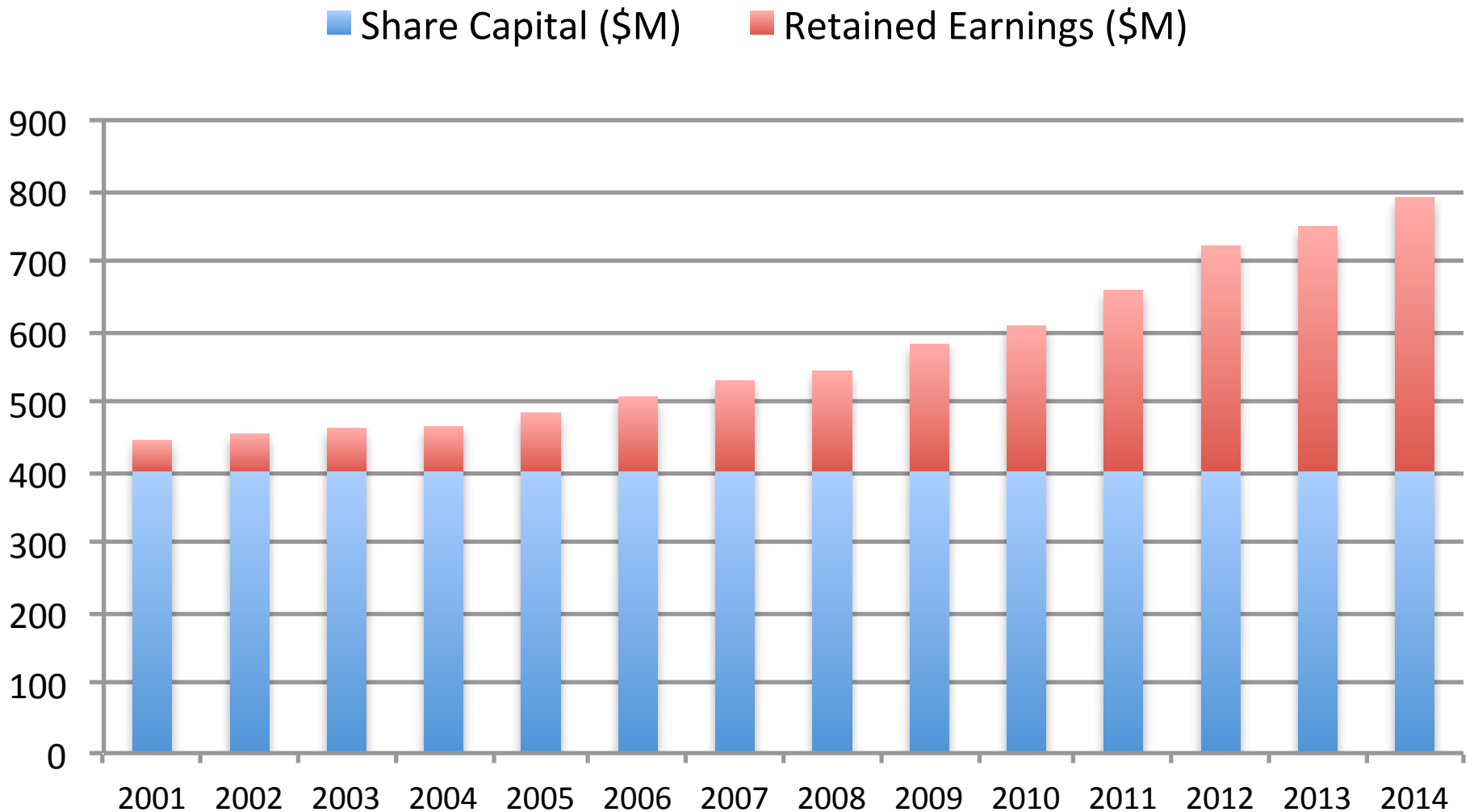
$$\text{Return on Equity} = \frac{\text{Net Profit After Tax (NPAT)}}{\text{Shareholder Equity}}$$

Shareholder Equity is the networks actual equity investment – i.e. the sum of the networks' share capital plus retained earnings

# Powerlink – Historical Annual Profits and Dividends

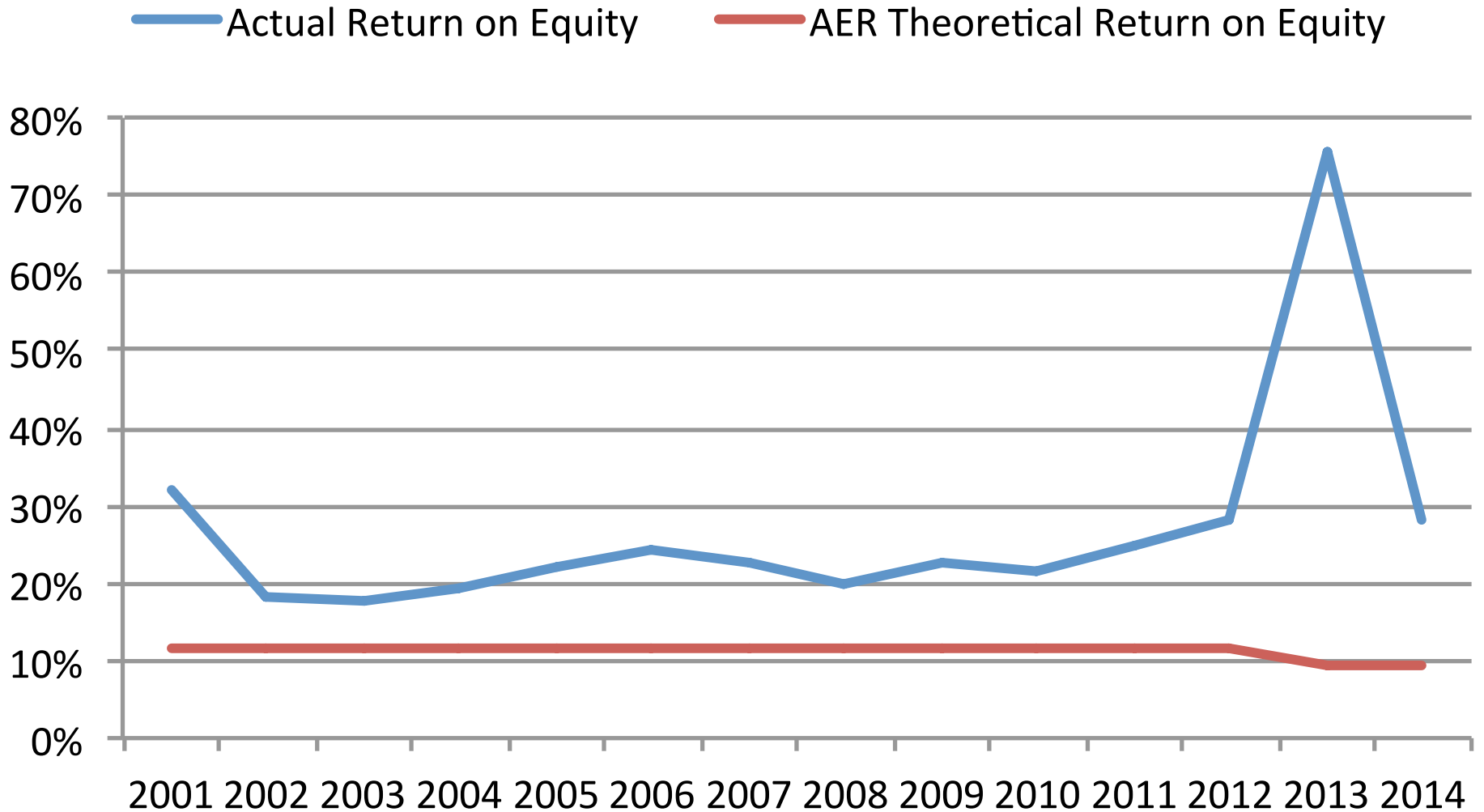


# Powerlink: Historical Equity Trend





# Powerlink Actual Return on Equity



# Powerlink's Actual Returns - Observations

- Over the past 15 years Powerlink's annual profits have grown strongly
- In some years there were significant spikes in Powerlink's profits
- At no time over the past 15 years did Powerlink experience low profits or losses (unlike all other businesses of its size)
- Powerlink has consistently extracted very high dividend levels, with dividend payout ratios averaging around 90%
- Consequently, Powerlink has reinvested minimal amounts of retained earnings into the business

# Powerlink's Actual Returns - Observations

- Powerlink's extraordinary growth has been predominantly funded by increased debt
- Powerlink's RAB grew by around 4 times with no change to its share capital of \$401 million
- Funding such levels of growth through debt would not be possible for businesses that operate in any other sector of the Australian economy
- The funding constraints that apply to commercial businesses would require them to inject significant levels of equity to fund such growth levels

# The Implications of the Recent TransGrid Sale

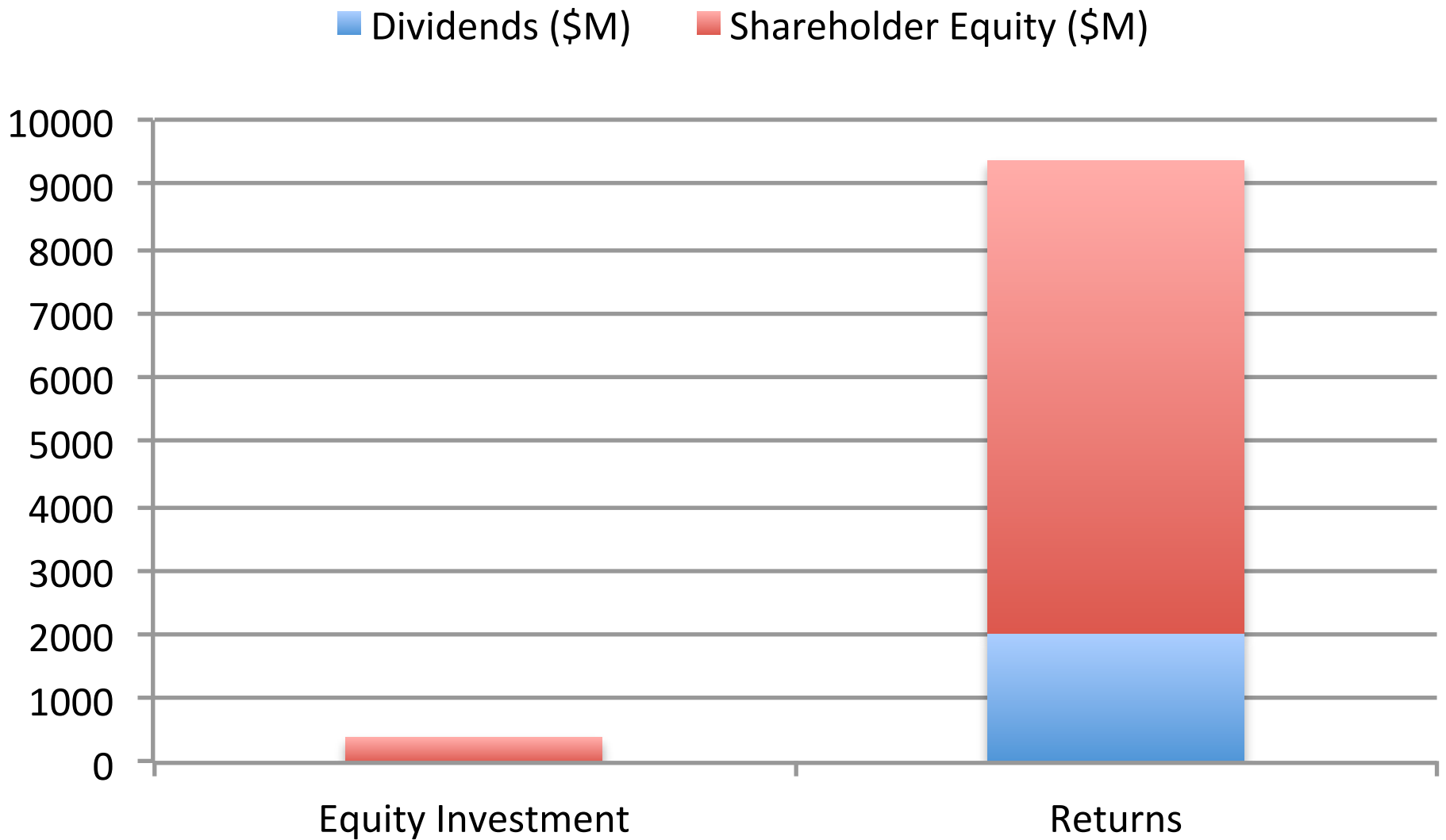
- In November 2015, a number of investment consortiums attempted to purchase the NSW transmission network (TransGrid)
- It was sold for \$10.3 billion – approximately 165% of TransGrid's RAB value
- Over the past two years, Australia's electricity networks have made many assertions that the AER's return on equity allowances would:
  - Not enable them to recover efficient financing costs
  - Make them unattractive to equity investors
  - Result in lower investment in the network
  - Significantly increase their financing risks
- The extraordinary sale price achieved by TransGrid makes a mockery of those claims

# The Implications of the Recent TransGrid Sale

- All informed investors and industry analysts are aware that the electricity networks' statements to regulators, policy makers and consumers are very different to their statements to investors
- A review of the *Spark Infrastructure* equity investment prospectus \* outlines why investors are queuing up to pay such large premiums above the networks' regulatory values
- Informed investors and industry analysts were not in the least surprised that TransGrid sold for 165% of its regulatory value
- They know that they will be provided with 'return on equity' allowances of around 4 times the level that they actually require to invest in the networks

# POWERLINK INVESTMENT RETURN OVER 15 YEARS

# Powerlink's Return on Equity Over The Past 15 Years



Shareholder Equity is calculated as Business Value less Debt  
The Current Business Value has been calculated as 165% of RAB, as per the recent TransGrid sale

# Powerlink's Actual Total Returns

The Queensland Government's \$401 million equity investment in Powerlink has accrued total returns of \$9.4 billion, i.e.:

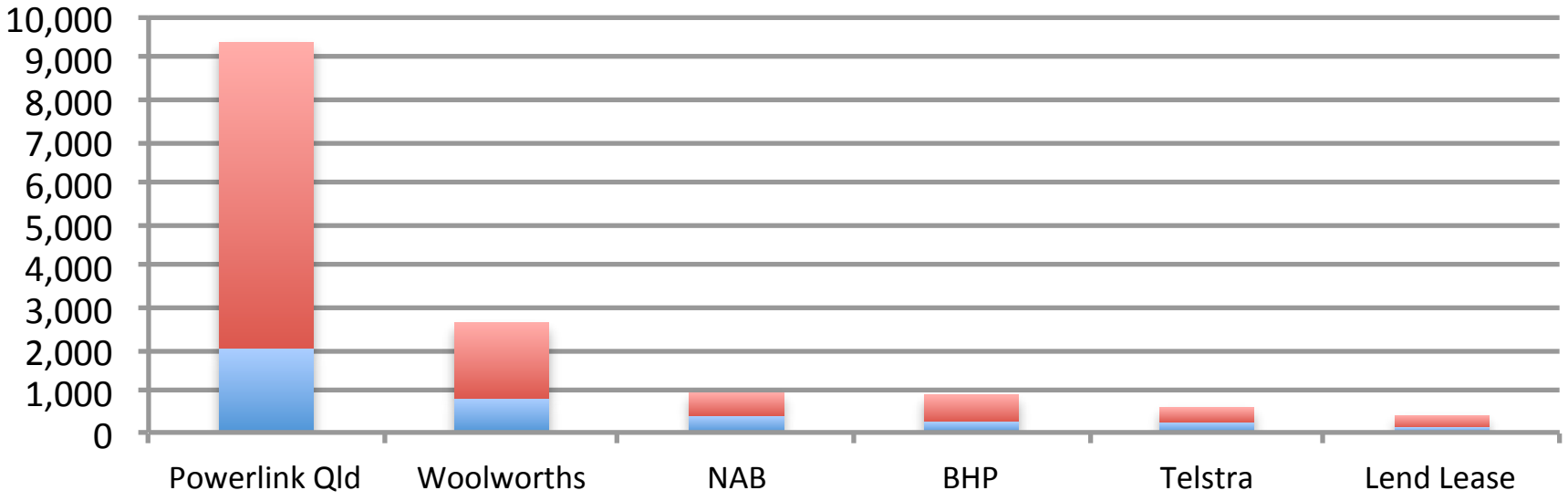
**It has returned over 23 times the equity investment**



**HOW DOES THIS COMPARE WITH  
THE RETURNS BEING REALISED BY  
BLUE-CHIP ASX50 INVESTMENTS?**

# Comparison of Powerlink's Returns With ASX 50 Companies

■ Dividends (\$M)    ■ Shareholder Value (\$M)



# Powerlink's Returns Compared to Blue Chip ASX50 Entities

Over the past 15 years, the Queensland government's \$401 million investment in Powerlink has delivered:

- 23 times the returns achieved by the Australian construction sector (Lend Lease)
- 15.5 times the returns achieved by the Australian telecommunications sector (Telstra)
- 10.5 times the returns achieved by the Australian minerals and resources sector (BHP)
- 10 times the returns achieved by the Australian banking sector (NAB)
- 3.6 times the returns achieved by Australia's most profitable supermarket (Woolworths)

No other ASX 50 stock comes close to Powerlink's returns

**These extraordinary returns are being achieved, despite Powerlink being the most inefficient transmission network in Australia**

# Comparison of Powerlink's Returns with ASX 50 Companies

Powerlink is an incredible investment – from both an income and a capital growth perspective

## Income

- Powerlink's is typically delivering 20-30% return on equity
- Most ASX50 companies have struggled to deliver 5%

## Capital Growth

- The Queensland government's \$401 million equity investment in Powerlink is now valued at around \$7.4 billion – **i.e. it has grown by over 18 times over the past 15 years**
- Most ASX 50 companies have struggled to grow their shareholder value by 50% over that period, with the share prices of many companies actually reducing, e.g.:
  - Telstra's share price dropped by 11%
  - Lend Lease's share price dropped by 30%

**WHAT IS DRIVING THESE  
OUTCOMES?**

The 'Return on Equity' estimation requirements in the National Electricity Rules (NER) are not particularly prescriptive:

## **6A.6.2 Return on Equity**

- (f) The return on equity for a regulatory control period must be estimated such that it contributes to the achievement of the allowed rate of return objective*
  
- (g) In estimating the return on equity under paragraph (f), regard must be had to the prevailing conditions in the market for equity funds*

Source: National Electricity Rules Chapter 6A, Version 79, Economic Regulation of Transmission Services, Clauses 6A62 (f) and (g), Page 784

# What is Driving These Outcomes?

- These AER's methodology for determining its % ROE is **inconsistent** with the capital base it applies its % ROE to
- The AER is currently estimating that investors require a ROE of around 7.3% to invest in businesses with similar risk profiles to Australia's electricity networks
- This 7.3% estimate has been determined on the basis of the % return that equity investors require on their **actual** investment
- For example, it is based on the market risk premium (MRP) that investors require on their **actual** equity investment
- However, the AER calculates its 'return on equity' allowances by multiplying the 7.3% to a theoretical equity base
- For Powerlink, that theoretical equity base amounts to around 4 times Powerlink's **actual** equity investment

# Recommendation to the AER

The AER needs to either:

- Modify its return on equity (ROE) estimation methodology to reflect that the % ROE will be applied to an inflated equity base; or
- Apply its % ROE to an equity base that is more reflective of the networks' actual equity investment – which is clearly much lower than 40% of RAB



# The AER Must Not Be Distracted by Attempts to Confuse the Issue

- The AER must not be distracted by attempts to confuse the issue
- For example, the above recommendation:
  - Is not challenging the requirement to applying artificial inflation to the ongoing RAB revaluations
  - Is not challenging the AER's approach to applying artificial inflation to the calculation of the networks' depreciation allowances
- **The fundamental issue is that AER's methodology for determining its % ROE is inconsistent with the capital base it applies it to**
- **That is what is driving the networks' extraordinary profitability**

**CAPEX**

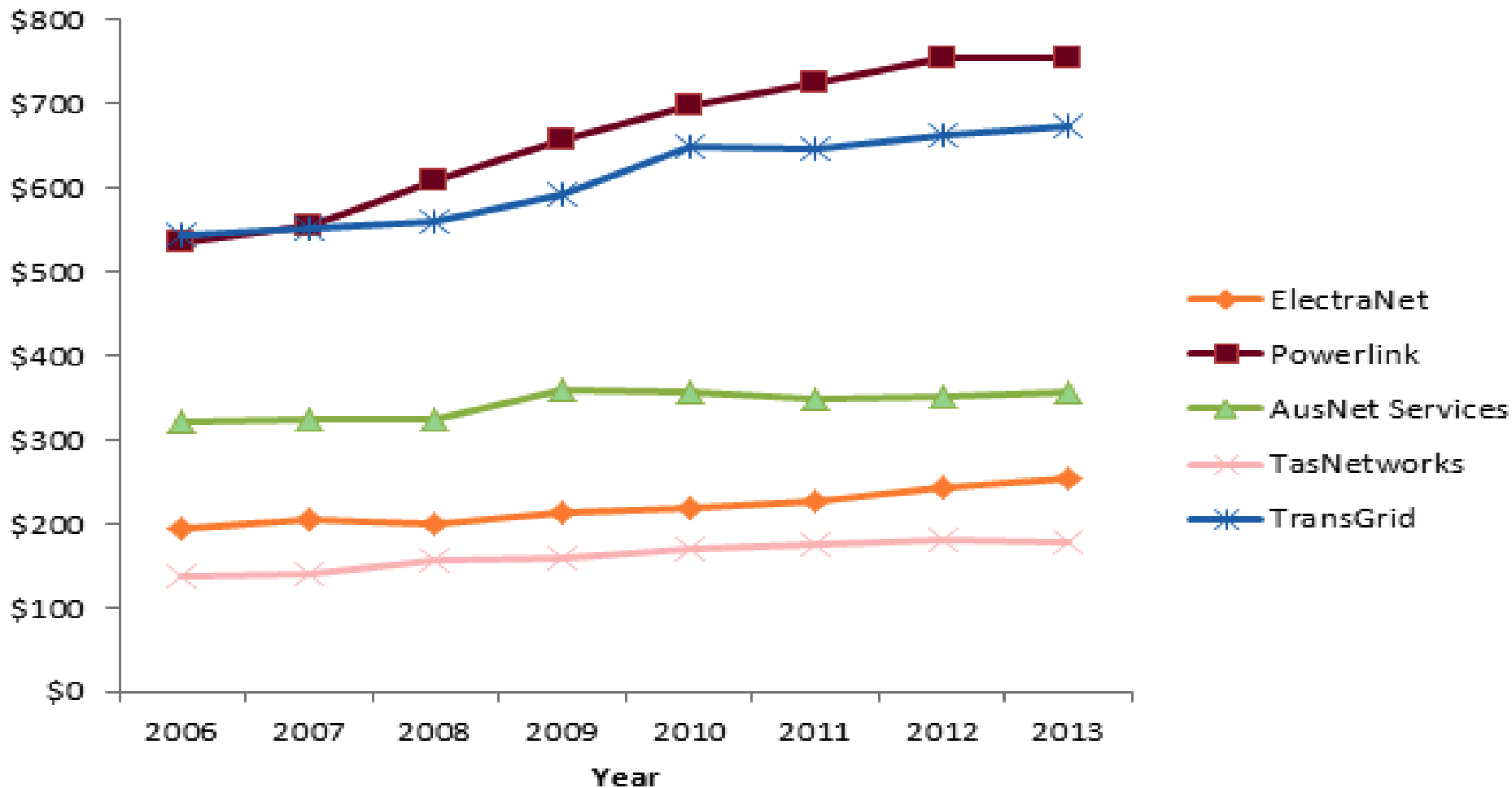
# CAPITAL EFFICIENCY

*“An industry engineering culture biased toward expanding the network infrastructure and enlarging the capital base of the NSPs - driving inefficient expenditure”*

*“A deficient commercial model in that there was no rigorous capital rationing by the Government, as shareholder and provider of capital, to guide investment decisions”*

*“A regulatory model that does not allow the Australian Energy Regulator (AER) to drive the networks to deliver efficient capital and operating programs”*

# Total Costs of Australia's Transmission Networks



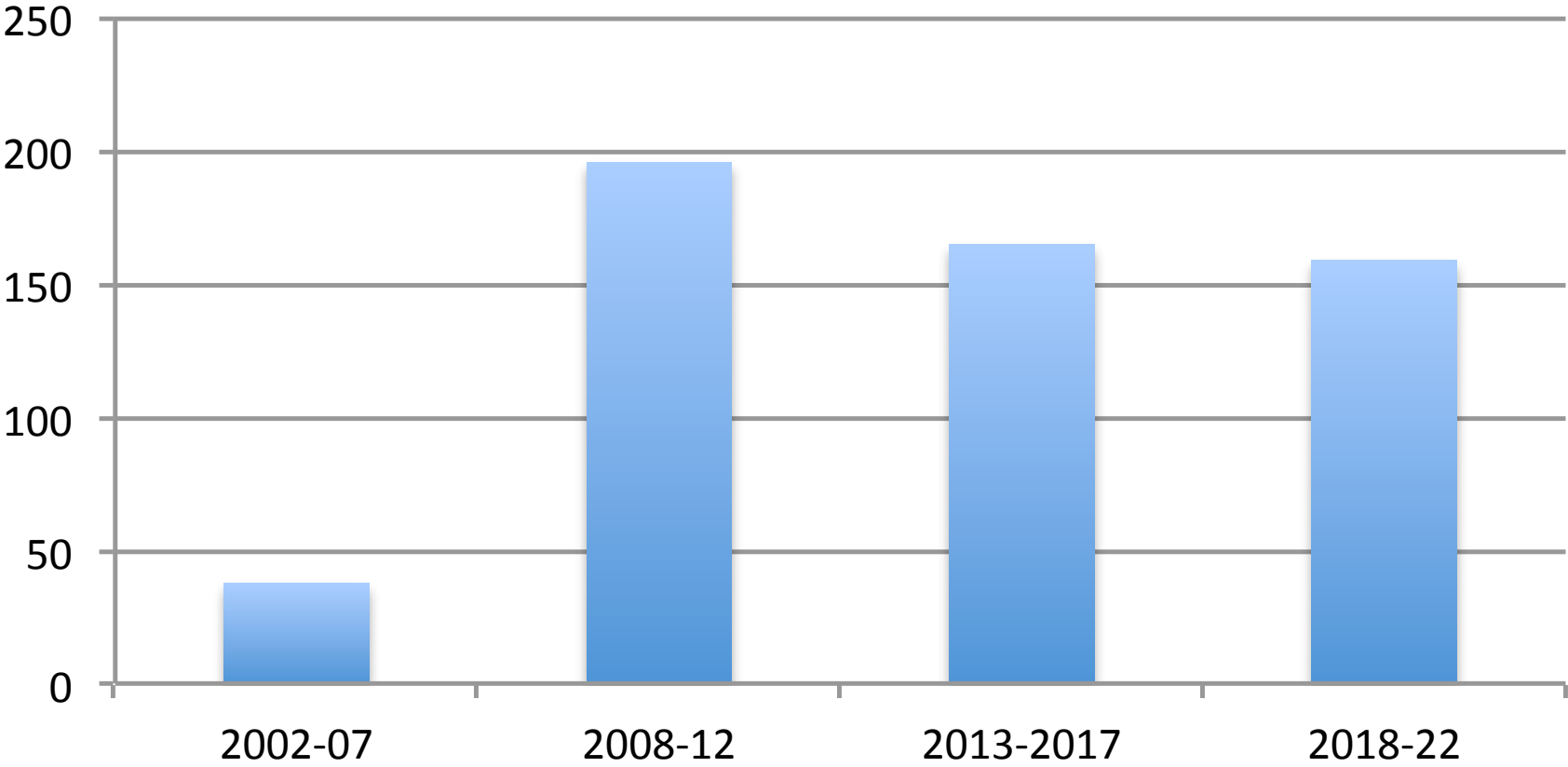
# Powerlink's Excess Network Capacity

- Powerlink's excessive capex programs over the previous decade have produced significant levels of excess network capacity
- This excess capacity will ensure that Powerlink continues to exceed the reliability standard requirements for many years to come
- The AER has not appropriately considered the networks' excess capacity in its recent capex determinations
- This issue is particularly important to the AER's assessment of Powerlink's capex proposal

# REPLACEMENT CAPEX

# Powerlink: Historical/Proposed Replacement Capex

## Powerlink Repex (\$M average/year)





## What Drove Powerlink's Dramatic Step Change in Repex in 2007?

- A review of Powerlink's justifications for its dramatic step change in repex in 2007, identifies that its was considered to be a "once in a generation" increase
- However, the AER has subsequently accepted Powerlink's 2008-12 repex levels to represent "business as usual" expenditure

# Key Issues with Powerlink's Repex Forecasts

- **Insufficient Demonstration of Outcomes**
  - Powerlink has failed to demonstrate the outcomes (e.g. system performance outcomes) that its major proposed repex expenditure will deliver
- **Not Justified On Actual Asset Condition Information**
  - Powerlink' provides very scant asset condition information
  - Rather, it is heavily reliant on statements suggesting that its assets are ageing
- **Insufficient Consideration Of Powerlink's Major Repex Spend Over The Past Decade**
  - Powerlink's extraordinary repex spend over the past decade has effectively 'pre-installed' a large proportion of its future repex needs
- **Insufficient Top-Down Restraint**
- **Insufficient consideration of Powerlink's excess system capacity and declining system utilisation**

# Key Concerns with the AER's Repex Assessment Process

- Insufficient consideration of actual asset condition information
  - Overly reliant on asset age as a proxy for asset condition
  - The AER's limited consideration of "Asset Health" indicators, has typically involved cursory observations of asset utilisation and remaining life trends
- The AER's process is overly reliant on short-term trend analysis and acceptance of the networks' recent asset replacement practices
  - The AER is predominantly setting repex allowances on the basis of the networks' repex spend levels during the previous period – which have not been demonstrated to be efficient
- Insufficient consideration of the networks' major repex spend over the past decade
- Insufficient consideration of the networks' increasing excess capacity and declining asset utilisation levels

# Standard Asset Lives?

- The networks are assuming asset lives much shorter than they actually achieve in practice
- There are also major variations in the “standard asset lives” being used by Australia’s electricity networks
- The AER is providing the networks with too much discretion in the setting of asset lives
- The AER needs to enforce greater consistency in the determination of “standard asset lives”, rather than continuing to allow the networks to choose asset lives that optimise their returns for each revenue reset
- There are also significant variations in the networks’ assumed unit prices for similar assets, suggesting differences in relative efficiency

# CONTINGENT PROJECTS?

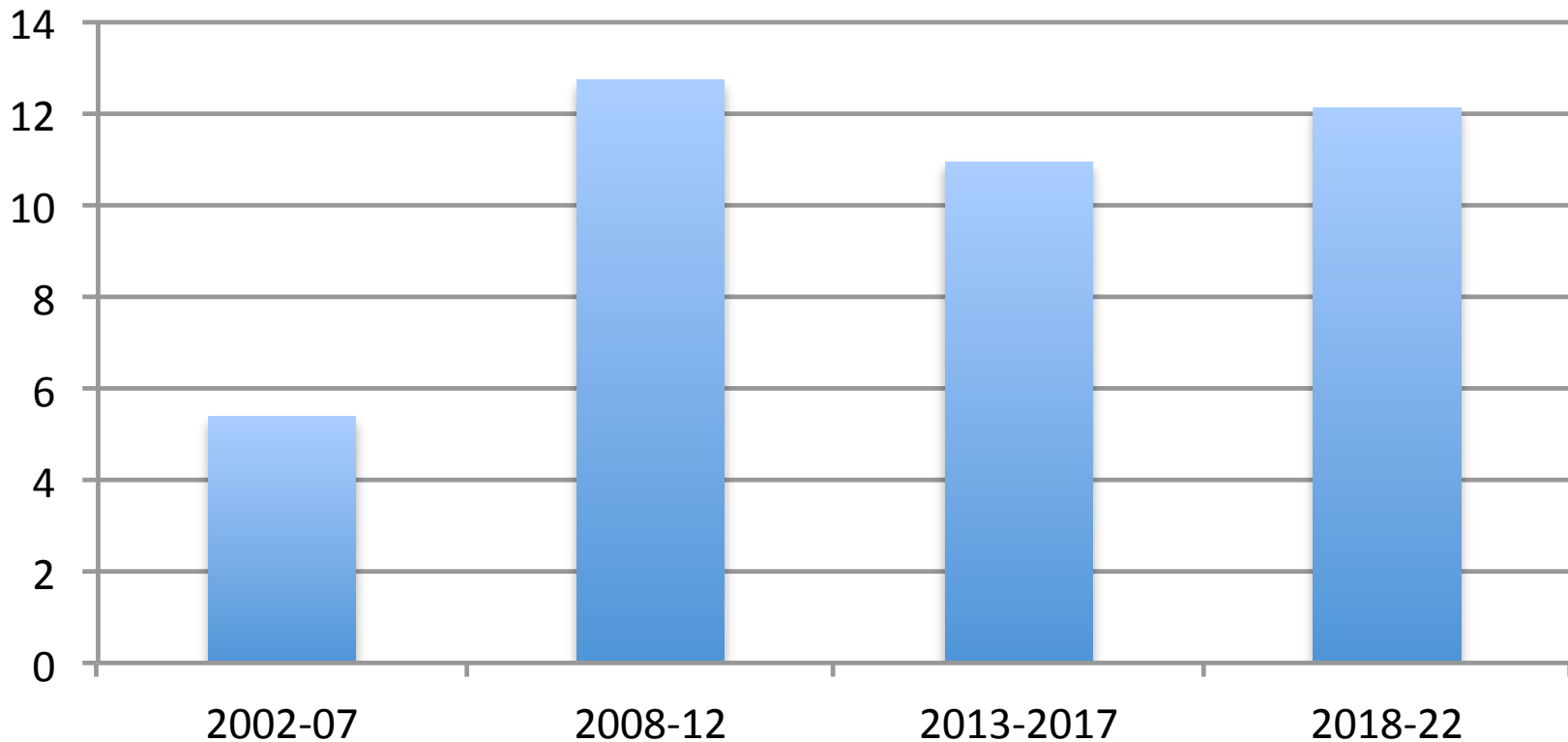
# Contingent Projects

- Powerlink is proposing \$590 million in contingent projects
- This would increase Powerlink's proposed capex by around 60%
- The AER needs to demonstrate that it is in consumers' long-term interests for such a high level of contingent projects to be determined outside of the revenue determination process

# BUSINESS IT CAPEX

# IT Capex - Historical and Proposed

## Business IT Capex (\$M average/year)





# What Drove Powerlink's Dramatic Step Change in IT Capex in 2007?

- A review of Powerlink's justifications for its dramatic step change in IT Capex in 2007, identifies that its was considered to be a "once in a generation" increase
- However, the AER has subsequently accepted Powerlink's 2008-12 IT Capex levels to represent "business as usual" expenditure

## ■ **Software/Hardware Refresh Program (\$22M)**

- Powerlink's justification for this major expenditure program is limited to two sentences:

*“The Software / Hardware Refresh program aims to maintain Powerlink's existing Business IT hardware and software assets to ensure they are reliable and fit for purpose. The program seeks to replace and refresh existing hardware as it reaches end of life and manage the software upgrades required, to ensure consistent delivery and conformance to Enterprise Architecture and industry standard standards”*

- In light of the Powerlink's major IT expenditure over previous regulatory periods, Powerlink needs to provide much more detail on the business case for such a major expenditure program

- **Spatial Business Intelligence and Analytics (\$7.5M)**
  - It appears that Powerlink already has a number of business intelligence (BI) applications
  - The proposal does not demonstrate how a further BI tool will deliver business benefits or improve Powerlink's efficiency
  - The AER needs to consider the outcomes of Powerlink's previous BI expenditure before considering further BI expenditure
  
- **ERP Modernisation Expenditure (\$4.1 M)**
  - With the major levels of ERP funding provided over the past two regulatory periods, it is not clear why there is a need for ERP modernisation
  - Powercor and Energy Australia both have significant investments in SAP applications, but have not proposed such "modernisation" expenditure
  - It would be expected that such expenditure is already included in Powerlink's proposed Software/Hardware Refresh Program

## ■ **Enterprise Integration (\$3.2M)**

- It appears that Powerlink has previously received significant funding for enterprise integration
- Again, it would be expected that this expenditure is already included in Powerlink's proposed *Software/Hardware Refresh Program*

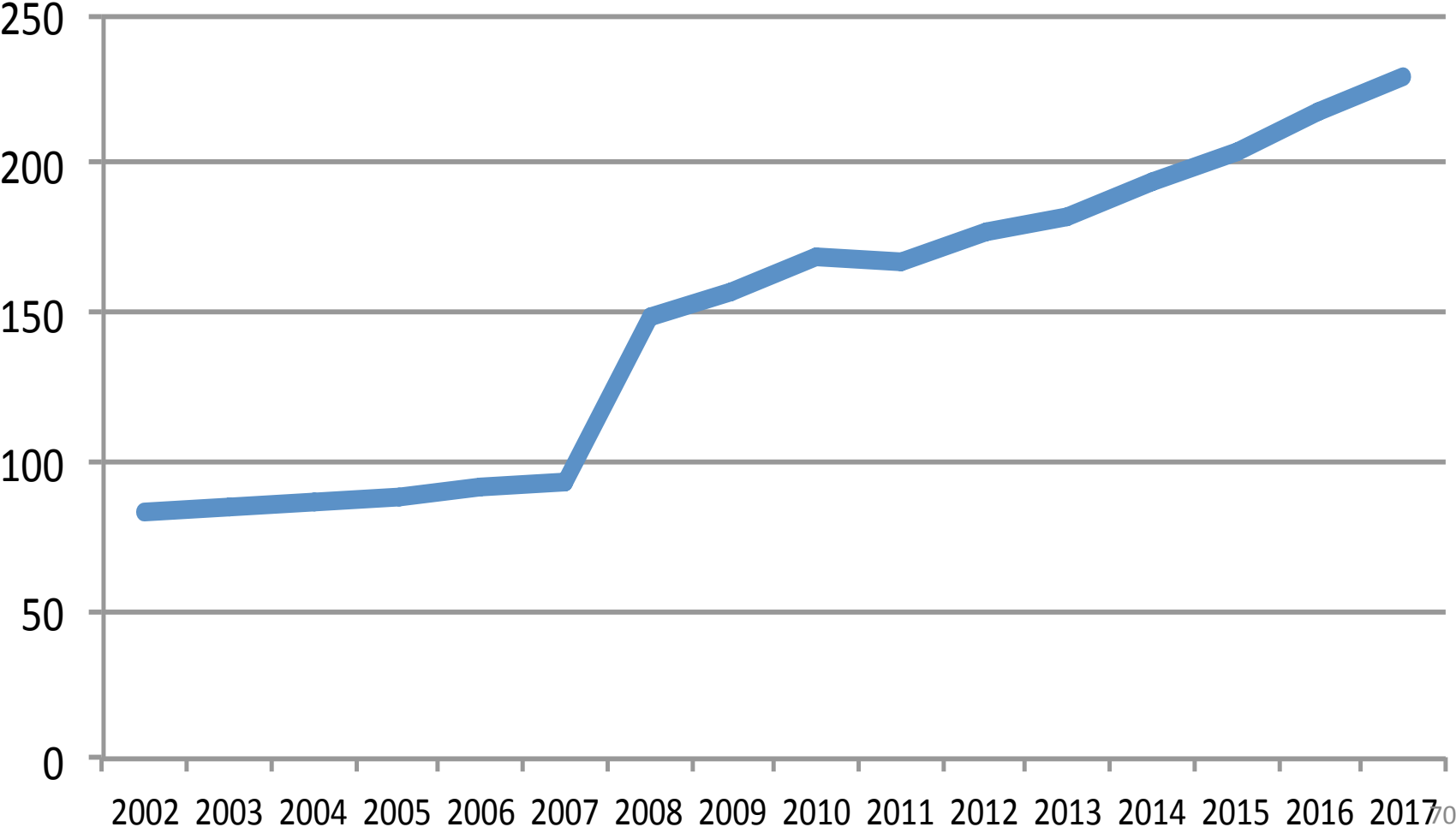
## ■ **Insufficient Demonstration of Business Benefits**

- Powerlink's IT Capex proposal does not demonstrate the business benefits it has realised from its major IT expenditure over the previous decade
- Furthermore, there appears to be some significant duplication of expenditure for Powerlink's proposed IT programs and its proposed recurrent *Software / Hardware Refresh Program*

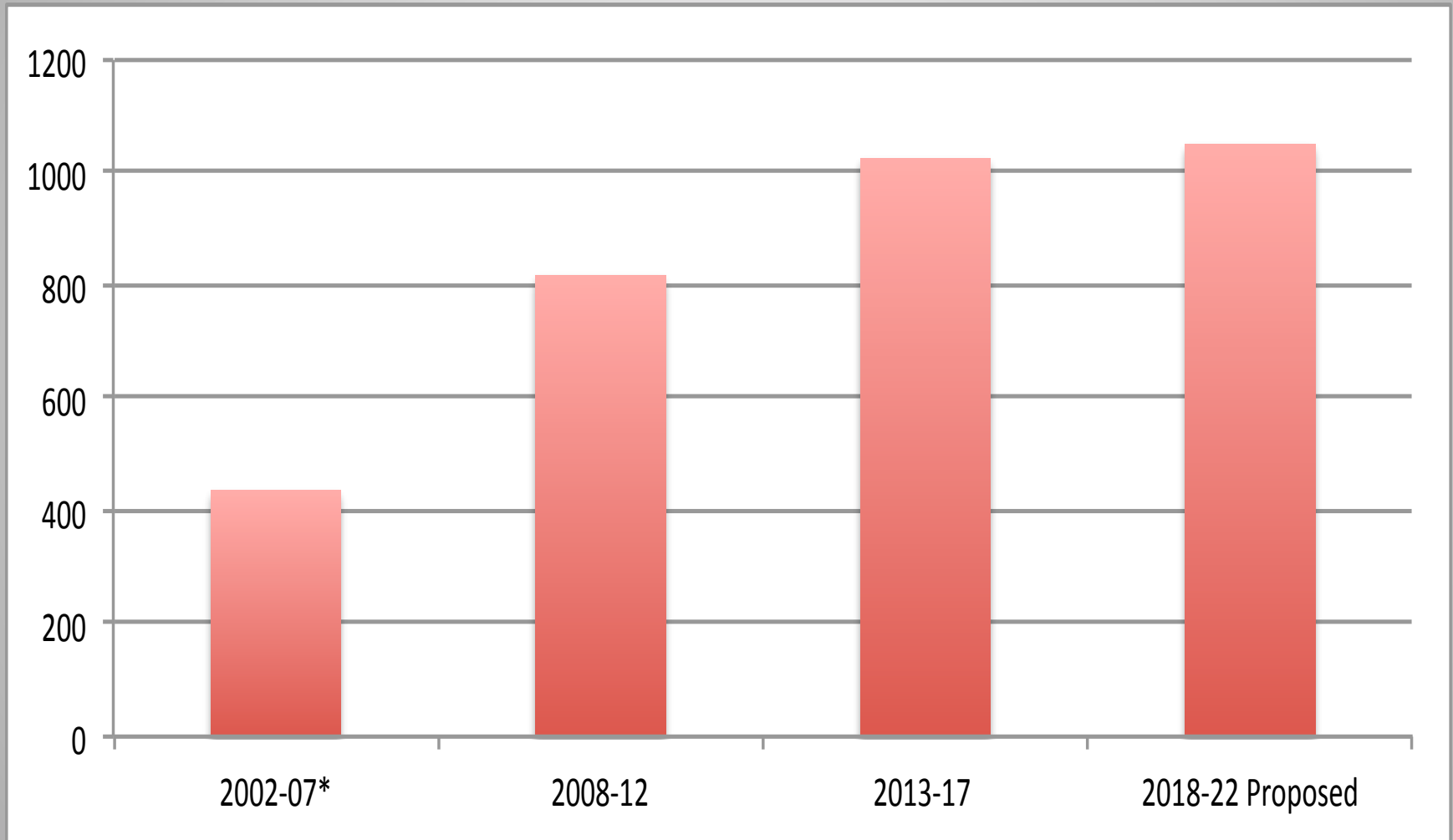
OPEX

# Powerlink: Historical/Proposed Opex

## Powerlink Opex trend (\$M)



# Opex by Regulatory Period



\* 2002-07 figures pro-rated to 5 years (rather than 6 years) for comparison purposes

# EFFICIENCY OF POWERLINK'S BASE YEAR OPEX?



# The AER's Opex Assessment Approach

- The AER intends to use the *base-step-trend* approach to its determination of Powerlink's opex allowances, i.e.:
  - **Determination of the efficient base year opex**
  - **Application of step changes** – adjusting the base year expenditure to account for any other forecast cost changes over the regulatory period due to new regulatory obligations
  - **Determination of rate-of-change factors** - determination of escalation factors to take account of changes over the regulatory period due to price, output and productivity changes
- This approach is overly dependent upon trend analysis and an acceptance of the networks' historical costs as being efficient
- It does not demonstrate the efficiency of the networks' base year opex

# THE NEED TO APPLY BENCHMARKING

# The Need to Apply Benchmarking to Powerlink's Opex

- The Rules formally require the AER to:
  - Undertake benchmarking to assess the relative efficiencies of networks
  - Apply the outcomes to determine efficient costs for the networks
- In its recent determinations, the AER applied benchmarking to determine the efficient base year opex for the distribution networks - **but not for the transmission networks**
- There is extensive evidence of material inefficiency in Powerlink's base year opex
- The AER determination of Powerlink's efficient base year opex needs to be informed by benchmarking

# The AER has Comprehensive Opex Benchmarking Information

- The AER develops its Transmission Benchmarking Reports using data collected from its regulatory information notices (RINs)
- This data has been compiled in accordance with the AER's consistent information requirements and it includes five years of data that has been audited by the transmission networks
- As outlined by Economic Insights:  
*“While no dataset will ever be perfect, this data is the most consistent and thoroughly examined dataset of the transmission networks yet assembled in Australia”*
- As stated by the AER:  
*“We consider that the benchmarking analysis presented in this report is reasoned and comprehensive. We have collected data on all major inputs and outputs for transmission businesses, and we consider the data used is robust. The PPIs present expenditure against known drivers, and the MTFP specification by Economic Insights is consistent with established literature”*

# The TNSPs Have Comprehensive Opex Benchmarking Information

For many years the TNSPs have selectively used the numerous benchmarking reports to support their opex efficiency claims, e.g.:

- Powerlink has consistently been highly selective in the use of ITOMS benchmarking results to demonstrate its opex efficiency
- Powerlink's 2018-22 revenue proposal refers to an *“independent expert opinion”* from Huegen Consulting
- TransGrid and Transend's recent revenue proposals selectively referred to the outcomes of the following benchmarking 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
  - The Huegen Transmission Benchmarking Study 2013 Report

# The TNSPs Have Comprehensive Opex Benchmarking Information

- A review of the TNSPs' previous regulatory submissions identifies that the TNSPs' have selectively referred to around 40 benchmarking studies in support of their previous opex claims
- Clearly the required data and information for benchmarking the TNSPs' opex is readily available and the AER has the information gathering powers to obtain whatever information it needs
- It is also clear that the AER's previous regulatory decisions were informed by the opex benchmarking results presented by the TNSPs

## SP AusNet Believes That It is Much More Efficient than the other TNSPs

- All of the transmission networks appear to have engaged Huegen Consulting during this round of resets to demonstrate their opex efficiency
- For example, SP AusNet's current revenue proposal states that:

*“Huegin’s analysis of OPFP demonstrates that AusNet Services has delivered higher rates of opex productivity growth than its peers and **well above the industry average**”*

*“Economic Insights explains that an adjustment for step changes further improves historic performance, with AusNet Services **achieving substantially better rates of improvement than the industry average**”*

*“AusNet Services’ **strong track record of outperforming the industry average** with respect to productivity gains is prima facie evidence that its base year opex is efficient”*

*“In Queensland operating expenditure increased significantly, whereas the operating expenditure of the TNSPs in other states remained reasonably constant. Per MWh delivered, there is a significant difference between the lowest and the highest”*

*“Even for TNSPs with comparable levels of delivered energy, operating expenditure per MWh differs significantly. For example **in Queensland twice as much operating expenditure per MWh delivered is recovered than in Victoria**”*

*“The provision of transmission network services in Victoria has been consistently better than in other states in respect of regulated revenues, the size of the regulated asset base, and the level of operating expenditure and capital expenditure”*



# The AER Has Not Justified Its Decision to Not Use Benchmarking

- It appears that the AER's main reason for not applying benchmarking to the TNSPs' opex determinations is due to resource constraints
- That suggests that the AER should focus its scarce resources on identifying the most material opex inefficiencies
- There is extensive evidence that Powerlink's opex is the most materially inefficient of the 5 Australian TNSPs
- Therefore, the AER should devote its scarce resources to applying benchmarking to the determination of Powerlink's efficient base year opex

# Benchmarking Can Be Supplemented By Other Techniques

- In its recent opex determinations for the distribution networks, the AER supplemented its benchmarking with other assessment techniques
- The AER can apply a similar approach to Powerlink's opex determination
- Like all techniques, benchmarking has its imperfections
- 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
- All regulators that use benchmarking acknowledge those imperfections, and take them into account in their decision-making

# LABOUR COSTS

# The AER's Approach to Determining Labour Costs

- In determining its labour price change factor for TransGrid and Transend, the AER adopted the average of Deloitte Access Economics' and Independent Economics' wage price index (WPI) forecasts for the *Electricity, Gas, Water and Waste Services (EGWWS)* industry
- That approach resulted in the AER applying real price growth factors to TransGrid and Transend's labour prices
- The above forecasts do not reflect the specific drivers of the electricity network sector
- The electricity network sector is currently in contraction due to declining demand for its product/services, whereas the other sectors covered by the forecasts are not

## Industries in Contraction Do Not Face Real Labour Price Increase Drivers

- The Australian electricity network sector is currently in a major contraction phase
- **Industries in contraction do not face real labour price increasing drivers**
- There is currently minimal wage pressure within the Australian economy – the mining boom has passed and skilled labour is readily available
- The AER needs to use labour price forecasts that are specific to the electricity network sector
- Such forecasts will confirm that Powerlink's labour costs should be reducing, rather than increasing

# Labour and Workforce Practices - Qld Govt IRP Report

***“The IDC was particularly concerned about the IRP’s reports of a noticeable cultural disregard for cost within the distribution network businesses”***

***“The capital programs and operating costs of the GOCs have increased sharply and unsustainably”***

***“Overhead expense (indirect costs) have grown rapidly in recent years and places the Queensland DNSPs among the least efficient in the NEM”***

***“Across the three companies, 647 employees earned in excess of 1.5 times their base pay....27 employees earned twice their base pay in 2011/12”***

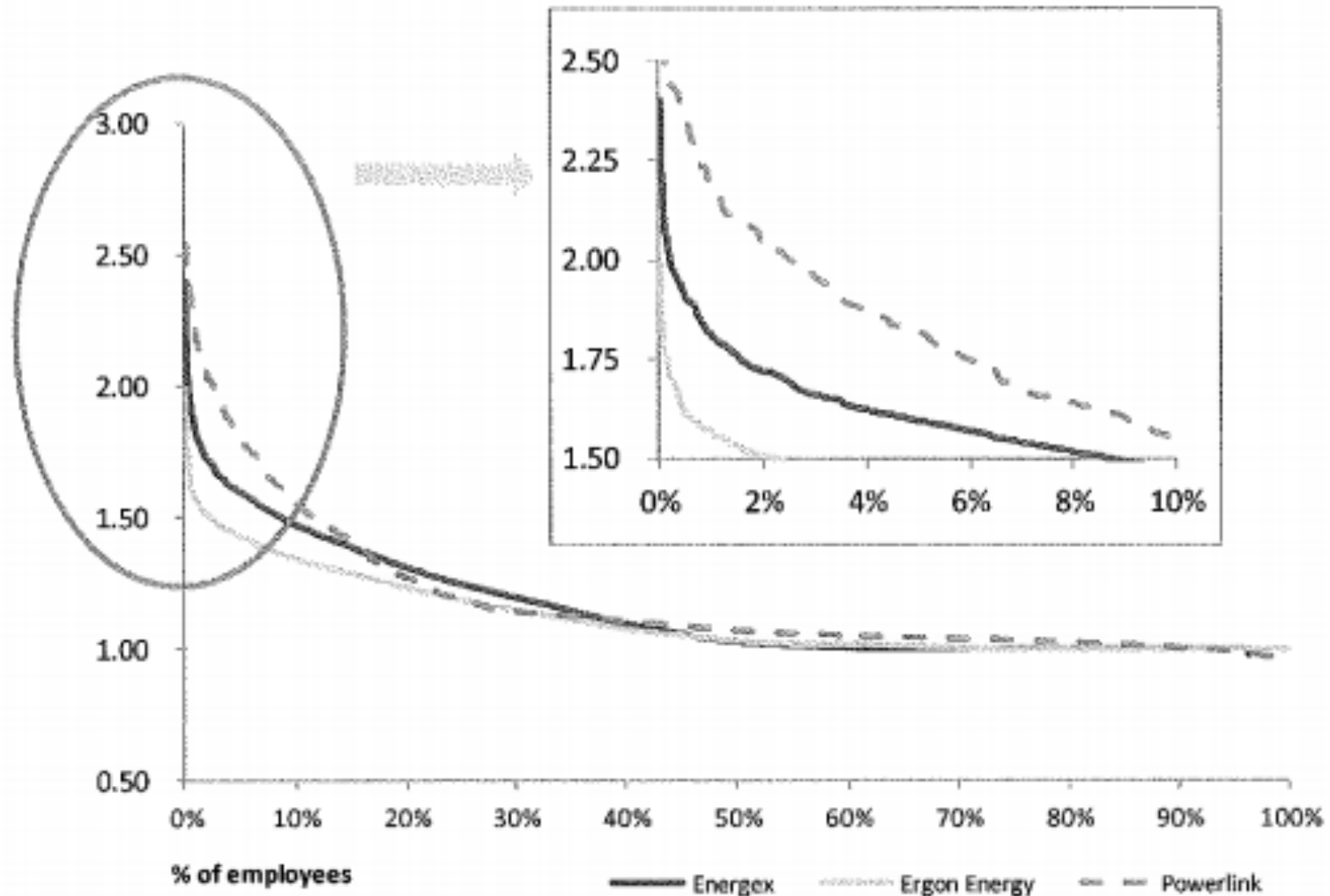
***“Contract resources are used inefficiently.....internal resources are being under-utilised”***

***“The start times of work crews are often not matched to the requirements of particular projects. A rigid adherence to these start times means that there is a mismatch, leading to reduced productivity and possibly longer outage durations”***

***“The differences in fatigue management policies complicate crew scheduling and joint workforce management leading to response delays, inefficiencies and potential safety issues”***

# Labour and Workforce Practices - Qld Govt IRP Report

Figure 35. Total to Base Pay Ratios for the NSPs, 2011/12



# The Queensland Networks' EBA's Are Driving Inefficient Labour Costs

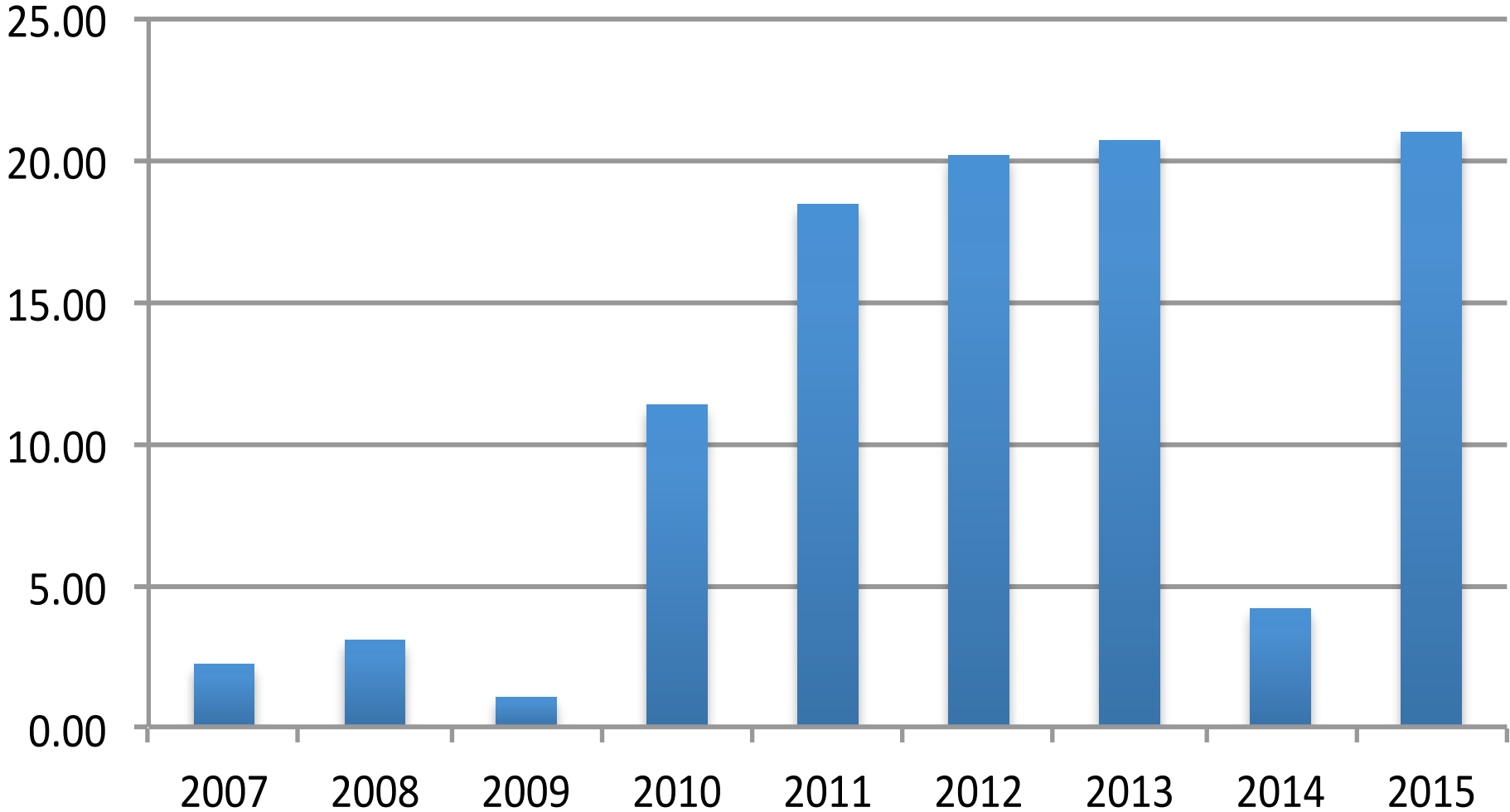
- The Queensland government IRP Report\* identified that the Queensland networks' enterprise agreements are driving inefficient labour practices and labour costs
- The AER must ensure that Powerlink is not allowed to continue to treat EBA outcomes as a “pass through”

\* Queensland Government Independent Review Panel (IRP) on Network Costs



# SERVICE TARGET PERFORMANCE INCENTIVE SCHEME (STPIS) OUTCOMES

# Powerlink - STPIS Bonuses (\$M)



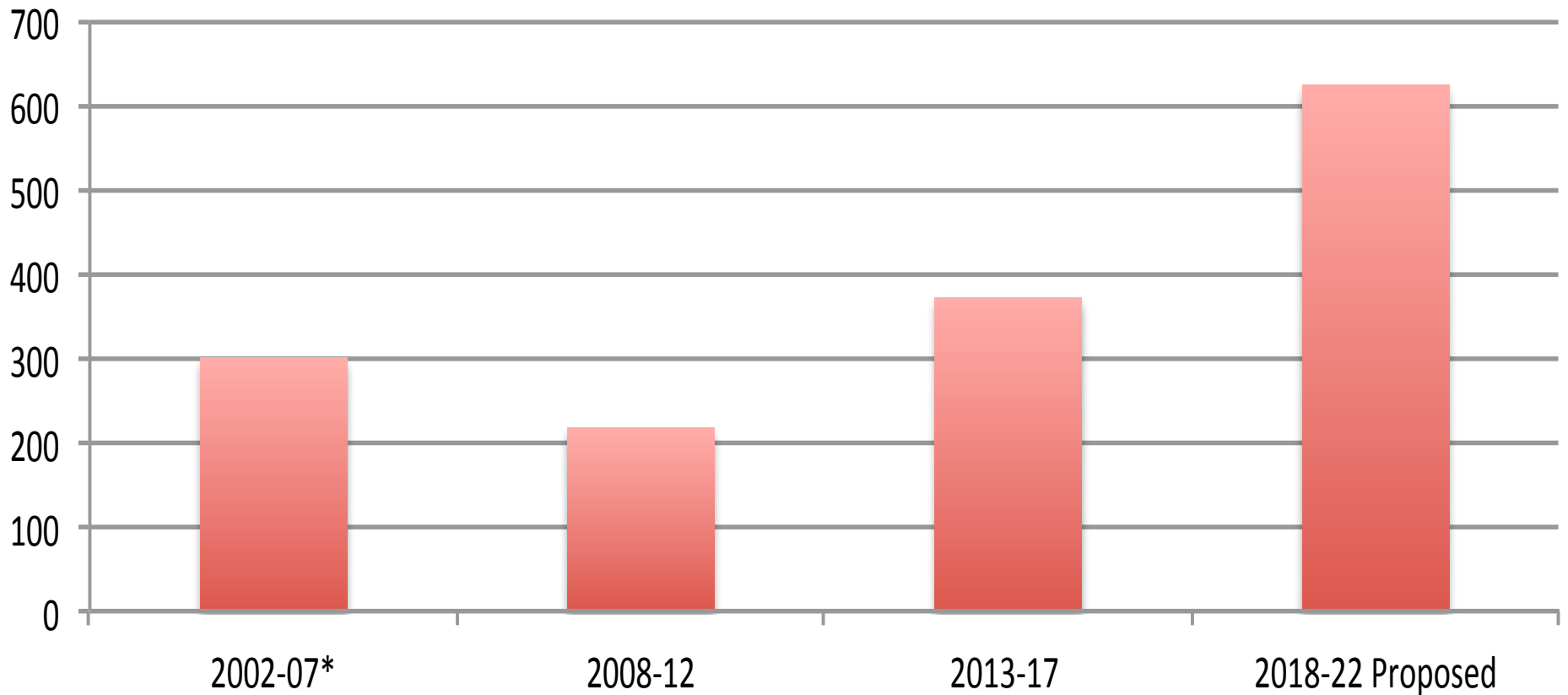
# Incentive Scheme Outcomes

- The outcomes of the AER's incentive schemes indicate highly asymmetric outcomes in favour of the networks
- The AER needs to negotiate targets that deliver genuine efficiency and service performance improvements

# DEPRECIATION

# Powerlink Depreciation Trend

## Depreciation (\$M)



\* 2002-07 figures pro-rated to 5 years (rather than 6 years) for comparison purposes

# What is Driving Powerlink's Proposed Depreciation Allowance Increase?

- The AER Issues Paper identified that there are 2 key drivers of Powerlink's proposed depreciation allowance increase
  - Lower remaining asset lives
  - Changes to the inflation adjustment
- The AER needs to ensure that remaining asset lives applied to its depreciation allowances reflect the actual asset lives being achieved by the networks

**Thank You**

**Hugh Grant**

**AER Consumer Challenge Panel Member**