Powerlink Revenue Proposal – preliminary views

AER Public Forum
Brisbane, Tuesday 24th July 2011

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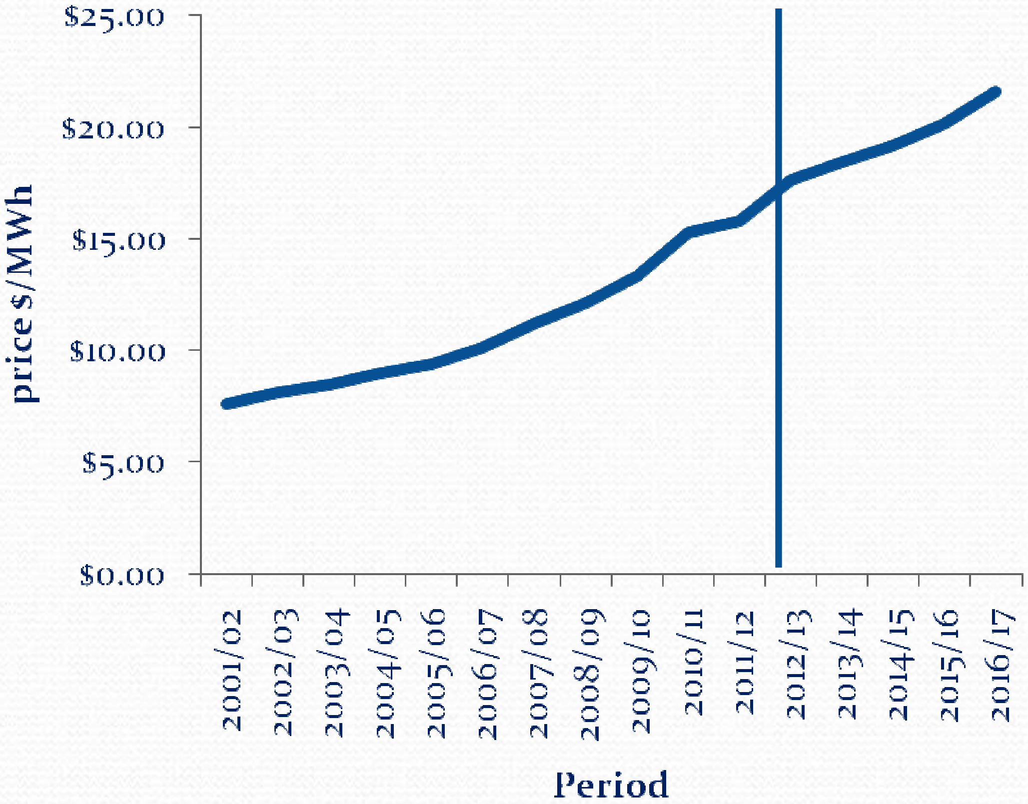
Powerlink's Proposal & Transmission Prices

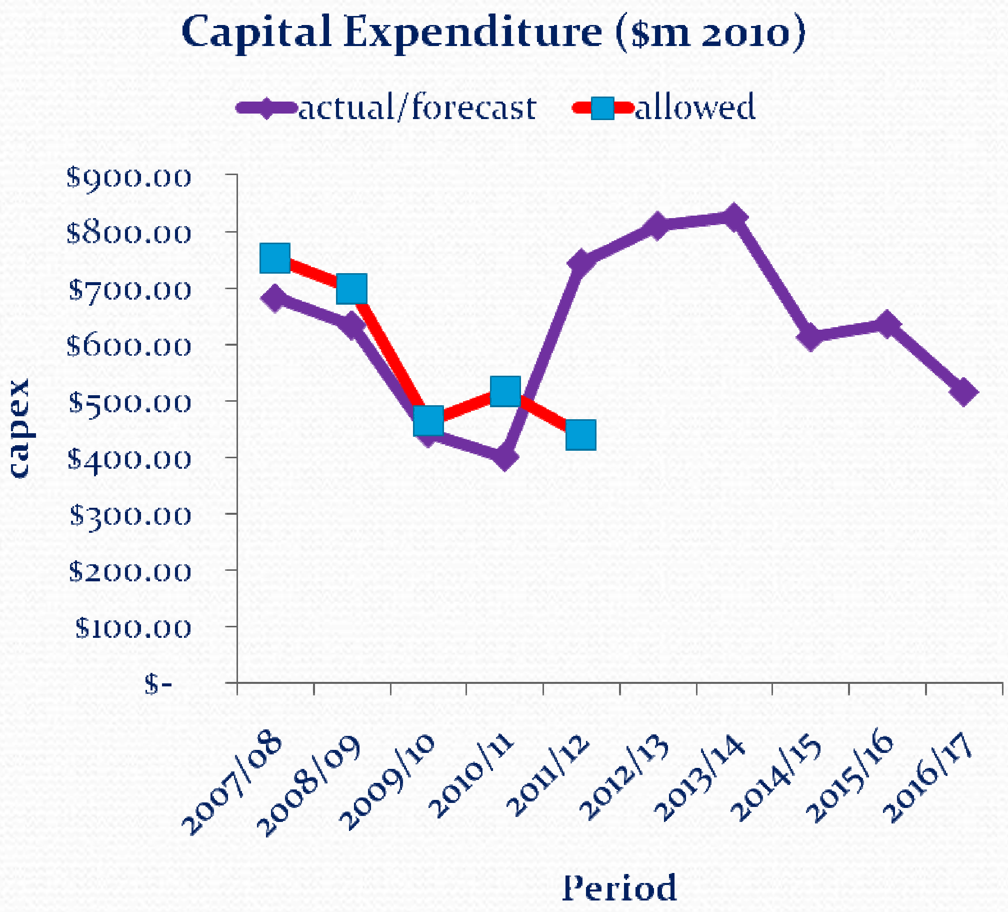
($real 2010)

- ❑ Transmission prices to increase by approximately 11% in real terms in 2012/13.
- ❑ Transmission prices to increase by 24% in real terms by 2016/17 from the end of the current regulatory period. Following a 41% increase last period.
- ❑Transmission is around 10% of the bill for most consumers (not insignificant)
  - ❑For larger users it is a significant cost
  - ❑For those directly connected to the Powerlink network it is even more important (these are usually export competing firms)
- ❑Electricity prices in Qld already escalating rapidly due to distribution prices, RET/solar subsidies & (soon) carbon. This proposal will add to that.



Capital Expenditure (Capex)

- ❑ Total forecast capex of $3.4bn over the next regulatory period; an increase of 17% over the current period ($2010).
- ❑ Powerlink forecast to overspend their capex allowance in 2011/12 by 69% in real terms ($2010). Concerned about this.
- ❑Capex overspend in the final year of previous period was 25%.
- ❑ The overspend will be rolled into the asset base for the first year of the 2013-2017 regulatory period. Concerned about roll-forward provisions.



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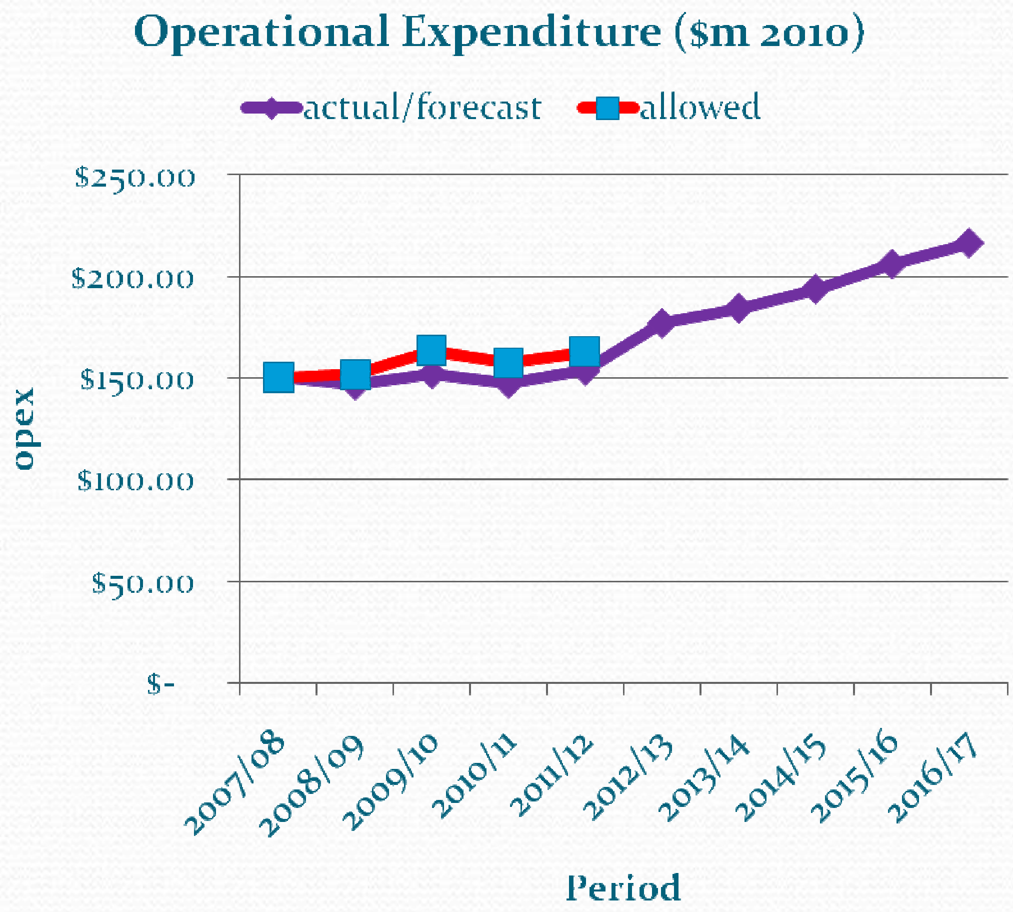
Operational Expenditure (opex)

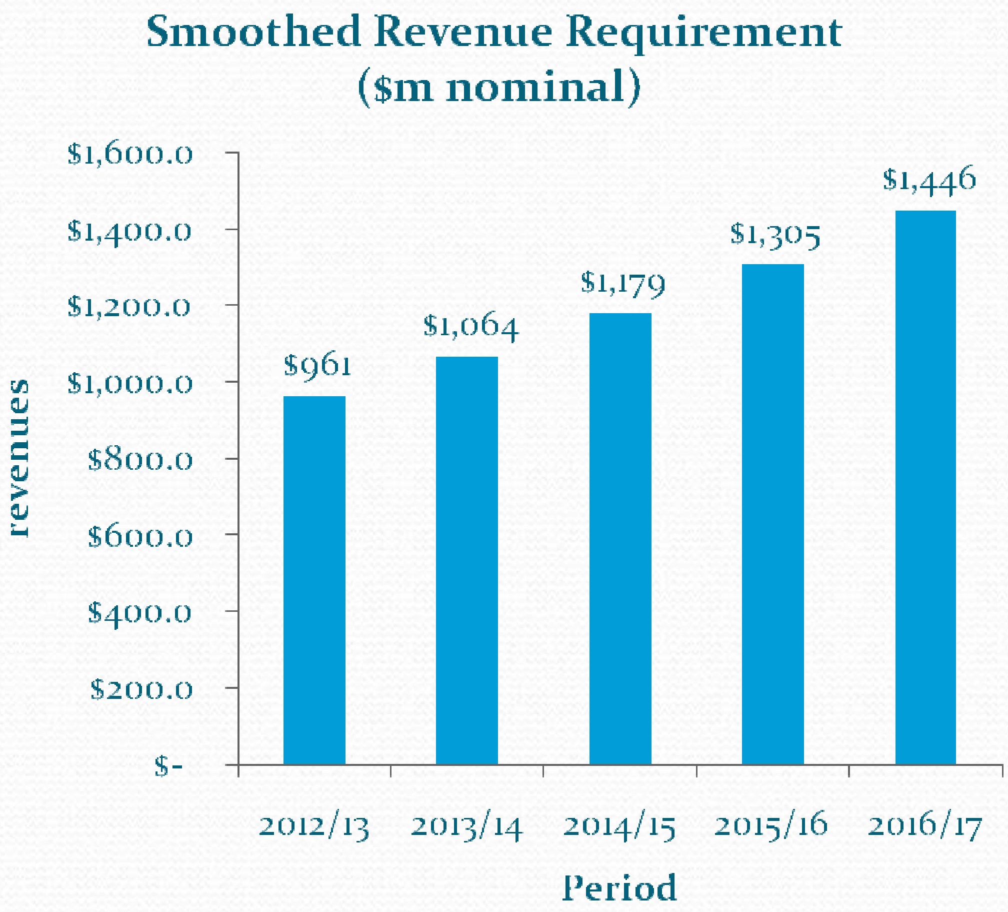
- Total of opex of $977m ($2010) over the next regulatory period.
- 30% increase over their actual opex over the current period ($2010).
- Concerned about large increase in opex. Is this efficient? What productivity gains?



Revenue Requirement

- ❑ Smoothed revenue requirement of $5.9bn ($nom) over the next regulatory period.

- ❑ An increase of 78% (nominal) from the allowed revenues for the current regulatory period.



Application of Capex/Opex Benchmarking by the AER

- EUAA considers benchmarking of opex and capex essential and notes the requirement to benchmark under the Rules & use of benchmarking by Powerlink to support its case.

- EUAA strongly believes that a robust benchmarking of expenditure is critical but best done by an independent entity such as the AER.
  - This is needed for transparency and credibility.
  - It is even more critical given the shortcomings in the Rules acknowledged by the AER as leading to 'high end' capex and opex.
  - Hence, EUAA strongly urges AER to implement its own benchmarking of Powerlink's expenditures as mandated by the Rules.

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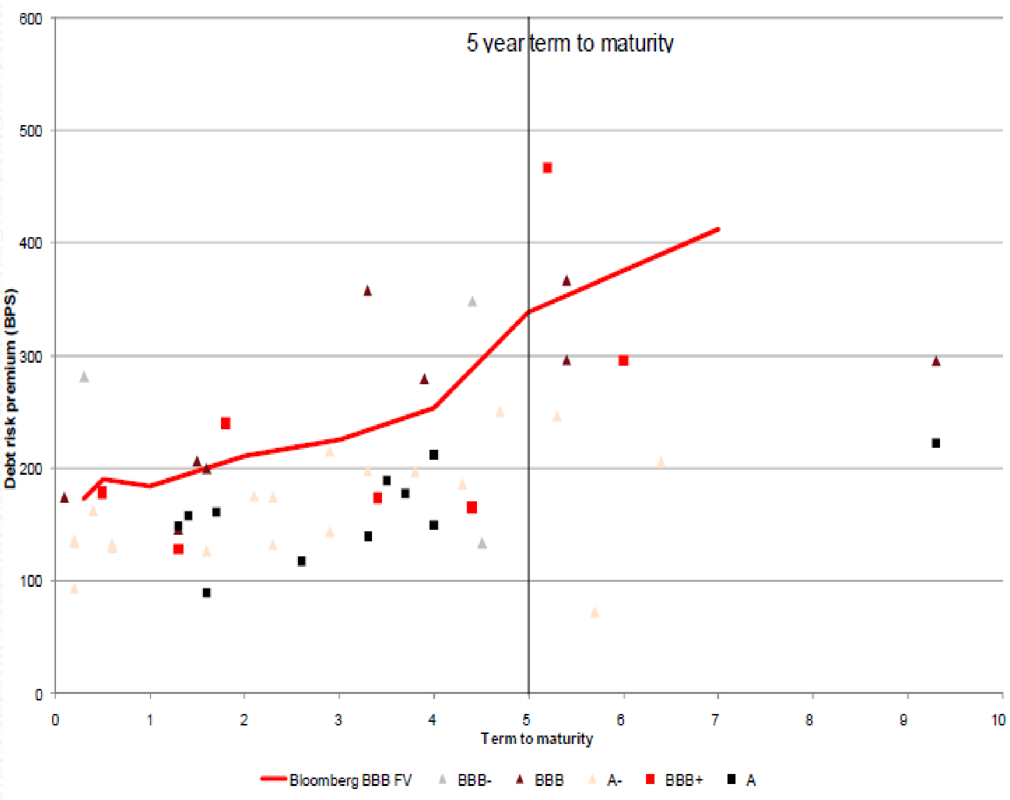
Cost of Capital

- ❑ WACC of 10.3%
- ❑ Consisting of
  - ❖ risk free rate of 5.62%.
  - ❖ Debt risk premium 4.34%.
- ❑ The EUAA considers the DRP of 4.34% to be excessive.
- ❑ The inclusion of year 5 in the fair value calculation distorts the DRP. The inclusion of the 5th year increases the basis points (bp) from 250 to 340bp.
- ❑ The exclusion of the 5th year would give a DRP of approx. 3%.
- ❑ Using the averaging period of 4 years terms to maturity, implies an increase of 18pb per annum.
- ❑ The inclusion of the 5th year means the annual increase is 32pb per annum.

Figure 3.1 Bloomberg BBB fair value debt risk premium and Bloomberg A to BBB- rated fixed coupon bonds



The Current Rules & Powerlink's Proposal

- After reviews of transmission and distribution networks the AER Chair has acknowledged that there are a number of "shortcomings" in the regulatory framework.
    I. The regime incentivises the businesses to submit revenue proposals that are at the top or over what can be considered a reasonable reflection of required expenditure.
    II. The rules require all actual capex to be rolled into the asset base at the start of the next regulatory period without review of its efficiency even when the business has overspent its allowed expenditures. This results in step-changes in prices at the start of the next regulatory period.
    III. The AER is restricted in the application of the cost of capital due to the rules which require the AER to assess the cost of debt against corporate bonds issued in Australia which not reflective of the actual debt raising activities of the NSPs. [EUAA view is that they also force the AER to rely on proxy's that are not fit–for-purpose.]
    IV. There have been further increases in revenues granted to the networks from appeals to the Australian Competition Tribunal (ACT). The cost of appeal is weighed against the results from a successful outcome incentivises appealing an AER determination. The cost of an appeal can be recovered from the NSP's customers. Powerlink will have the same strong incentive to 'cherry pick' the AER's Final Determination & appeal

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- The chair of the AER, Mr Andrew Reeves, argued at the EUAA's annual seminar, the need for wide ranging reform of network regulation to deal with the widespread and large electricity price increases being felt by electricity users in the National Electricity Market (NEM).

- He has also acknowledged that the framework under which the regulator must operate is a factor in the network price increases.

  "The AER considers that changes to these rules are necessary for regulatory outcomes to better meet the objective of the law [the long terms interests of consumers of electricity].

- Two specific issues pointed out by Mr Reeves are of particular relevance here:

  I. Distorted incentives to overspend under the current rules

  II. The method of estimating the cost of debt does not reflect the true cost of funds.

  Both these distort AER determinations towards higher network prices. How does the AER intend to overcome this in the Powerlink review? Or how will it inform consumers about the extent of this bias especially given the heightened concerns about electricity price increases?

- Consumers consider that it is unreasonable for them to have to wait until at least 2014 (or in Powerlink's case 2018) to be relieved of these impacts on their network prices

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