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# ENERGY MARKETS REFORM FORUM

Review of AER DD on NSW electricity  
network businesses

PRESENTATION BY  
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# ENERGY MARKET REFORM

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- Energy Markets Reform Forum: Major Energy & Energy Infrastructure Users
- Members include: OneSteel, BHP Billiton, BlueScope Steel,, Orica, Visy Paper, Tomago Aluminium, CIF, A3P, and by association others such as Kimberly Clark, Adelaide Brighton Cement, auto manufacturers
  - companies exposed to international and import competition
- Interested in energy markets reforms in electricity, gas, and networks issues
  - objective: competitively priced energy and energy infrastructure

# ISSUES COVERED IN THIS PRESENTATION

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- General concerns regarding the DD
- Specific issues with each network element

# Regulatory conservatism (1)



- Regulators take a conservative view to ensure that the “lights stay on” and this is supported in principle but less so with current regulatory practice
- Throughout a decision, every element is assessed conservatively, and these compound
- Eg WACC inputs are a case in point – a 10% movement in each of the parameters results in a 25% margin over the RFR

Parameters	% debt	DRP	$\beta_e$	MRP	% equity	RFR	Nominal WACC
AER	60%	2%	1	6%	40%	6%	9.6%
AER + 10%	54%	2.2%	1.1	6.6%	46%	6%	10.5%
AER - 10%	66%	1.8%	0.9	5.5%	34%	6%	8.8%

- The same happens with opex and capex and forecast escalation
- When all conservatism is aggregated, the total impact is massive

## Regulatory conservatism (2)



- Even the DORC based approach to return on capital is biased against future users of new assets
- The regulatory process itself incentivises capex at the expense of alternatives
- NSW electricity transport assets never had an equity injection (assets were inherited), yet we still pay an equity return on 40%
- Incentive regulation is intended to drive regulated businesses to maximum efficiency, yet we continue to see tariffs increase faster than inflation
- Increasing amounts of capex are awarded with fewer controls on the outcomes
- Opex is meant to be benchmarked, but regulators award opex along the lines requested without using benchmark performance, including that of the business itself
- Even service standards are discounted for capex impacts
- When all these conservative aspects are added, we have a massive over contribution, with the outcomes being ever increasing tariffs

# The world is a different place (1)

- where will capex funding come from?



- Overall the AER proposes NSW NSPs should spend some \$18 billion over the next five years
- Is the AER seeking to implement an electricity networks led economic recovery?
- Where is the money going to come from? This is a critical issue – NSPs gain increased revenue even if capex is not used, whether from “efficiency gains” or not spending because there is no money
- The equity share should come from retained earnings and the depreciation account but the NSW government is already seeking increased contributions from the NSPs and are deferring \$850m in capex – mini budget
- The debt share comes from borrowings, but from who? <sub>6</sub>

## The world is a different place (2)

### - where to go for debt funding?



- Banks are very cautious and have tightened lending
- Private infrastructure investment suffers the B&B complaint
- The NSW gov't capacity to borrow is limited by its credit rating objective
- The NSW gov't is adding a distributor levy to pay for clean coal technology and energy efficiency, and transferring these costs to consumers
- We are already seeing government corporations being limited on how much they can borrow from the state finance providers (eg T-Corp), with what is available being dedicated to essential infrastructure
- The NSW mini budget has already forecast reductions in capex for electricity networks
- The networks will be competing for limited cash against all other electricity networks and from other utilities (electricity, gas, water, public transport, roads)

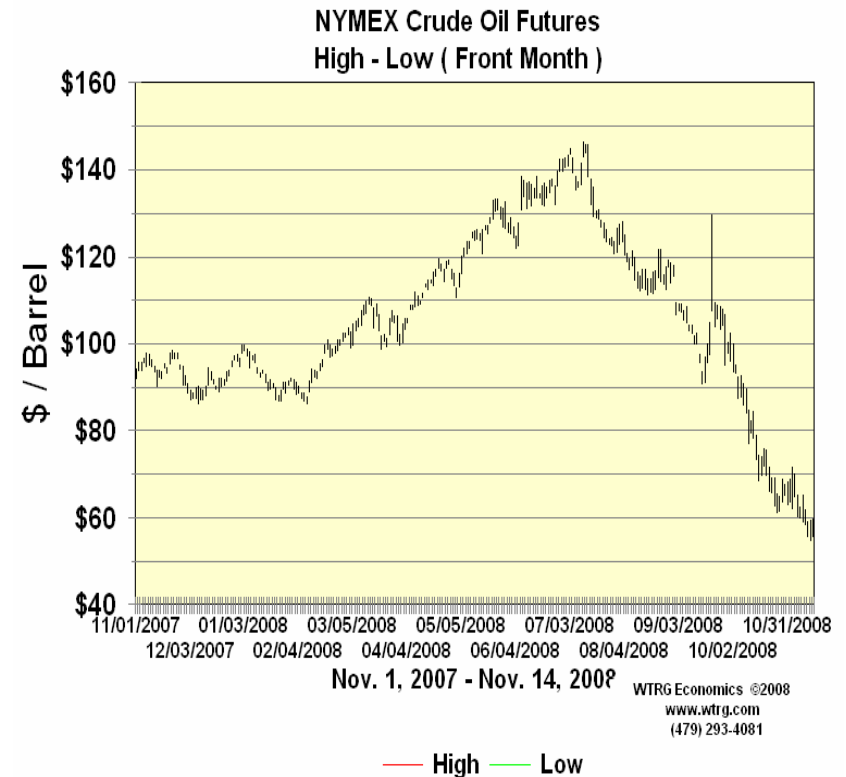
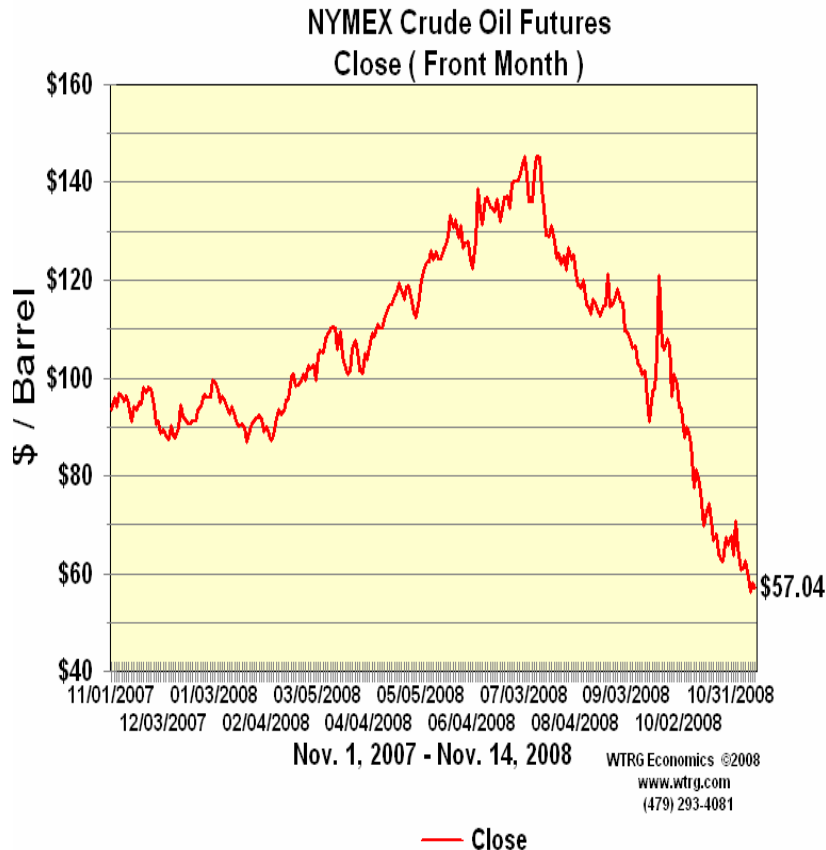
## The world is a different place (3)



- All these factors raise a fundamental question
- If the AER allows the capex to be included but funds are not available and therefore the capex does not occur, the networks will be granted "free" revenue.
- There is substantial doubt regarding the ability of the networks to use all capex allowed and if the capex is not spent, the "free" money is still provided
- The ex ante approach to capex and the requirement to carry forward actual capex into the RAB (thanks to AEMC and MCE), means that the networks can spend the allowed capex on anything with impunity
- The world has already punished those investing unwisely, so why should the networks be given virtually all the capex they request without the substantial discipline needed in the post sub-prime financial crisis world of today?



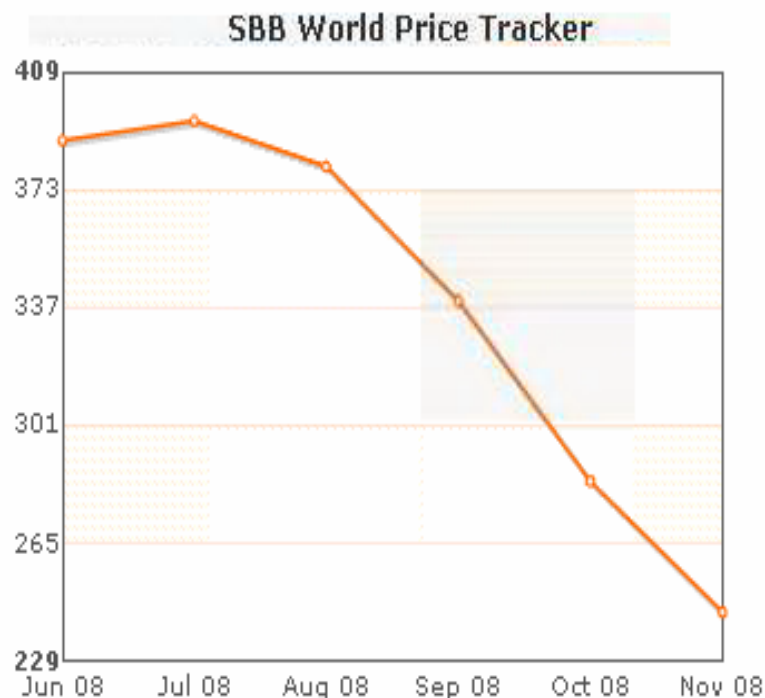
# Capex is augmented to allow for material price increases – why? (1)



# Capex is augmented to allow for material price increases – why? (2)



## SBB World Steel Prices including Daily Steel Futures



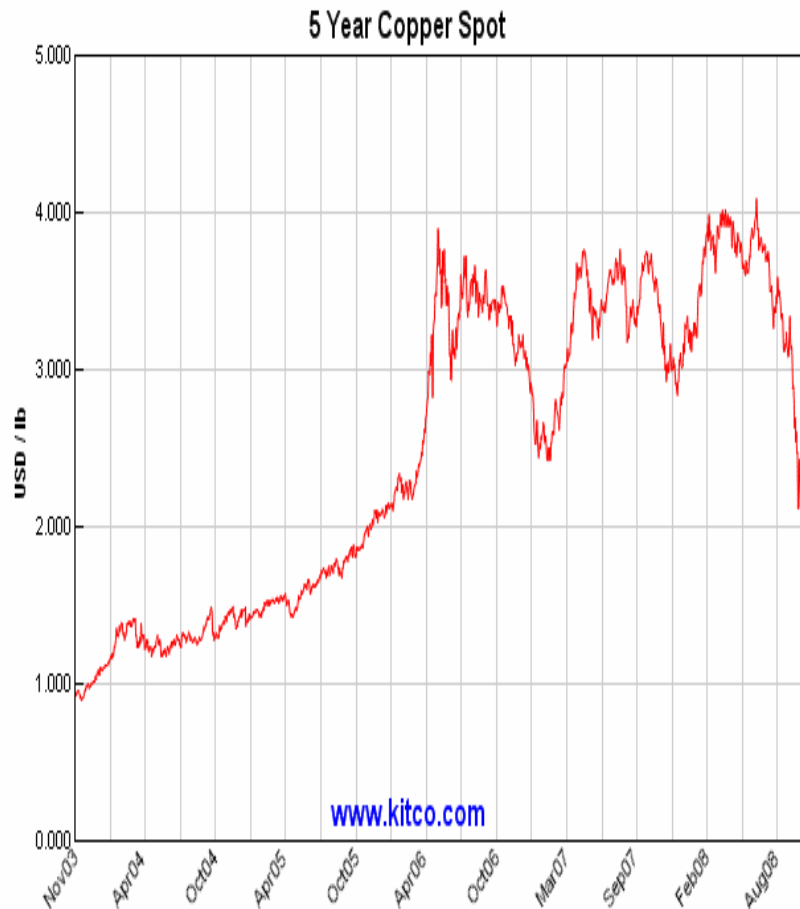
## LME Steel Billet – Far East

Please select the start date, end date and contract type for the graph you wish to view. Click on "show" to see the graph results.

START ON:	17	Jul	2008
FINISH ON	17	Nov	2008
CONTRACT TYPE	Cash buyer		
<a href="#">SHOW</a>			



# Capex is augmented to allow for material price increases – why? (3)



# Capex is augmented to allow for material price increases – why? (4)



# Capex is augmented to allow for material price increases – why? (5)



- The largest reduction in material costs for 08/09 assessed by the AER is -15% and many other costs are forecast to increase
- The AER is forecasting real increases from 07/08 in labour and materials for the next five years – this is a very courageous call
- Most OECD countries are in recession now and the US is projected for a deep and long lasting recession
- Australia just missed negative growth in Q3/08 due to strong farm output and Q4/08 is forecast to be negative => recession
- With projects all over the world being deferred (some indefinitely) and capital projects in Australia being similarly impacted, there is increasing manufacturing capacity for plant needed by the networks
- Prices for new plant will fall dramatically as manufacturers seek to fill empty manufacturing “slots” caused by cancellations
- Competition will be fierce for any work as manufacturers fight for sufficient work to maintain viability

# Capex is augmented to allow for material price increases – why? (6)



- **The NSPs have set their own opex and capex benchmarks based on their own performance in the past period**
- **This performance was incentivised and therefore is a reasonable estimate of self benchmarking**
- **Changes from the self set benchmark need to be fully justified – but has it?**
- **The current benchmarks include very high costs for materials and labour, certainly higher than current costs**
- **In reality, costs are likely to be lower than in the current period**
- **Why has the AER allowed a step change from the current levels of capex and opex based on “real” escalation, when the base already has these premiums embedded in it?**
- **This defies logic, as it further compounds the allowances being granted. (eg the benchmark already includes a premium for EGW over general labour costs)**
- **With increasing unemployment and a falling labour demand for construction, there will be a move of labour to EGW putting downward<sup>14</sup> pressure on EGW wage growth**

# Capex and opex is augmented to allow for labour price increases – why?

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- Labour costs are being constrained
- The labour market is seeing a move away from low unemployment towards increasing unemployment
- Graduates who were offered jobs on graduation are now being told those jobs are gone
- Mining investment is being deferred, some indefinitely, and already skilled labour is being released from these projects
- Manufacturers are closing => releasing more labour, and those not closing are “hunkering down”, and releasing some labour.
- Can consumers absorb the increases being claimed?

# Growth in demand and consumption is already falling (1)



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- **Growth in power demand is driven by commercial and residential demand and increasing penetration of air conditioning**
  - **Forecasts made 6 months ago are now wildly optimistic, those made a month ago are demonstrably out-of-date**
  - **NSW population growth rates have shown a consistent fall over the past 20 years and this is projected to continue or remain flat**
  - **There are chilling forecasts of greenhouse gas impacts eg Nyrstar will close if carbon costs > \$40/T**



# Growth in demand and consumption is already falling (2)



- **CitiBank forecasts are showing strong negative signs**
  - Non-residential buildings approvals have now fallen in 4 of the last 5 months
  - Residential building approvals falls are much larger than expected (-5.4% vs. market f/c)
  - Household wealth destruction is unprecedented (shares and house values) driving an increase in savings and reduced spending
- **The low \$A is forecast to cause reductions in electrical goods sales (including air conditioners)**
- **Industrial demand is falling as production lessens, and augmentations are deferred eliminating growth potential**
- **This puts severe doubt of the growth forecasts underpinning the capex programs**

# SUMMARY COMMENTS (1)

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- The world economy is experiencing a severe shock (with significant widespread negative growth) and is undergoing a deep and long term adjustment process
  - Many OECD countries are already in recession (including the US) and Australia is expected to dip into negative growth in 2009
  - Global growth is not expected to return until well into 2010
  - Many Australian businesses are already experiencing problems, reducing expenditure, cancelling projects and laying off staff
  - Unemployment in Australia is expected to increase
  - Inflation is easing with labour and materials costs falling
  - Funding is harder to get

## SUMMARY COMMENTS (2)

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- This change requires the AER to review its DD and:-
  - Review its economic growth forecasts (energy/demand consumption, cost escalations) as those used are out of date
  - Review opex and capex claims – they are totally over the top for the expected forecast conditions for business and residential changes in demand
  - Consider the ability of the NSPs to raise the funds necessary in light of the NSW gov't declared constraints on debt, banking constraints and the financial market appetites
  - Look at the reaction of the market to infrastructure investments

## SUMMARY COMMENTS (3)



- The AER needs to assess whether it just approves what is sought (and this is what it appears) or acts like a proper regulator and addresses the issues on a forward looking basis
- It has not properly addressed
  - The compounding effect of the conservatism it has incorporated
  - That incentive regulation is NOT just agreeing to increasing amounts of opex and capex with fewer controls – it means using incentivised actual performance as the basis for setting future allowances
  - That the market is totally different to when the applications were written and when the DD was drafted
  - That the tariff increases allowed might actually cause a deterioration in ability to pay by consumers

# Specific Issues

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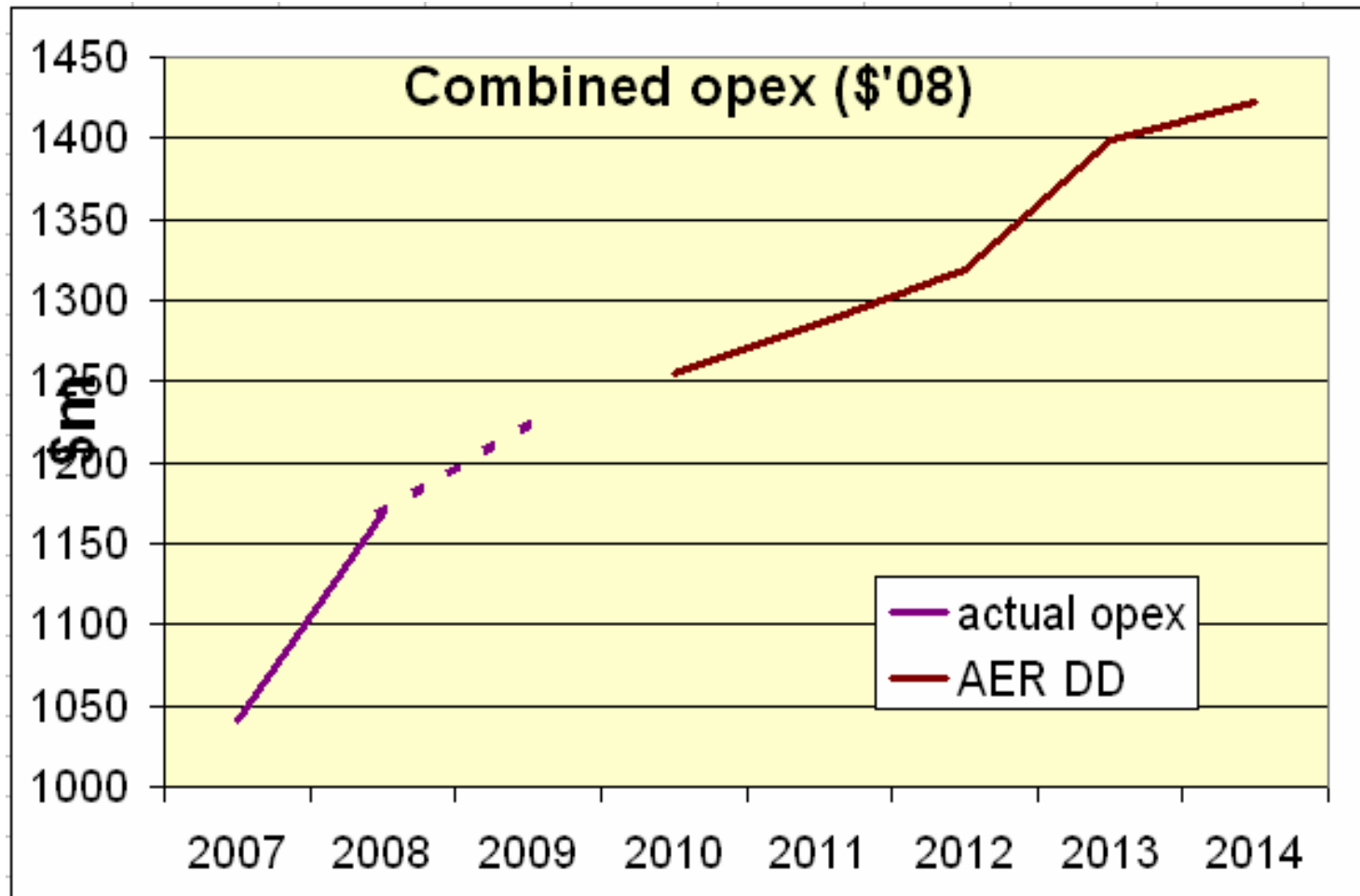


# Opex

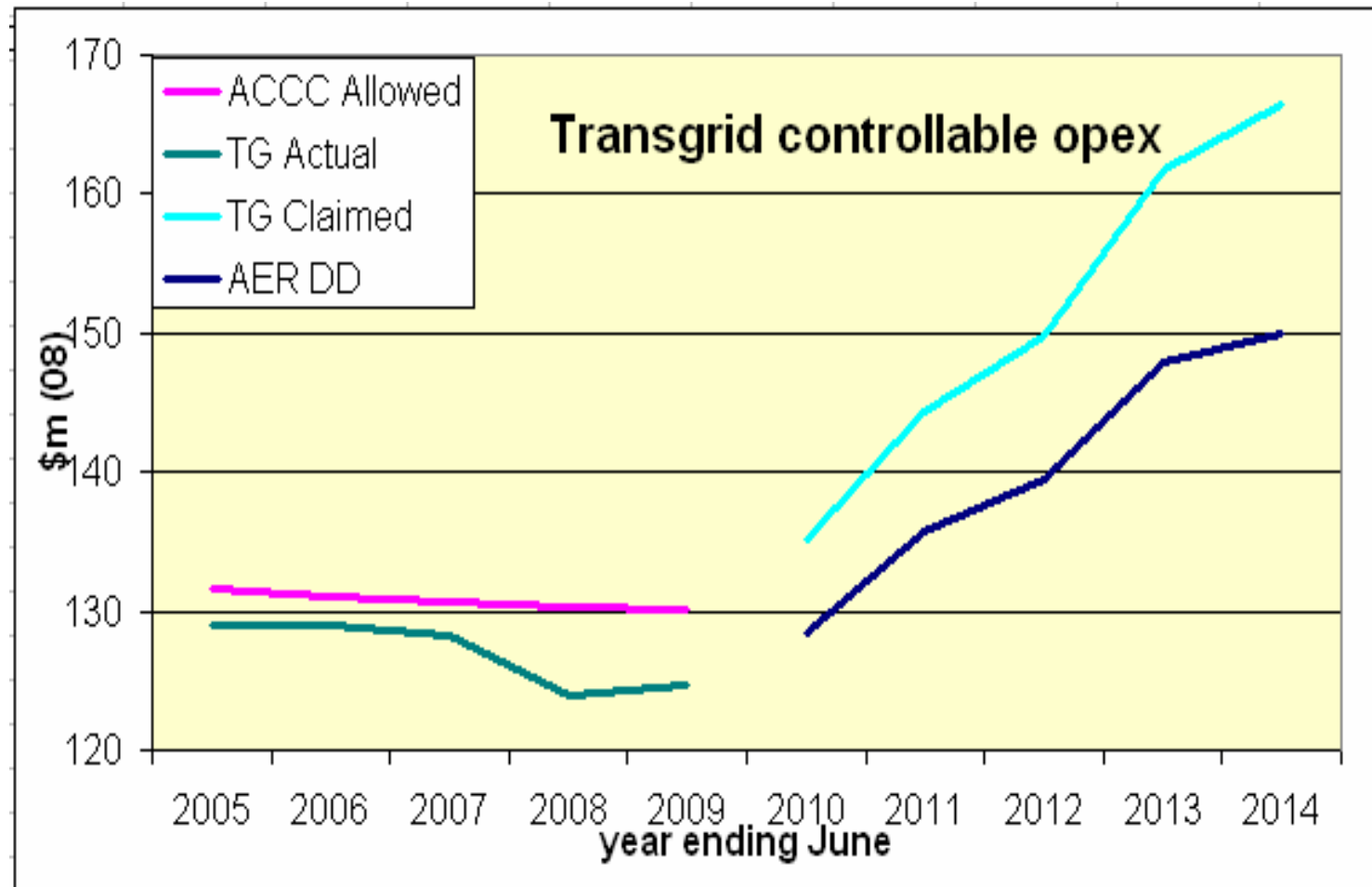


- AER relates opex to asset value by AER. Why?
- Installing new replacement assets (even if larger than previous) increases the RAB significantly but not opex and therefore puts a major query against the "asset growth ratio" approach used
- Opex increases for increased lengths of power lines, added substations and new trains at substations, along with marginal increases for increased aged assets
- An increase in RAB is not a justification for more opex, yet the AER discussion seems to see this as a legitimate reason along with aged assets – yet is the average age after all the capex, greater than the benchmark year?
- When opex savings from replacement capex is compared the simple pay back is measured in 100s of years
- Where then is the incentive to minimise opex?

# Combined Opex

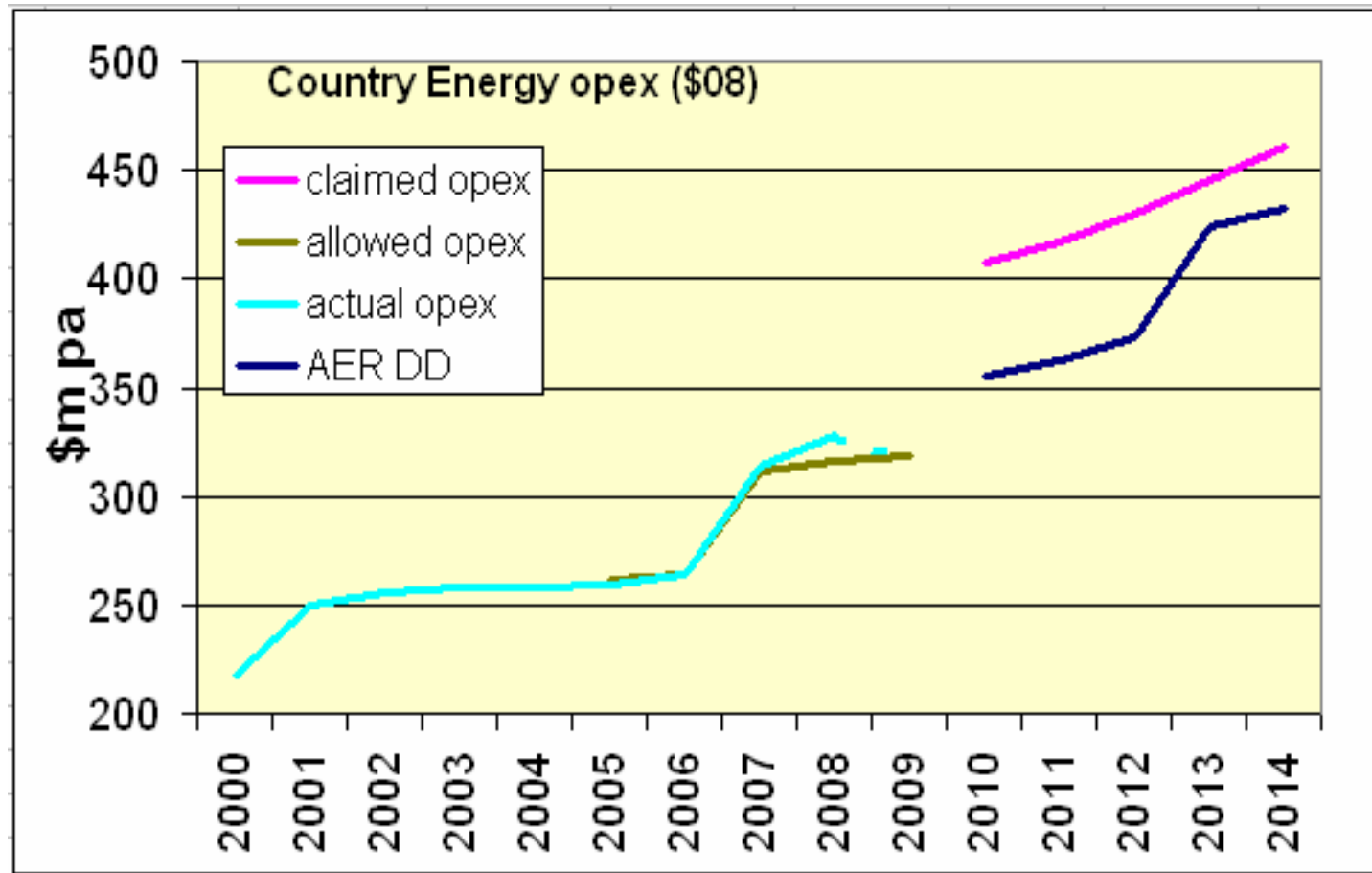


# TransGrid Opex

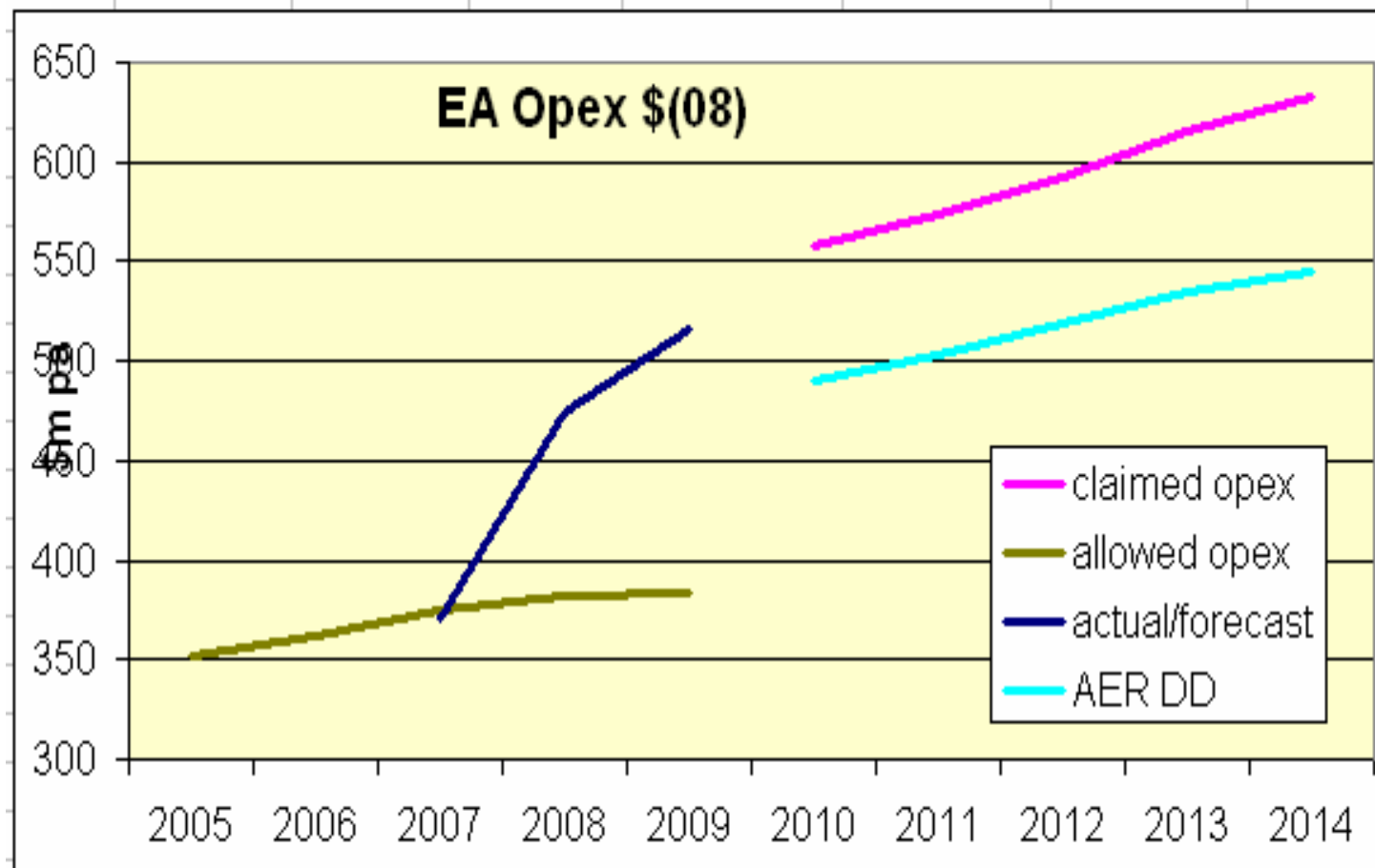




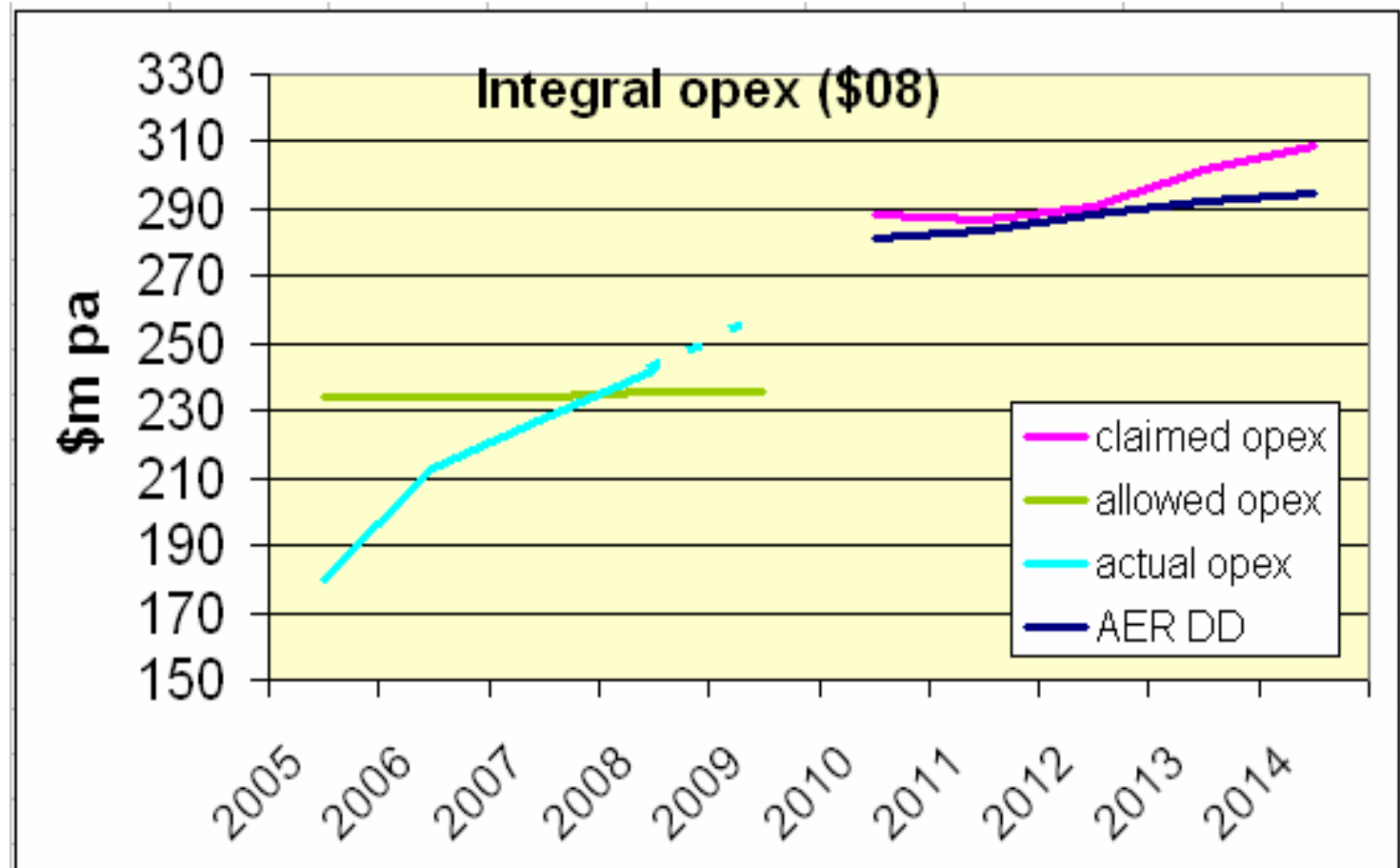
# CE Opex



# EA Opex



# IE Opex

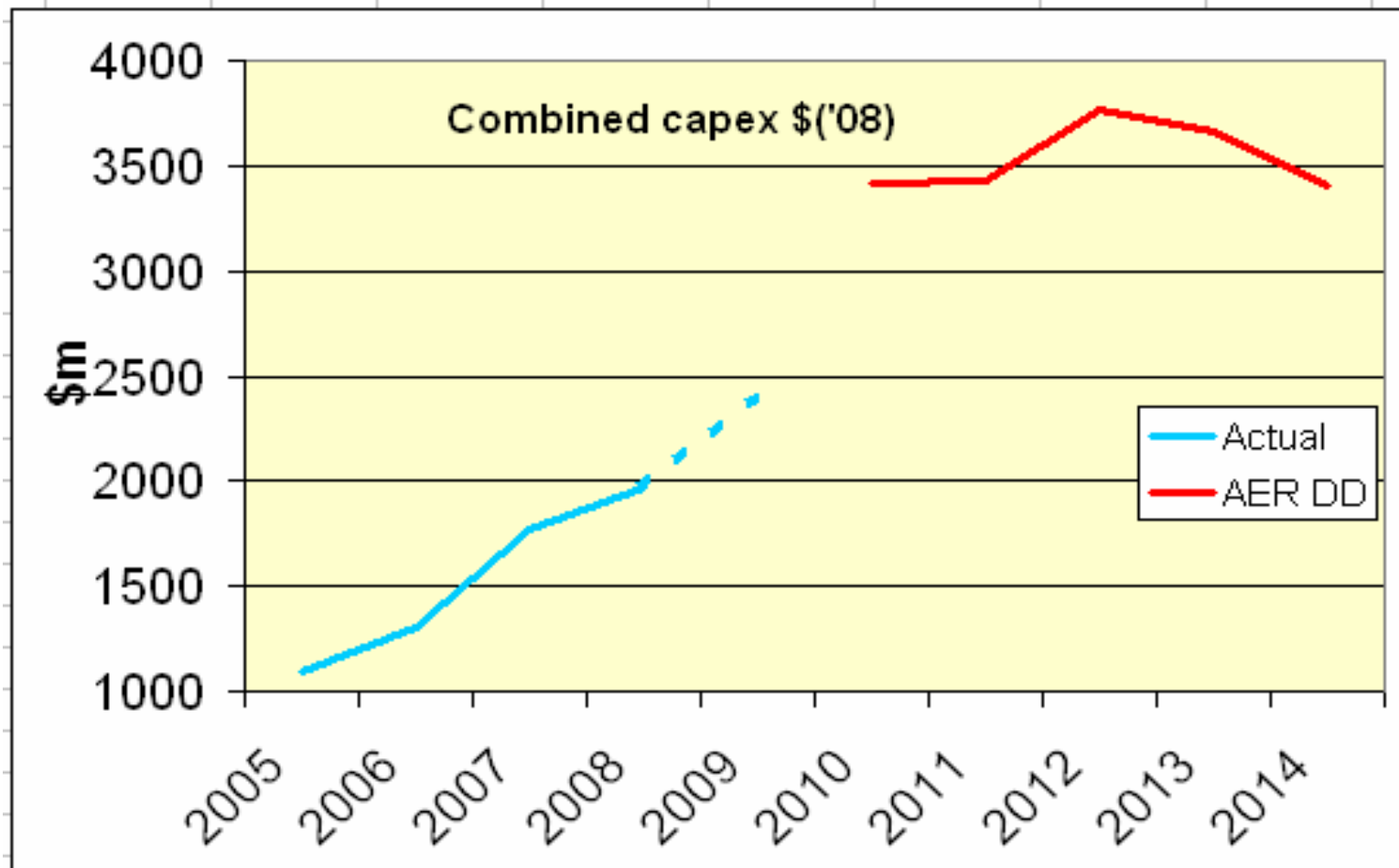


# Capex

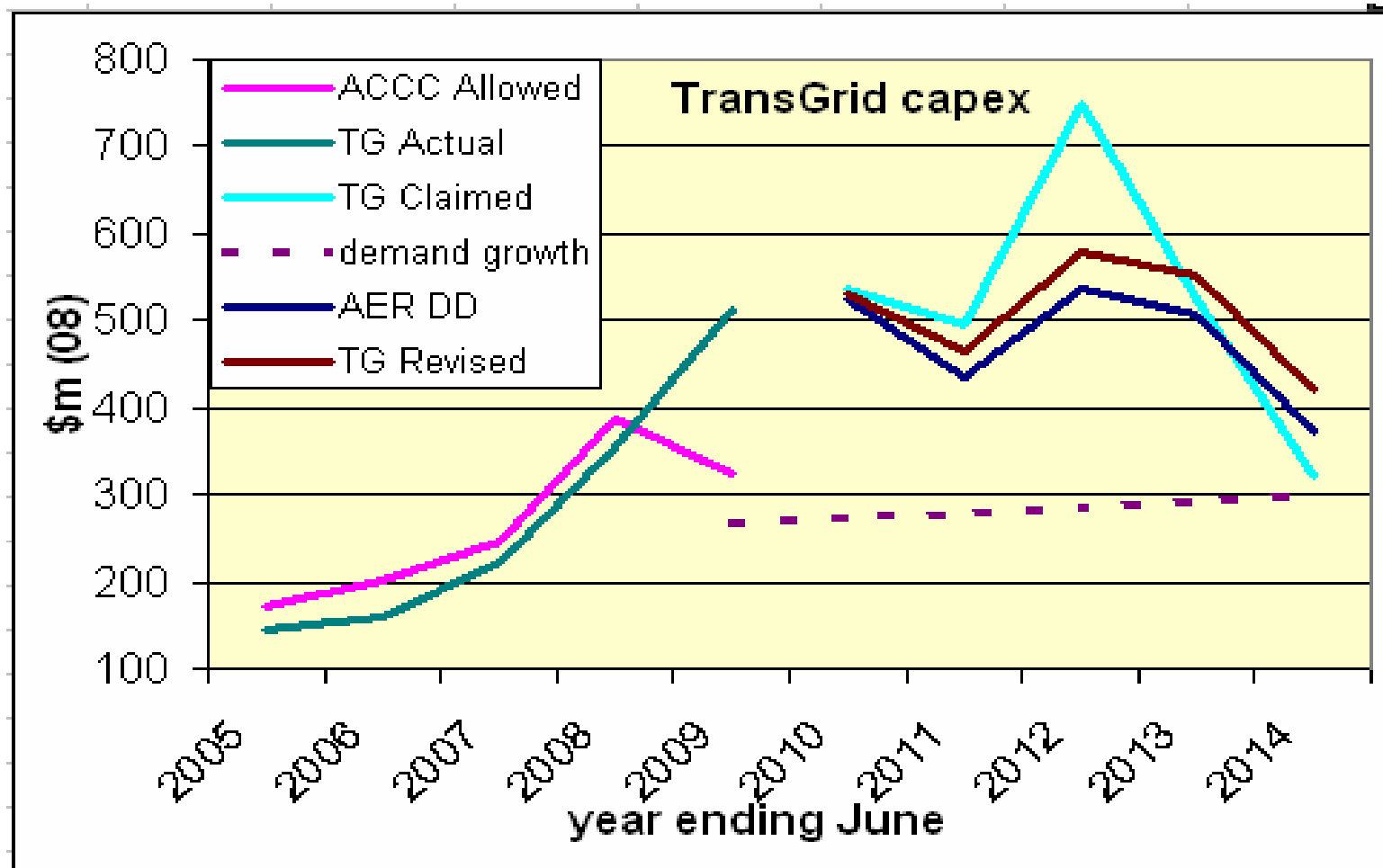


- Growth and the need for replacement capex are listed as the drivers for capex
- Replacement capex is a small % of total capex, yet all draw attention to a problem with aged assets
- In the 2004 review the forecast growth in demand was greater than for this review, yet augmentation capex is many times that allowed by the ACCC/IPART
- Replacement capex should reduce opex and the payback for this capex is measured in 100s of years yet ~4 years is the usual upper level
- AER identified that DB capex equity share exceeds retained earnings, yet the depreciation account is not included?

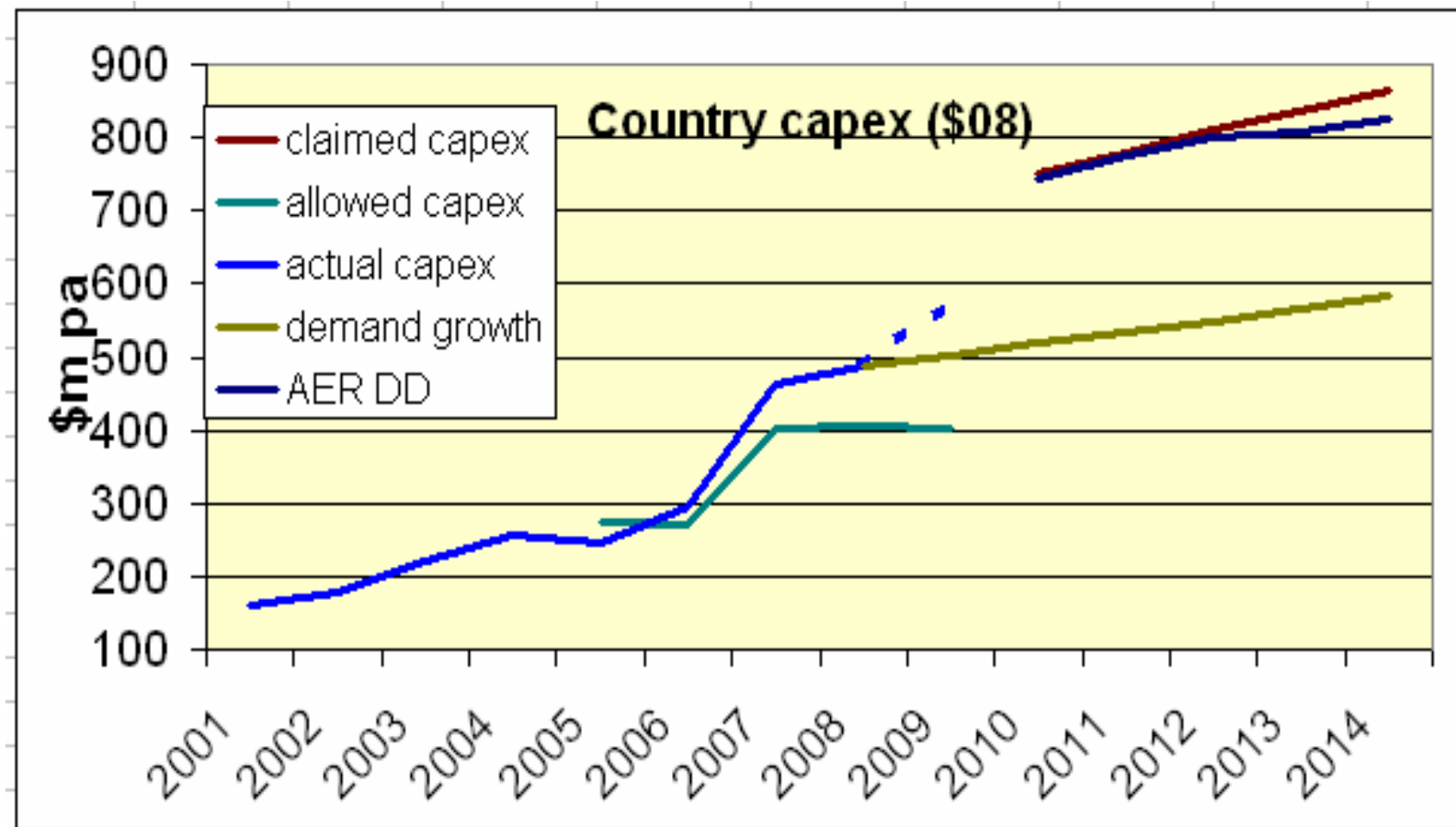
# Combined Capex



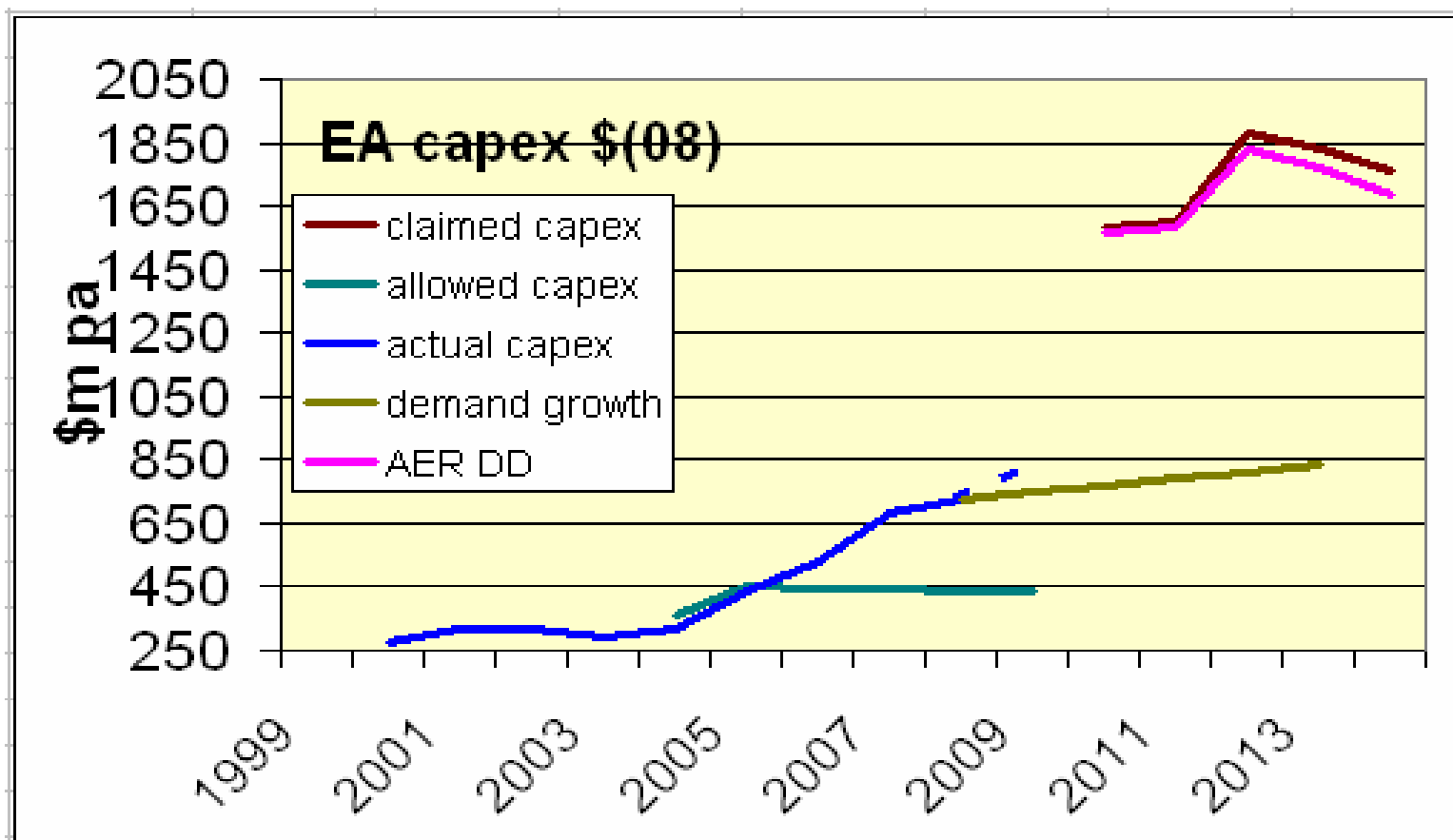
# TransGrid Capex



# CE Capex

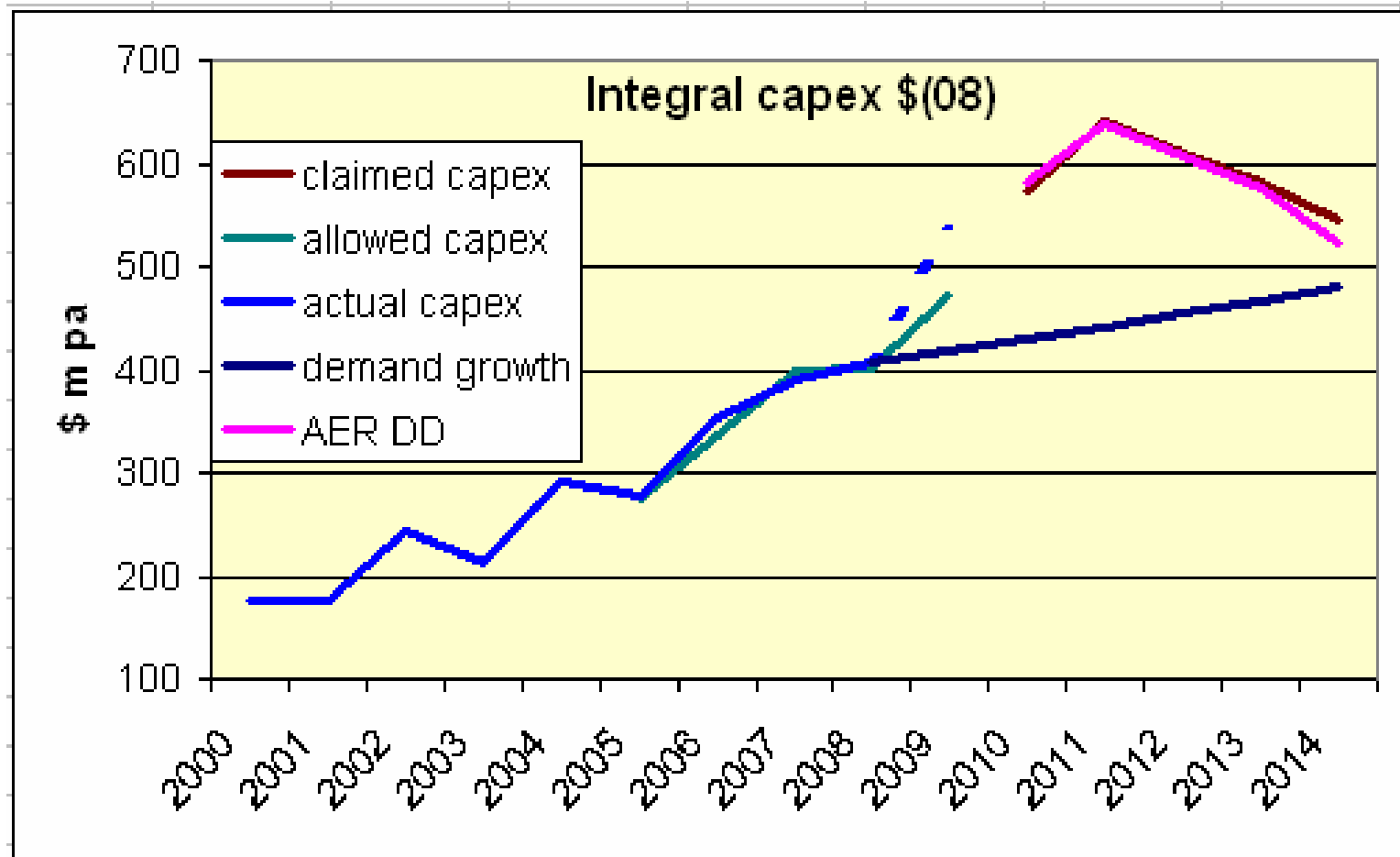


# EA Capex

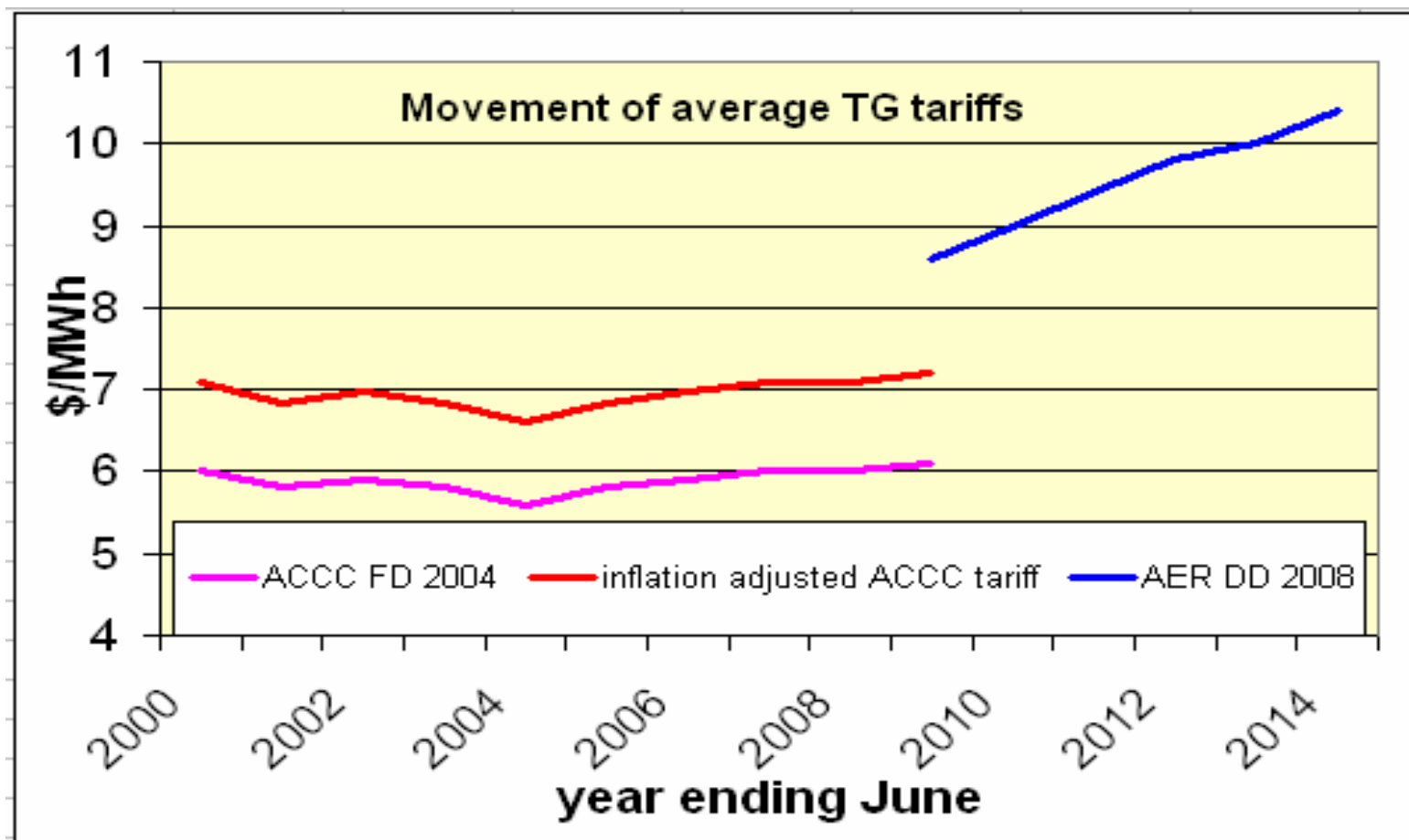




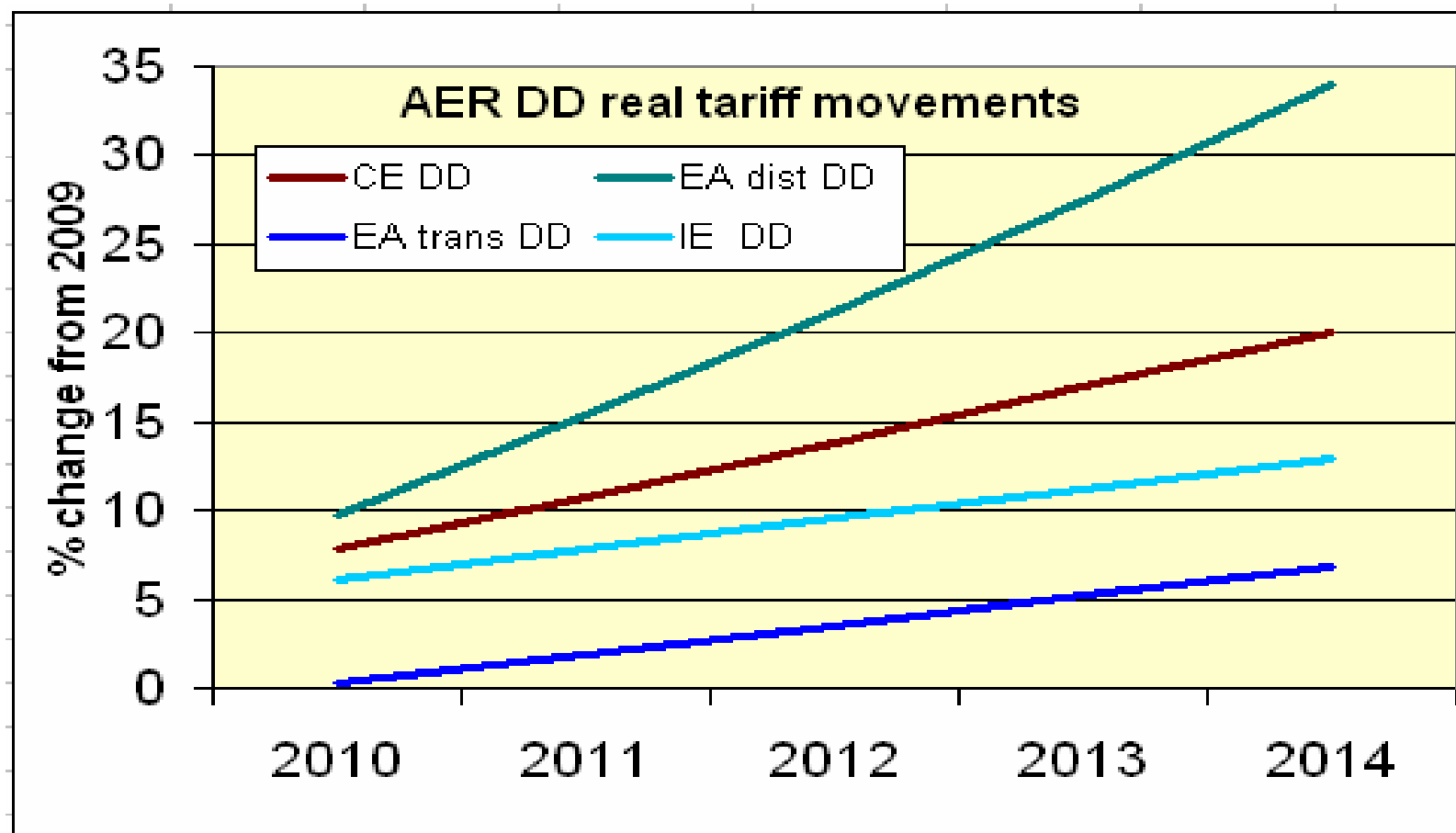
# IE Capex



# The impact of the TG draft decision



# The impact of the DB decisions



# SUMMARY COMMENTS (1)

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- Tariff increases (especially EA) are excessive
- Examination of the opex and capex claims and the DD allowances seems to indicate that the DD is about a NSP led economic led recovery for NSW
- Not only are the NSP claims ambit and ambitious but the AER supports that these are essentially reasonable
- The economic and business environment is totally changed from that when the applications and the DD were made.
- The forecasts by the NSPs and AER are out-of-date and therefore the projections must be severely compromised

# SUMMARY COMMENTS (2)



- The DD is clearly now out-of-date and is simply wrong for the current economic conditions.
- It lacks credibility and is based on an unrealistic and now totally changed economic and business environment, and outlook
- In fairness to all, the AER must
  - Re-address its assumptions, and if needed, extend the review period
  - Seek fresh, updated and realistic projections for labour and materials costs
  - Review the forecasts for demand and energy consumption
  - Assess the need for the projects identified, and interrogate if there are alternatives
  - Identify if there is the funding available for the capex programs proposed
  - Either reduce the capex allowance or build in a “claw back” arrangement
  - Review and re-assess the opex allowances in light of realistic projections and benchmarks
  - Assess the ability to pay for the programs allowed in the decision