Response to APTPPL Revised Proposal Submission

ADDENDUM PREPARED BY FRONTIER ECONOMICS FOR THE AER

Introduction

This note responds to elements of the revised access arrangement proposal submission by APTPPL (revised proposal) and forms an addendum to Frontier's original report to the AER of April 2012.

In particular, this note responds to two issues from the revised proposal:

- Inclusion of a terminal value in the stylised description of the benefits that are likely to accrue to users due to the PMA buyout and
- Figure 4.1, which misrepresents the benefits and costs likely to accrue to users due to the PMA buyout

Terminal value

The table on page 29 of APTPPL's revised proposal purports to describe the economic value flowing to users from the PMA buyout. Item 5 in the table is "the cost saving delivered to users as a result of the PMA buyout *following the period of the PMA buyout amortisation*" (emphasis in original). The economic value to users of this benefit is noted as being positive but not valued. On page 30 of the revised proposal, this benefit is described in the following terms:

> Once the amortisation of the PMA contract is complete, all operating cost savings accrue directly to users. This is represented in the diagram below by the green-striped rectangle. While not necessary to clear the Rule 79(2)(a) hurdle, this represents an additional benefit to users.

In our view, there is no justifiable reason for attributing value to the termination of the PMA from the period after 2020. In its report for APTPPL, KPMG noted that (in the absence of earlier termination), the PMA would have expired in 2020 subject to any mutually agreed extension. Therefore:

> At 2020, APTPPL would have had the opportunity to terminate the PMA if it so wished.[1]

This means that any capex and opex savings flowing from the PMA buyout can only relate to the period 2007 to 2020. If cost savings were available at the expiry

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1 KPMG report, p.30.

of the PMA in 2020, it can and should be inferred that a rational profit-maximising entity in the position of APTPPL would allow the PMA to expire at that time. Therefore, cost savings post-2020 cannot be attributed to APTPPL's decision in 2007 to buyout the PMA.

According to KPMG, the only potential benefit from PMA termination post-2020 is know-how brought in-house due to the termination of the PMA. However, KPMG did not seek to value this benefit, preferring to take a more conservative and prudent approach by ignoring it.[2] In any case, know-how regarding particular infrastructure and processes depreciates over time as much as any asset. Therefore, it is unlikely that any know-how gained in 2007 would have material value after 2020.

Figure 4.1

Figure 4.1 misrepresents the benefits and costs likely to accrue to users due to the PMA buyout in two ways:

- First, it illustrates benefits to users from the buyout from the period beyond 2020. For the reasons explained above, the buyout should not be credited with any benefits post-2020. This means that the green rectangle representing post-2020 benefits should be removed from the Figure.
- Second, the Figure and surrounding text describes the pre-2020 cost savings from the buyout as greater than the value of the buyout premium. As explained in our original report, the value of the capex and opex benefits from the buyout is considerably less than the buyout premium that APTPPL is seeking to recover from users. For the Figure, this means that the vertical difference between the tariffs including and excluding Agility's margin should be smaller – that is, the red shaded rectangle should be thinner.

Therefore, a more appropriate Figure 4.1 would show:

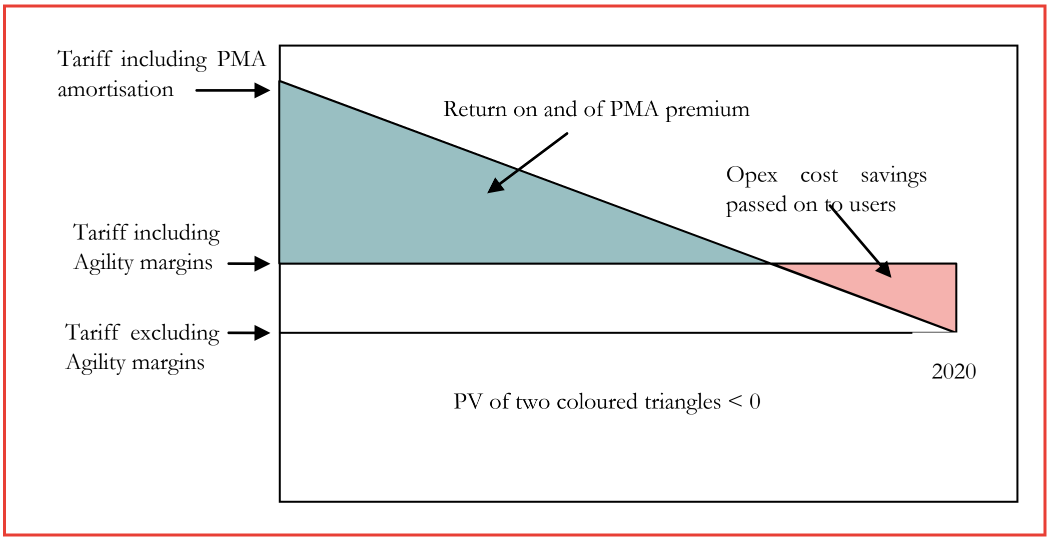
- No green rectangle indicating no post-2020 benefits attributable to the PMA buyout
- A relatively larger blue triangle, indicating that in the early years following the buyout, the Reference Tariff would be *considerably higher* than if APTPPL had continued to operate under the PMA – to the detriment of users
- A relatively smaller upper red triangle, indicating that in the later years following the buyout, the cost savings due to APTPPL not operating under the PMA are considerably smaller than suggested by APTPPL

2 KPMG report pp.5 and 30.

- As a result of the above, the termination benefit is less than the premium value that APTPPL is now seeking to recover from customers – in other words, the PV of the blue and upper red triangles should be negative.

A revised Figure 4.1 is provided below.

Figure 1: Revised Figure 4.1



Source: Frontier Economics