



Powerlink's Revenue Proposal

AER Public Forum
EUAA Presentation

Brisbane, 20 April 2006

Role of Transmission

- ❑ Transmission critical to NEM
 - Stimulating competition, trade, liquidity, reliability
- ❑ Importance goes beyond direct costs
- ❑ Might even be prepared to accept some degree of “over investment” if there are offsetting benefits to customers
- ❑ But allowing for this, TNSP costs still need to be “efficient” and subject to close regulatory scrutiny
- ❑ A critical role for this review is to balance these factors

EUAA Perceptions of Powerlink

- ❑ A well run and generally efficient TNSP
- ❑ High calibre management & people
 - Very well lead
- ❑ In many ways has done a ‘good job’ for Qld
 - With some significant challenges
 - Shown leadership in NEM transmission issues
- ❑ Serious engagement with end users
 - Including this reset

Now for the Application ...

Challenge for the AER

Powerlink has submitted a lengthy application which has clearly benefited from a lot of effort ... but it has some gaps and raises some important questions

AER should accept the positive aspects of Powerlink ... but don't accept the Application without putting it to the test

First 'test' of the AER

How Unique?

- ❑ Geography/decentralisation
- ❑ High demand growth
- ❑ Reliability of supply obligations
- ❑ Generation development
- ❑ Regulatory obligations: vegetation/environmental/safety/planning
- ❑ Reliance on trade exposed, energy intensive industries (little mention)

... **Observation**: According to the Application “uniqueness” has a symmetrical impact ⇒ costs **ALL** go up?

But how unique is Powerlink? No doubt all above have an impact

- ❑ Other NSPs have other “unique” issues and raise them with the regulator (seen this in every review – NSW, Vic, Qld, SA, Tas)
- ❑ AER needs to test these claims and their cost impacts & make sure they are well founded

Powerlink does not appear to have justified ALL steep increases in cost

- ❑ Its claims are not always fully transparent
- ❑ How have listed regulatory obligations impacted costs?

Cost Pressures

- Powerlink argues that they are subject to escalating input costs and this justifies expenditure increases
 - Why should high labour and material costs affect Powerlink more than other companies?
- A relevant question for AER to ask: How do companies in a competitive industry behave in response to such cost pressures?
 - Can they simply raise prices?
 - Or will they seek to
 - Increase productivity/efficiency
 - Seek innovative ways to manage the increases
 - Absorb some cost pressures
 - Go to the regulator to seek pass through?

Regulatory Asset Base

AER should be aware that customer groups have always held the view that the ODRC method overstates the value of assets

Agree that constant revaluations create uncertainty and adversely impact on the cost of equity

But AER still needs to check that roll forward is robust and justified

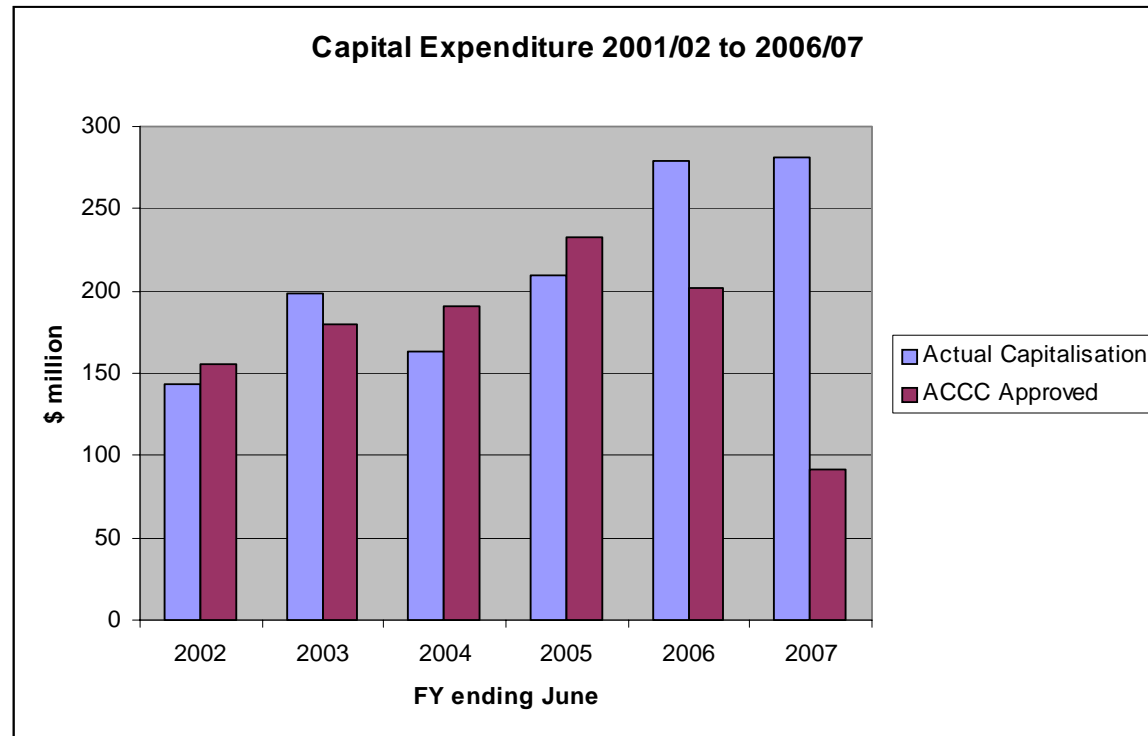
Regulatory Asset Base

- ❑ ACCC's Nov 2001 decision provided an inflation adjusted expenditure of \$1.055 billion for Powerlink's capital program for 2001/02 to 2006/07.
- ❑ Powerlink claims actual and forecast expenditure of \$1.274 billion, or 21% higher than provided by the ACCC approved.
- ❑ Most of this additional expenditure occurs (or is expected to occur) in the latter half of the regulatory period.
- ❑ In the first 3 years, average capex was \$168m per year; in second 3 years, this increased to \$257 per year, a 53% increase over the previous 3 years.

Regulatory Asset Base

- ❑ Has Powerlink responded to increased demand and cost pressures not foreseen; or has it significantly ramped up capex in the second period to increase its RAB? AER needs to get to the bottom of this question.
- ❑ Impact of once off \$530m of assets under construction – over 16% of RAB
- ❑ Assets under construction are depreciated even before they are completed?
 - AER needs to review this capitalisation policy, especially since it does not comply with any accounting standards.

Regulatory Asset Base



Capex Efficiency Savings

- ❑ Powerlink claims to have identified several instances of management induced efficiencies
 - Especially the reinforcement of supply to the Gold Coast through the early acquisition of easements.
- ❑ Reasons supplied, however, indicate that the savings may have been more fortuitous than any efficiency?
- ❑ Good management demands planning ahead
- ❑ Customers also carry the cost of the acquisition of the easement

CAPEX

Powerlink's forecast Capex/RAB ratio has significantly increased from the current regulatory period and is also significantly higher than comparable TNSPs.

	Actual *			Powerlink forecast				
	2003	2004	2005	2008	2009	2010	2011	2012
ElectraNet	4.2%	4%	6.1%					
EnergyAustralia			6%					
Powerlink	8.1%	6.2%	7.7%	14.4%	14.3%	12.0%	12.3%	12.5%
Transend		9.5%	8.3%					
TransGrid	9.3%	8.3%	3.8%					

* Source: AER, Transmission Network Service Providers - Electricity Regulatory Report for 2004/05 , April 2006

Weighted Average Cost of Capital

Market Risk Premium – Why a ‘high’ 6%

- ❑ UK regulators have all adopted (around) 3.5% based on forward-looking market views (and judgments)
- ❑ Regulators have not provided any evidence that the Australian financial market is less efficient than the UK and US markets
- ❑ Recent surveys have indicated that Australia MRP is no higher than 4%-5%
- ❑ Logical inconsistency of looking forward for all other values used for CAPM except MRP
- ❑ AER needs to review MRP value from that stated in SRP.

Weighted Average Cost of Capital

- ❑ Equity Beta
- ❑ ACCC acknowledged that setting equity beta at 1.0 was
 - generous
 - biased towards service provider
 - inconsistent with the market risk profile
- ❑ Sample market equity beta estimates of 0.16 in September 2003 and 0.18 in December 2003
- ❑ Previously indicated that more reliance will be placed on market data, in determining an estimate of equity beta
- ❑ Yet SRP persists (illogically) in setting equity beta at 1.0

Weighted Average Cost of Capital

Debt Margin

- ❑ Powerlink is seeking a debt margin of 1.1%.
- ❑ Powerlink's credit rating of AA to A suggests that a debt margin of under 1% is more appropriate.
- ❑ Recent ACCC decisions suggest debt margin of 0.9%.

ACCC's Decision	Credit Rating	Debt Margin	Date
ElectraNet	BBB+	1.22%	Dec-02
PowerNet	A+	1.20%	Dec-02
Powerlink	A-AA	1.20%	Dec-02
Murraylink	A	0.86%	Oct-03
Transend	A	0.91%	Dec-03
EnergyAustralia	AA	0.87%	Nov-05
TransGrid	A	0.90%	Nov-05
Directlink	A	1%	Mar-06

CAPEX

- ❑ Unclear which load forecast has been used in the calculation of CAPEX?
- ❑ Apparent discrepancies between supporting info and submission

(\$m 06/07)			Submission	Derived from Att 1 info template xls	Discrepancy
Network	Load driven	Augmentations	1,222.71	1,258.6	-2.8%
		Connection	69.03	67.9	1.7%
		Easements	104.07	103.7	0.4%
	Non-load driven	Replacements	812.80	812.80	0%
		Security	115.85	119.2	0.2%
		Other	21.06	21.06	0%
	Totals Network		2,345.52	2,383.2	-1.6%

- ❑ Augmentations seems high compared to connections. Where will increased load come from if not generator/customer connections?
- ❑ How are capital contributions from generators, etc included?
- ❑ Augmentations are subject to Regulatory Test, but have not indicated whether these projects are likely to pass Regulatory Test. Supporting spreadsheet shows Reg Test carried out on only ~\$300M of projects (13%)

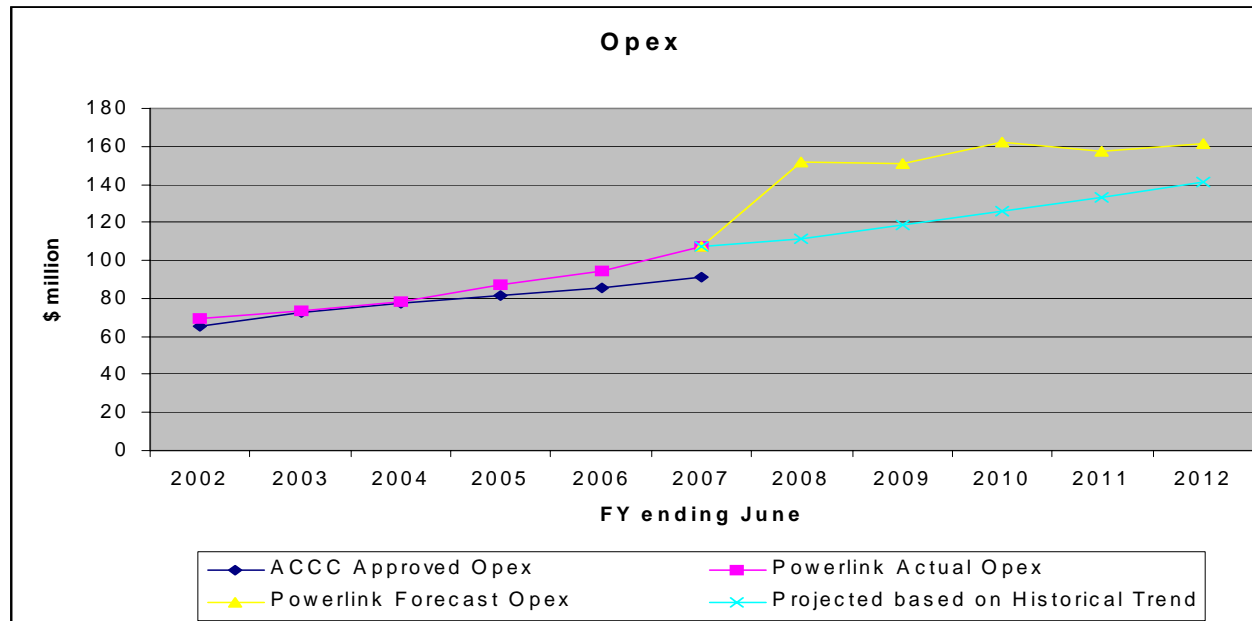
CAPEX

- ❑ To determine that Powerlink have estimated the efficient level of project expenditure, more detailed cost breakdown should be supplied for projects, including information on meeting the regulatory test
- ❑ Are unit costs in line with industry practice? Do Powerlink's specification & construction standards compare to good industry practice?
- ❑ Replacement capex of ~\$800M on RAB of \$3,266M equates to ~25% of value of network to be replaced. Age profile shown on p 69 does not appear to show this proportion of assets constructed prior to 1960/70 (50 and 40yr lives).
 - An asset management strategy has been supplied with the submission, but limited replacement costs and details of the replacements project have been supplied
 - More details required and put to scrutiny by AER

Opex

Forecast opex

- ❑ Exceeds trend projection by an average of over \$30m (~30%) pa.
- ❑ 40% above average opex approved by ACCC in 2001.
- ❑ 38% above average actual opex incurred between 2001/02 and 2005/06.



Opex

Is there evidence of double dipping?

In addition to its overall opex which includes finance costs (as part of its corporate costs, p 91 & 106), Powerlink has added

- \$3.3 million pa of debt-raising cost
- \$1.5 million pa of equity-raising cost
- Average of \$0.5 million pa of hedging cost

Opex

Regulatory gaming opportunity for ALL NSPs

- ❑ AER should examine the pattern of opex over the five year regulatory period
- ❑ Common pattern
 - Immediately after a regulatory reset, opex or opex growth is lower than that applied for and even approved by the regulators.
 - In the last two years, the opex spend seems to invariably increase to justify the higher expected expenditure in the next regulatory period.
- ❑ AER should be aware of this type of regulatory gaming and be taking steps to prevent it.

Opex/RAB

- ❑ Powerlink claims its opex/RAB ratio for 2004/05 is 2.46% - impressive
- ❑ Over the forecast period, this ratio is expected to fall to 2.13% - even more impressive
- ❑ Based on numbers in Powerlink's revenue proposal, historical opex/RAB was 3.1% between 2001/02 to 2003/04, 3.3% in the following two years and 3.6% in the final year of the current regulatory period.
- ❑ Based on its forecast opex and RAB, in 2007/08, opex/RAB will be 4%?

Opex/RAB

	2002	2003	2004	2005	2006	2007	2008
Opening RAB (\$m)	2,276.9	2,394.4	2,553.7	2,682.8	2,856.8	3,011.4	3,796.5
Powerlink Opex (\$m)	69.7	73.2	78.3	87.5	94.8	107.0	151.7
Opex/RAB (%)	3.1%	3.1%	3.1%	3.3%	3.3%	3.6%	4.0%

AER reports that in 2004/05, other TNSPs' opex/RAB ratio range from 3% to 3.7%, except for Transend (4.6%).

Powerlink is thus moving into the high range in comparison with its peers and **will not** "remain the most cost-effective transmission entity in the NEM" (p 85).

Opex

Productivity/Efficiency gains

- ❑ Powerlink have not specified any productivity/efficiency gains/targets for its operations.
- ❑ Claimed opex efficiency initiatives have not been specified or quantified.
- ❑ Precise impact of & justification for claimed pass through high wage & materials cost are not quantified
- ❑ ⇨ cost plus approach to pricing?
- ❑ How do industries in competitive sectors of the economy manage these cost increases? Do they simply increase prices or do they seek to increase productivity, manage cost pressures and absorb some cost increases?

Performance Standards

- ❑ Need for regulated transmission entities to be provided with appropriate incentives.
- ❑ However, 1% revenue at risk simply too small an incentive to do much.
- ❑ Large impact (relative to direct costs) transmission performance can have on energy prices and their risk premiums

Revenue adjustments ... Pass Through

Terrorist Events & Increased Security Measures

- How is such an event defined?
- Cost for self insurance are included in opex (p. 107)
- Costs of increased security measures should payable by Governments seeking them

Asymmetry of Information and Process

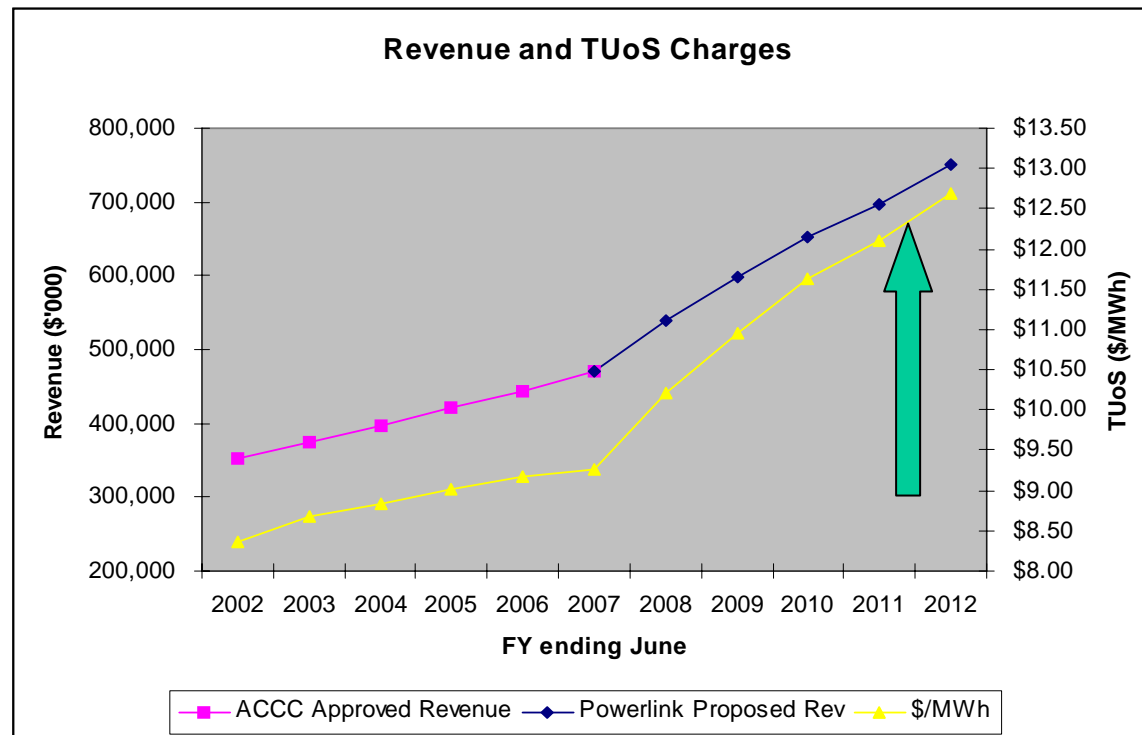
- How would customers know if an event has occurred that would allow a pass through of reduced costs?
- Are customers allowed to apply when there are lower costs?
- TNSPs are unlikely to make such an application.

Demand Management

- ❑ Little evidence in application to address any of the demand management and embedded generation opportunities.
- ❑ Opportunity to defer future capex with demand management/embedded generation
- ❑ Opportunity to better manage some of the cost pressures & avoid pass through to ALL Qld users
- ❑ Powerlink has undertaken some such measures in the past (to its credit) and been relatively transparent about it
 - Disappointing that there is little evidence of this in the Application
 - AER should ask Powerlink to respond

Customer Impact

- AER needs to take into consideration impact of any TUoS increases on customers
 - Important in context of Qld economy



Customer Impact

Proposed revenue will result in average TUoS increase of over 10% in 2007/08 based on the Queensland demand forecast published in NEMMCO's 2005 Statement of Opportunities.

FY end June	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
MWh	43,120	45,035	46,172	48,487	50,715	52,866	54,588	56,130	57,529	59,176
\$/MWh	\$8.68	\$8.81	\$9.11	\$9.17	\$9.26	\$10.22	\$10.95	\$11.64	\$12.10	\$12.70
% increase in TUoS	3.8%	1.6%	3.4%	0.6%	1.0%	10.4%	7.2%	6.3%	4.0%	4.9%

Price increase 'rationalised' as only \$3 per household customer ... less than a ...



But it's far more than that to Qld industry, investment and jobs ... AER needs to make sure its justified and worth it.

POWERLINK QUEENSLAND



QUEENSLAND TRANSMISSION NETWORK
REVENUE PROPOSAL

for the period 1 July 2007 to 30 June 2012