Energy Consumers Coalition of South Australia

AER Review

ElectraNet Revenue Reset

Draft Decision Forum

Presentation by

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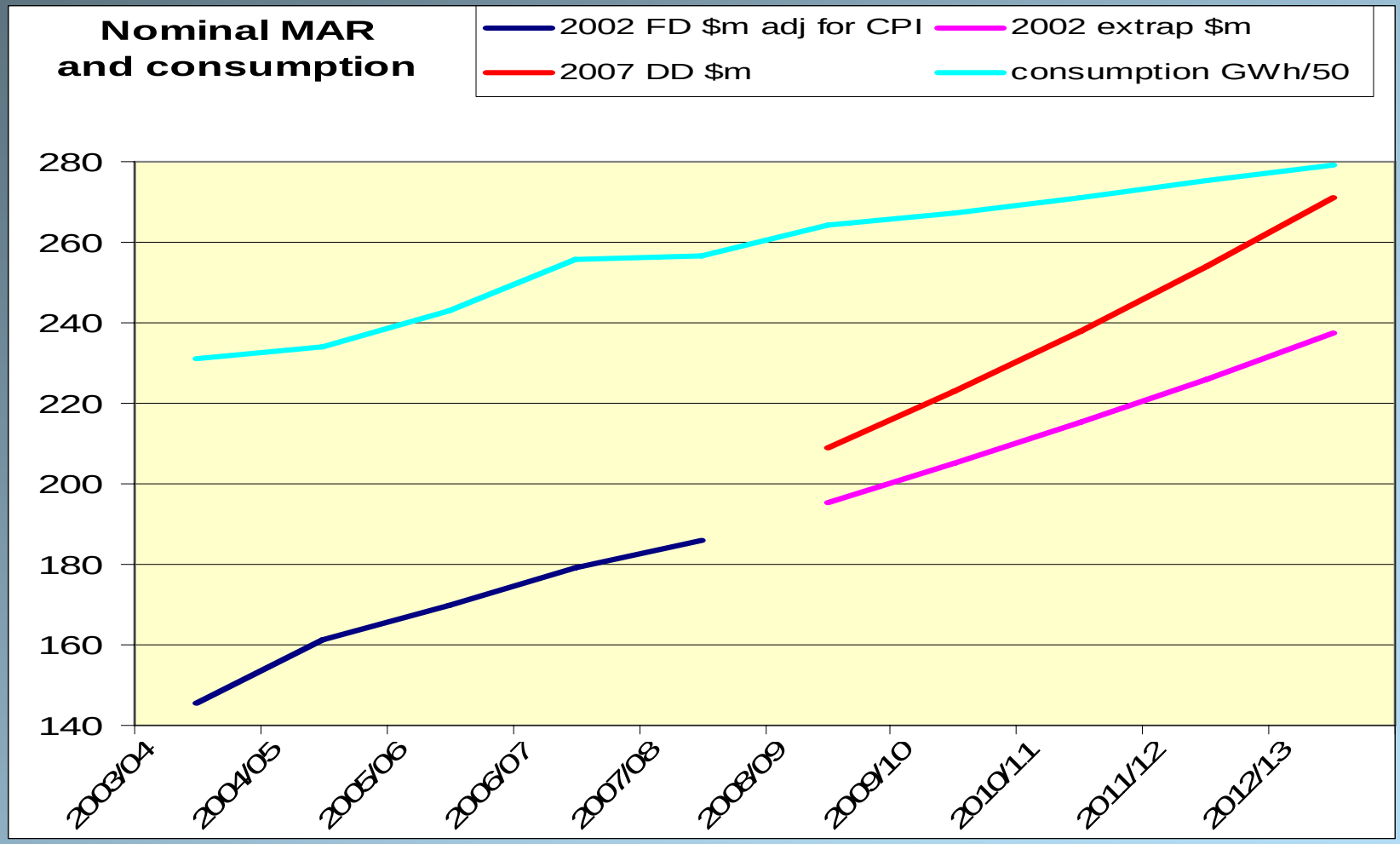
John Pike (ECCSA Chair)

11 December 2007

High level outcome of ElectraNet Draft Decision

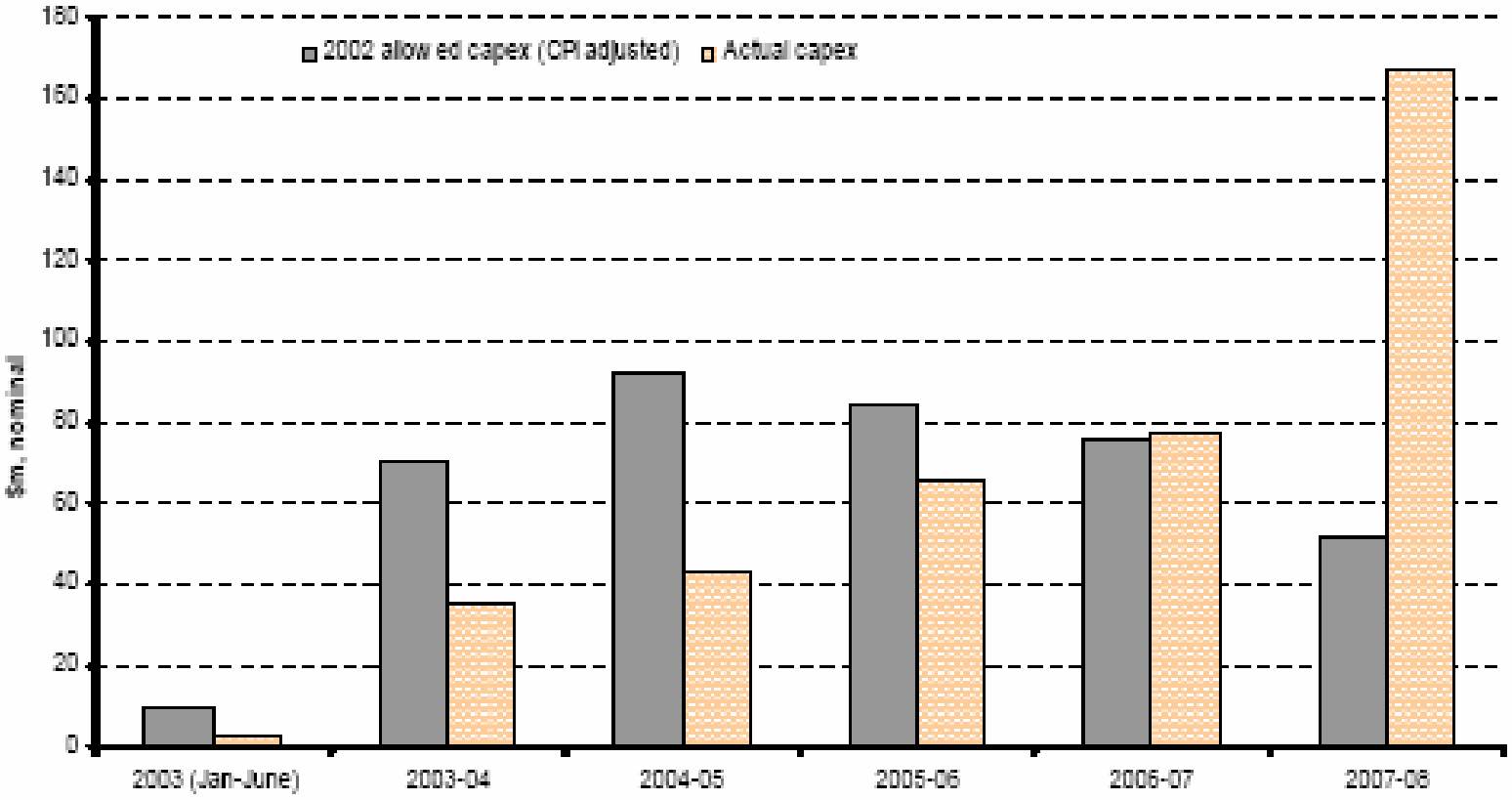


High level outcome of the Draft Decision

- Differential between 20002 FD extrapolated to 2007 DD rises from$14m in 2008/09 to $34m in 2012/13 yet consumption rises at 1.5% pa.
- The 2002 FD resulted in an average 5% increase pa while the 2007 DD allows for an increase of 7.4% pa
- In 2002 the average tariff was $10.60/MWh and allowing for inflation this becomes $13/MWh now
- By 2013 the average tariff will reach $19.40/MWh which is equivalent to $17.20/MWh now
- This is a real 32% increase in tariff for a 12% increase in consumption, a unit cost of $$.20/MWh
- From 2002-2006 average loss of supply was 73 minutes and circuit availability was 99.47%
- The new target is 84 minutes off supply and availability of 99.47%
- So for a 32% increase in tariff we get equal or less service performance

Past capex

Figure 2.1: Comparison of ElectraNet's 2002 allowance and its actual capex profile



Note: Updated for 2006–07 actual capex as advised by ElectraNet. The 2007–08 actual capex is forecast.

Past capex (2)

- Capex is seen to have balanced over the period – that is if ElectraNet spends twice the 06/07 capex in 07/08, yet augmentations were lower than forecast and refurbishment much higher
- Some of the capex expected to be spent during the last period is now to be spent in the next period
- Capex for land/easements, IT and spares cost $52m of an allowance of $11m (IT capex was 5 times the allowance), 60% of the augmentation allowance was spent, and 78% more was spent on refurbishment, yet the AER is "satisfied" and considers that consumers got value for money
- Its delayed capex program has netted some $38M in unearned income – a clear "gaming" of the regulatory process – yet the AER accepts this
- SKM accepts the past capex yet raises a number of concerns, the largest being over-runs against estimates of 22% (average?), yet these estimates were used for RT purposes

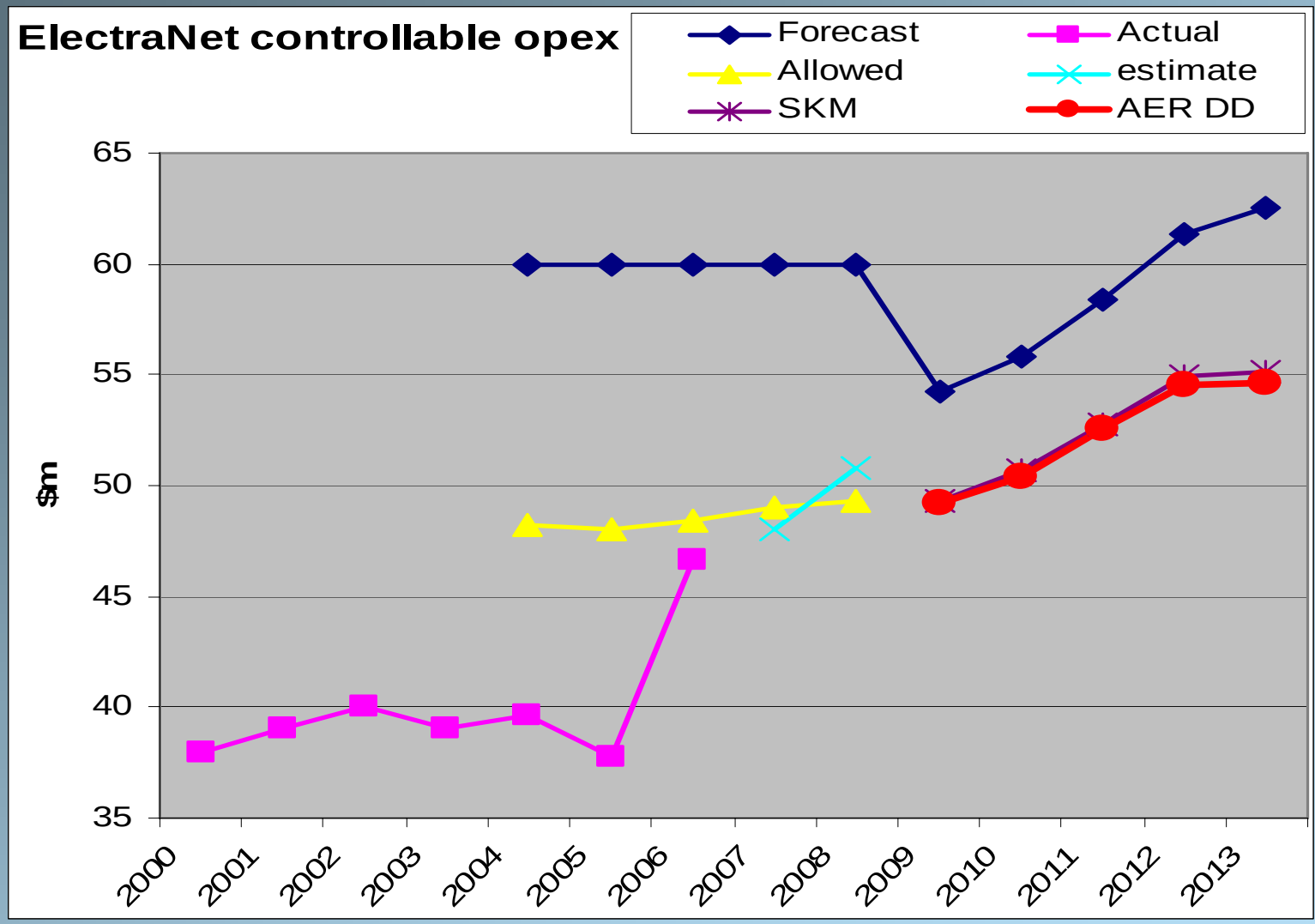
Easements

- In the 2002 decision the ACCC could find no reason to increase the RAB due to assumed acquisition costs for easements.
- The owners of ElectraNet purchased the ElectraNet assets knowing that only $3.1 m was included in the accounts for acquisition for easements
- There is no documentation within ElectraNet, either before the acquisition or after that provides any evidence that the costs for acquiring easements (transaction costs and compensation) were not “expensed” at the time, and therefore users have already paid for these as if they were “capital contributions”; ie the carrying costs of easements is $3.1m as stated
- ElectraNet has sought an increase in RAB assuming that more costs were involved than was stated at the time of purchase
- The AER considers that ElectraNet should be granted a “free” increase in RAB of $29m because it has assumed ElectraNet has incurred these costs and that the guessed compensation costs might be the same as might apply in a totally different network arrangement

WACC and CPI

- The WACC development requires the setting of the "real" risk free rate, and a forecast of inflation to adjust the RAB
- NERA developed a concept that the CGSs are distorted in value requiring an increase in the nominal bond rate and an even larger increase of in the indexed bond rate.
- There is a strong view that the indexed bond rate is too low, but the consensus is that the nominal bond rate accurately represents the nominal risk free rate
- Thus to get the "real" risk free rate now requires assuming inflation and use this and the nominal rate to set the "real" rate
- The AER considers that 3% CPI for the next 5 years is correct as it is the upper bound of the RBA target range for CPI
- The difference between CGS rates provided a market based estimate of inflation. The market provides this differential in other securities and these provide a better forecast than the AER guessing approach
- Using CGSs forecast inflation is 3.7%, using other market based data (eg Bloomberg swaps) it is 3.4%, well above 2.97%. Has the other data matched CGSs in the past?

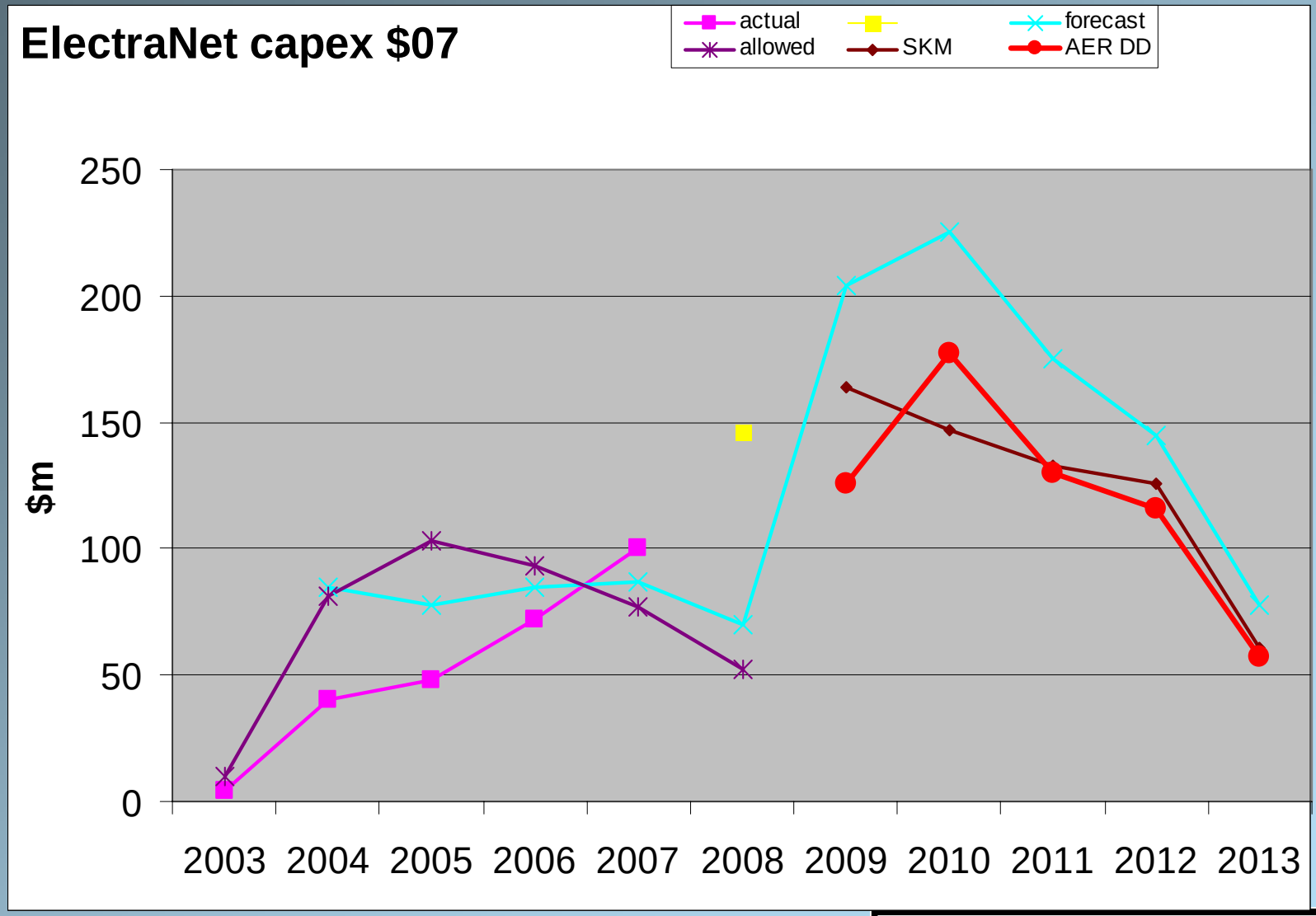
Change on Opex over time



Views on Opex

- ElectraNet gets a benefit of $17.2m for under-running allowed opex, yet the base opex is not used as the benchmark
- The only year where opex exceeded allowance is the estimate for 07/08
- What has happened to the concept of a benchmark with defined step changes? What are the step changes that warrant the continued increase in opex?
- Where is the reduction in opex due to the excess investment in refurbishing
- Allowed opex increases at 3% pa real and AER attributes this to an asset value relationship, but this is debatable
  - Opex does increase with age, but there is virtually no age change
  - Opex only increases with asset value when previously unsupplied areas are supplied
  - Refurbishment should result in opex decrease
  - Replacement of old with larger should not increase opex (increase in size is offset by benefit of new asset)
- AER has not used the concept of incentive regulation at all
- ECCSA agrees with AER on equity raising costs and comments that ElectraNet spent nothing on debt raising over the last period (SKM table 46)
- Use of retained profits costs nothing to raise, so debt raising costs should be reduced to only when debt is sourced

Change in capex over time



Views on Capex

- The AER has reduced the claimed capex by $120m (transfer to contingent projects) and $45m due to inflationary adjustments
- It has approved $805m for contingent projects (33% more than allowed capex – this would increase the average tariff by another $3/MWh from the new average $17.5/MWh
- The AER has approved capex at a rate higher than anything ElectraNet has achieved to date for 4 of the last 5 years, and even exceeding the very high forecast for this year.
- The service performance standards do not reflect the benefit of the past or new investment

An overview of capex

- There is significant effort devoted to assessing the reasonableness of the capex inflationary pressures and the amount of capex allowed
- ECCSA considers that AER has over provided for capex amount based on outcomes and previous performance
- The risk for consumers for an over-estimate of capex allowances is that ElectraNet will benefit from
  - Any overestimated allowances by virtue of getting a return on the amount unspent or delayed in spending
  - Having less pressure to minimise capex
- The ability to source funds is the only pressure to minimise capex
- The ex ante approach to capex is that actual capex will be rolled into the RAB so in theory ElectraNet has an incentive to be inefficient.

The drivers of TNSP profit

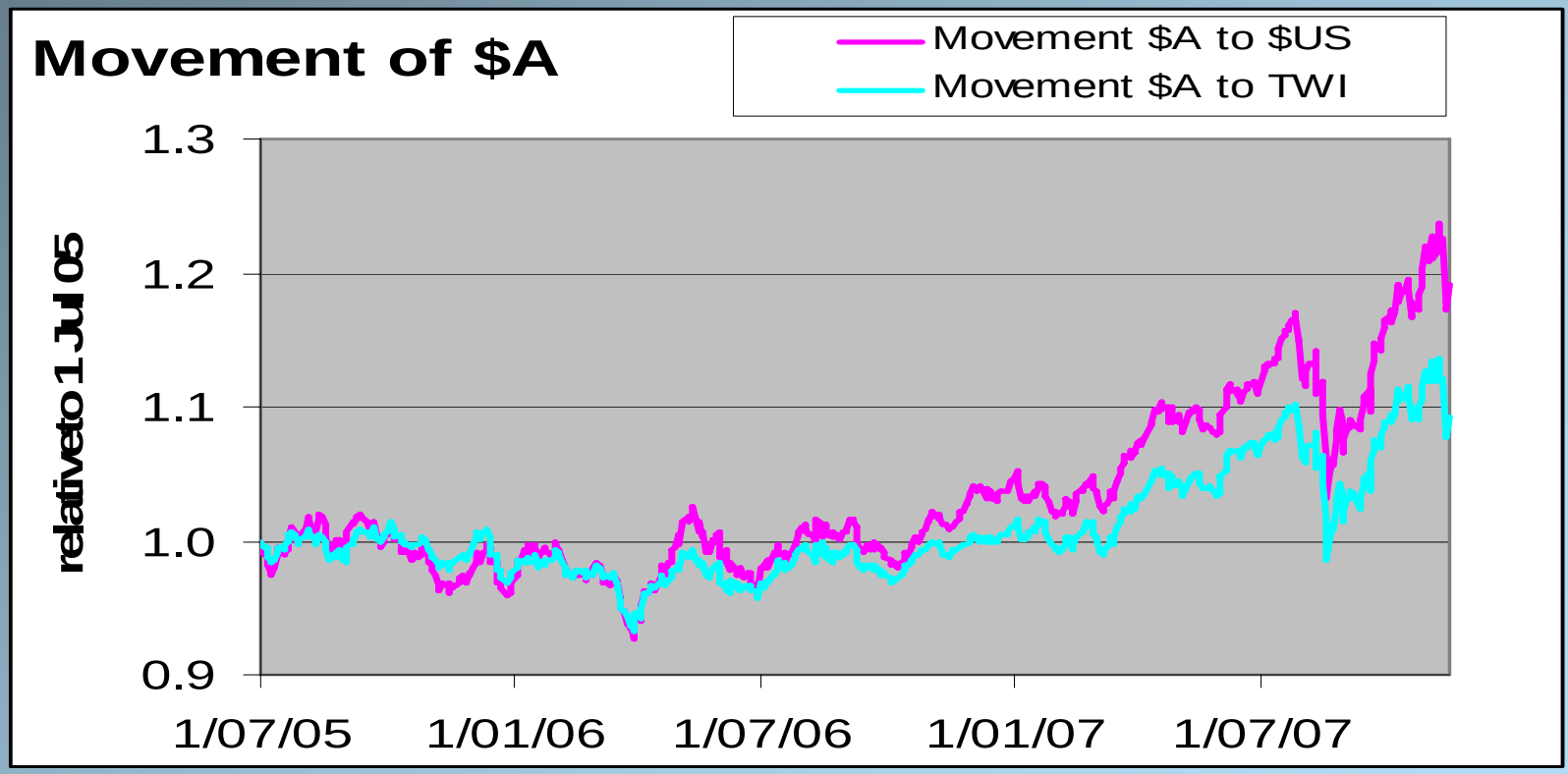
- Depreciation and opex, are recovered on a cost basis and theoretically have no profit attached to them
- Pass throughs have no profit for a TNSP attached to them
- Efficiency carry over has no profit attached to it and declines over time
- Achieving performance standards has a profit element but is not a secure source of profit
- The bulk of a TNSP profit comes from the WACC which is a return on assets
- Therefore a TNSP is actively incentivised to increase the assets involved so as to increase its profits

Inflationary pressures - wages

- Econtech advises that utilities wages rose more than the average and more than construction and use this as the base for wage movements
- ElectraNet capex and much of its opex is based on construction wages rather than utilities wages (contracted out opex uses construction workers)
- Utilities wages rises are distorted by the loss of lower paid staff caused during retrenchments and contracting out
- Wages have historically outperformed CPI by some 2.2% for 30 years.
- Should there be a premium paid as current wages are higher at the moment? To do so raises some very major risks – it is a move towards cost of service
- What of the asymmetry – a TNSP is not required to return benefits when the market works for them, why should the reverse apply?

Inflationary pressures - materials

- Since ElectraNet made its forecasts for materials it has had a major beneficial movement in exchange rates, yet this is not considered



ECCSA Conclusions

- The AER proposes a massive increase in allowances
- Average tariffs have risen by 32% in real terms under the guidance of the ACCC/AER and to put this into context,
  - tariffs used to be half the amount planned for 2013,
  - the tariff in 2013 will be nearly half the cost of generation
- The AER has approved contingent projects that could increase tariffs by another $3/MWh
- Opex is well above the “ElectraNet” benchmark
- Opex has been inflated for expected cost inflation above CPI yet no allowance has been made for the asymmetry of this decision, nor for underlying trends
- Capex nearly doubles, yet ElectraNet had trouble spending the last allowances, under-spending significantly in the early years
- An allowance has been included for compensation for easement acquisition, yet there is no proof this was either not incurred or expensed at the time, adding costs to consumers that may have already paid
- Opex and capex are to be inflated significantly yet the independent data does not really support an increase

ECCSA Assessment of the DD

- This assessment is the result of limited review of the documents, and the ECCSA will be providing a detailed response to the Draft Determination and the consultants reports
- Overall, the AER proposes to allow ElectraNet to greatly increase the costs to provide the service and to reduce the performance required ie unit costs to double since 2000.
- There is no evidence that the AER has applied the commercial pressures on ElectraNet that a competitive market would apply in the face of such large increases in cost
- Econtech has used incorrect sectoral assumptions in its review of wages growth, and has misguided the AER by not highlighting the underlying wages growth in the market
- ECCSA observes that SKM has had previous experience with ElectraNet and its assets in that it:-
  - Advised the SA Gov't (the then owners of ElectraNet) on asset valuations in 1998 to ensure the maximum sale price was achieved
  - Advised ElectraNet in 2002 that the replacement cost for easements should be a huge $123m (ElectraNet application page 5-6)
  - Advised ElectraNet in 2002 on optimised assets (ElectraNet application page 5-8)