AER Public Forum 19th October 2016

Preliminary Perspectives on the AER's Draft 2018-22 Revenue Determination for Powerlink Queensland

Hugh Grant

AER Consumer Challenge Panel Member

This Presentation

- This presentation outlines the perspectives of AER Consumer Challenge Panel (CCP4)
 Member, Hugh Grant, on the AER's Draft 2018-22 Revenue Determination for Powerlink Queensland
- The use of the terms "CCP4's previous submission" and "CCP4's previous advice" refers to the following documents:
 - Addressing The RAB/WACC Disconnect issues within The Current Rules (Hugh Grant, CCP4 Panel Member, 18 July 2016)

The Methodology For The Comparisons of The Electricity Networks' Return On Equity

With The Returns Of ASX 50 Companies — In The Context Of The Powerlink/Telstra Comparison (Hugh Grant, CCP4 Panel Member, 26 July 2016)

CCP4 (Hugh Grant and David Headberry) Submission to the AER on Powerlink

Queensland's 2018-22 Revenue Proposal (June 2016)

- Any unattributed statements or opinions expressed within this submission should be attributed to Hugh Grant
- Due to time constraints, this presentation focuses on my concerns with the AER's draft 'return on capital' determination for Powerlink
- I will provide a detailed formal submission addressing all elements of the AER's draft determination by 1 December 2016

1. RETURN ON CAPITAL

Return On Capital - CCP4's Previous Advice

CCP4's previous advice included a comprehensive 27 page critique (17 pages in the formal CCP submission, plus 10 pages of supplementary information), which demonstrated that:

- The AER's WACC estimation methodology is inconsistent with the RAB valuation methodology, as it does not appropriately consider the impacts of RAB indexation, i.e.:
 - The AER's methodology for estimating the required percentage returns (for both equity and debt) is based on the returns that investors require on their <u>actual</u> investments.
 - However, the AER calculates its 'return on capital' allowances by multiplying those percentage returns to artificially inflated capital bases
- This inconsistency is resulting in the AER providing return on capital allowances well above the required levels - e.g. the AER is providing 'return on equity' allowances to Powerlink of around 4 times the required level

The AER's Response To CCP4's Critiques

Disappointingly, the AER's draft determination has:

- Essentially ignored the primary issue that CCP4 raised in its previous submissions i.e. the RAB/WACC inconsistency
- Misrepresented CCP4's critiques and recommendations
- Focused its commentary on responding to issues that CCP4 did <u>not</u> raise (e.g. the removal of RAB indexation)

The following slides outline my perspectives on the AER's response to CCP4's critiques, broken down to:

- CCP4's analysis of the networks' actual profitability
- The AER's response to CCP4's profitability analysis
- The RAB/WACC inconsistency
- The networks' actual gearing ratios

CCP4's ANALYSIS OF THE NETWORKS' ACTUAL PROFITABILITY

The CCP's Profitability Analysis

CCP4's previous submission:

- Provided a comprehensive analysis of the actual returns being realised by the Queensland networks (Powerlink and Energex) over the past 15 years
- Compared those returns with the returns being realised by businesses in other sectors of the economy, on an 'apples for apples' basis

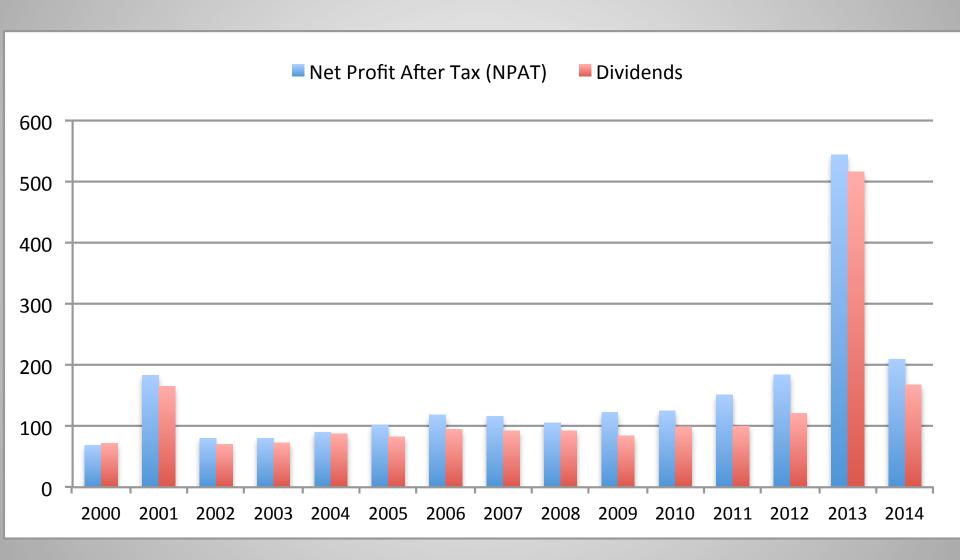
In essence, the CCP's analysis compared the returns that Powerlink's owner (the Queensland government) has realised from its equity investment in the Queensland networks with the returns it would have received if it had invested the same dollars in ASX 50 companies

CCP4's Profitability Analysis – Definitions and Data Sources

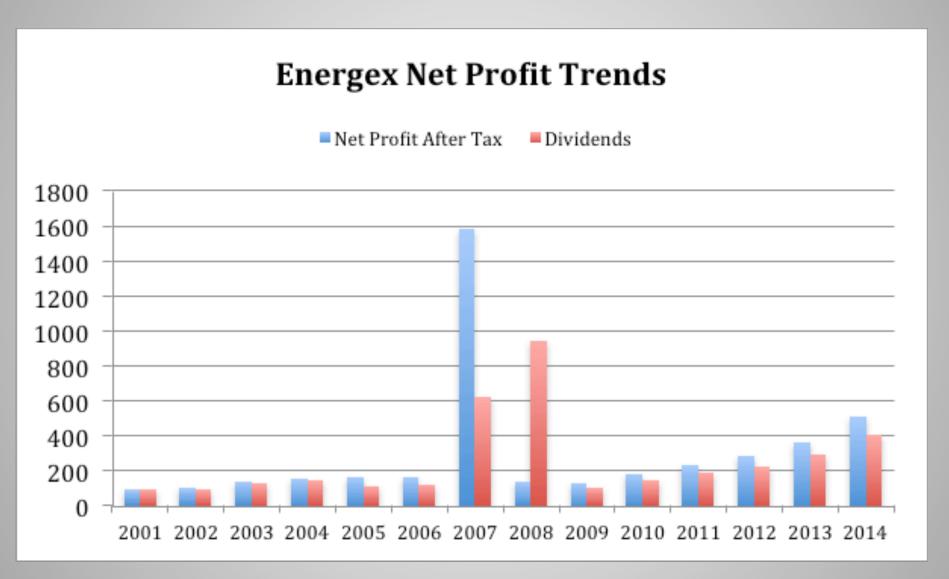
Return on Equity is the ratio (expressed in % terms) of the annual profit achieved by the business, divided by the equity investment:

- Shareholder Equity is the networks <u>actual</u> equity investment the sum of the networks' contributed share capital and retained earnings i.e. the commonly accepted definition that is used by all Australian businesses outside of the energy network sector
- All data (e.g. NPAT, share capital and retained earnings) was taken directly from Powerlink and Energex's audited annual financial reports over the analysis period

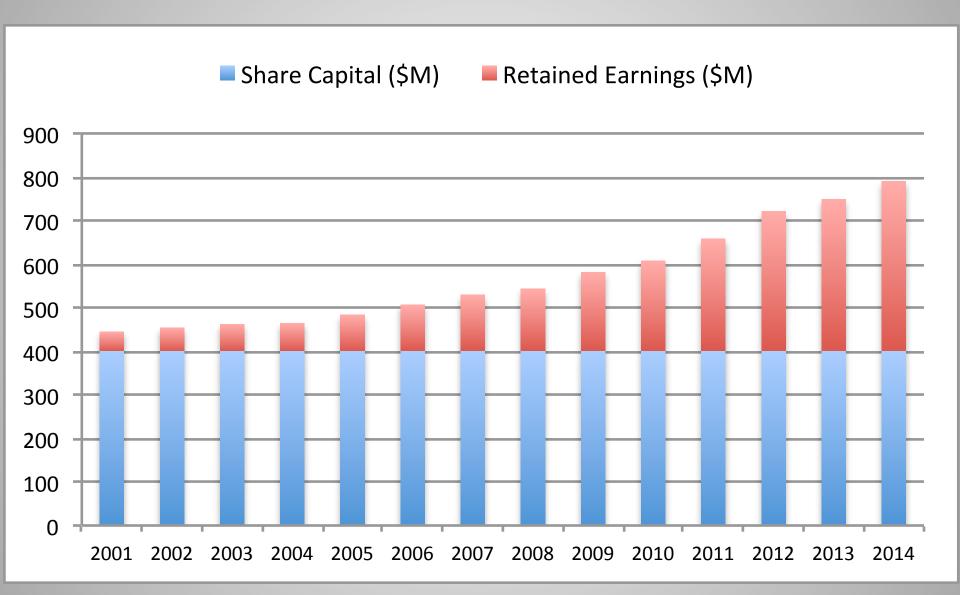
Powerlink – Historical Annual Profits and Dividends



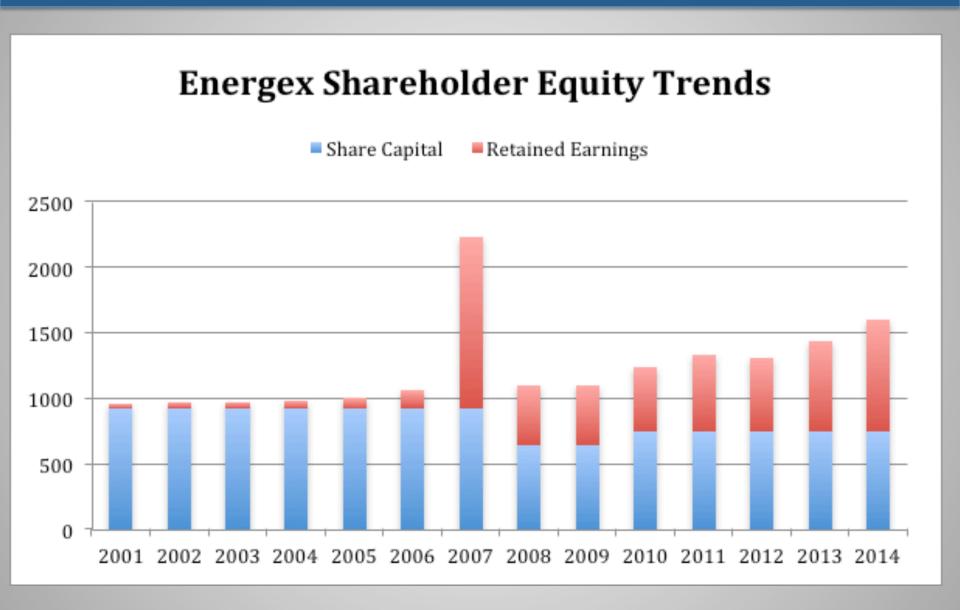
Energex - Historical Annual Profits and Dividends



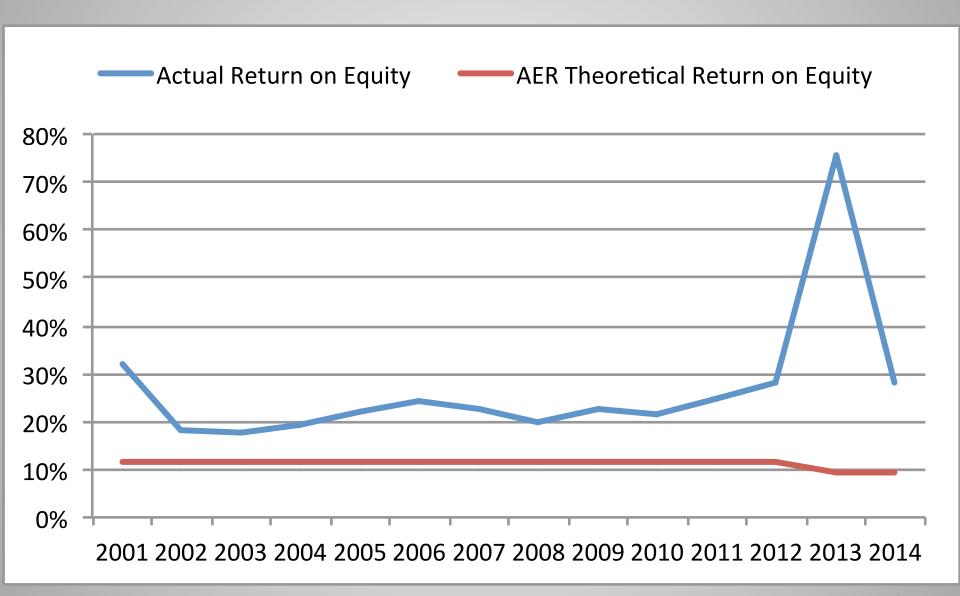
Powerlink: Historical Equity Trend



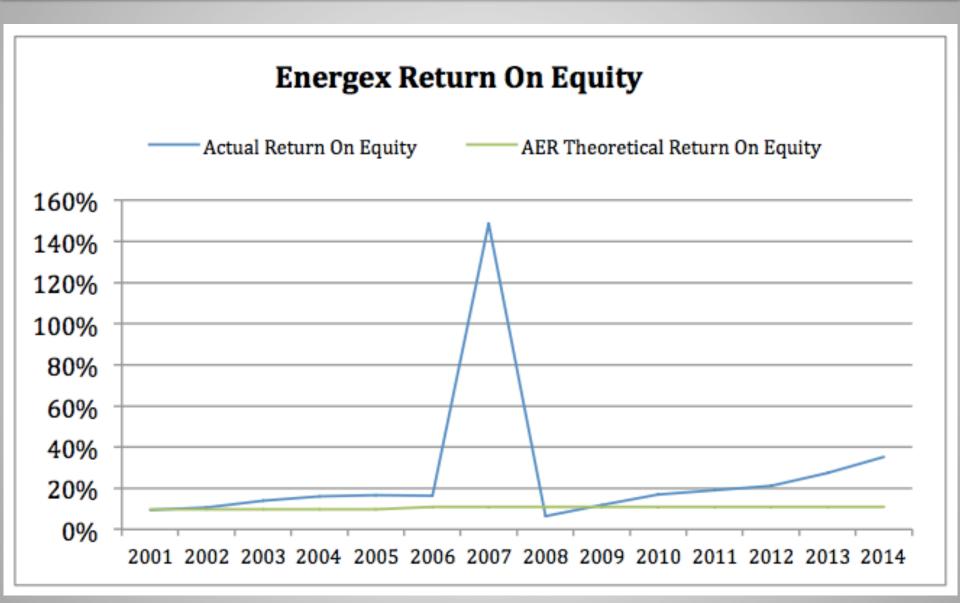
Energex: Historical Equity Trend



Powerlink Actual Return on Equity



Energex Actual Return on Equity



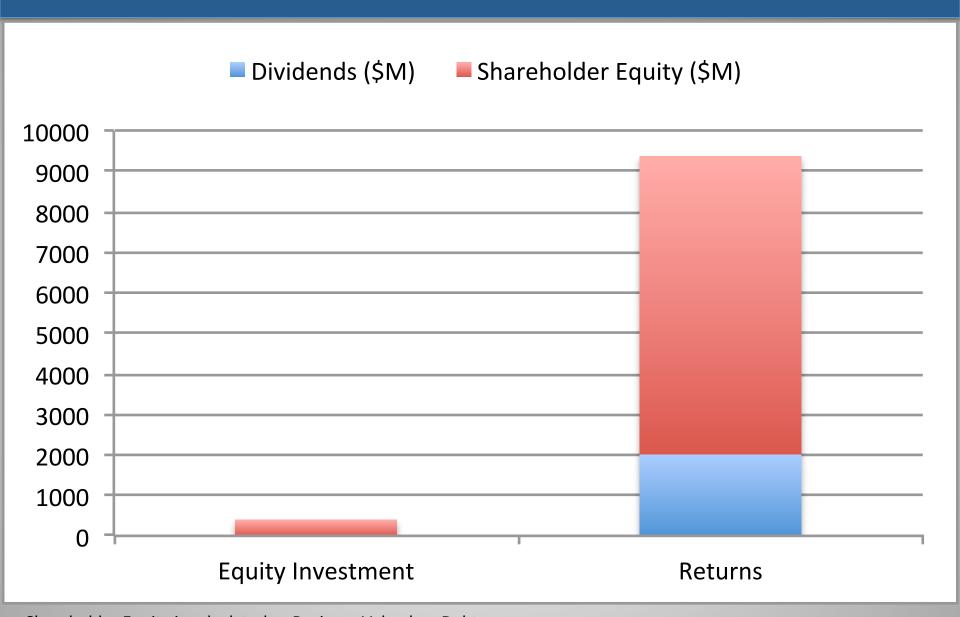
The Queensland Networks' Actual 'Return On Equity' - Observations

- Powerlink achieved actual return on equity levels of 18 -75%, up to
 8.1 times the AER's theoretical return on equity level
- Energex achieved actual return on equity levels of 10.5- 148%, up to 13.5 times the AER's theoretical return on equity level
- By comparison, most ASX50 companies struggled to achieve annual return on equity levels of 5% over that period
- Over the past 15 years the Queensland networks' annual profits have grown strongly with major spikes in some years
- At no time over the past 15 years have the networks experienced low profits or losses (unlike all other businesses of their size)

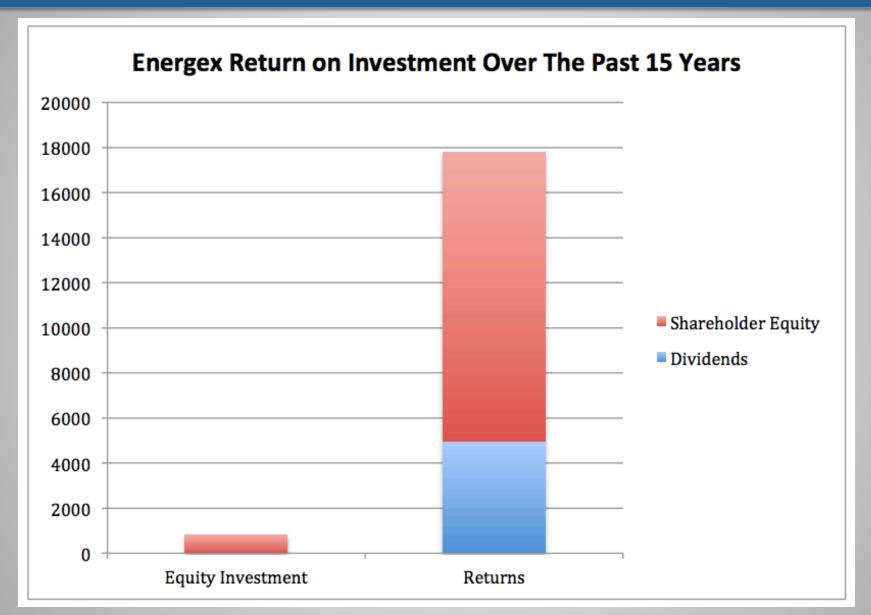
The Queensland Networks' Extraordinary Growth Was Predominantly Debt Funded

- The networks consistently extracted very high dividends, with dividend payout ratios averaging around 90% - i.e. they have reinvested minimal amounts of retained earnings into the business
- By contrast, ASX50 businesses typically reinvest over 50% of their earnings
- The networks' extraordinary growth levels have been funded by debt, e.g.:
 - Powerlink's RAB grew fourfold with no change to its 'share capital' of \$401 million
 Energex's RAB grew fourfold whilst its 'share capital' reduced by \$175 million (from \$921million to \$746 million)
- Funding such levels of growth through debt would be impossible for businesses that operate in any other sector of the Australian economy
- The commercial constraints that apply in all other sectors would require significant levels of equity injection to fund such growth levels
- This demonstrates how the regulatory framework for Australia's electricity networks is disconnected from the commercial realities faced by businesses in all other sectors of the Australian economy

Total Return on Investment Over 15 Years - Powerlink



Total Return on Investment Over 15 Years - Energex



The Queensland Networks' Total Returns

Powerlink Queensland

The Queensland Government's \$401 million equity investment has accrued total returns of \$9.4 billion – i.e. over 23 times the equity investment

Energex

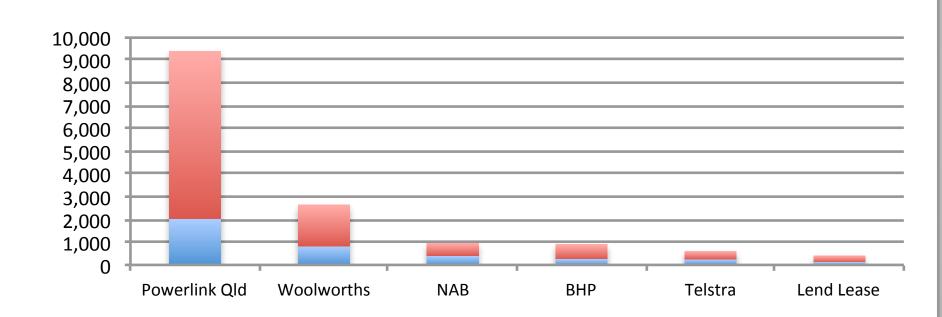
The Queensland Government's average equity investment of \$814 million has accrued total returns of \$17.8 billion – i.e. over 22 times the equity investment

Note:

- The Queensland government is unlikely to have actually invested the reported "share capital" levels, and therefore the actual return ratios are likely to be higher than the above ratios
- The above returns do <u>not</u> include the other pecuniary benefits that the Queensland government realises from its network investments (tax receipts, debt fees, etc.)

Comparison of Powerlink's Returns With ASX 50 Companies





Comparison Of Powerlink's Returns With Blue Chip ASX 50 Entities

Over the past 15 years, the Queensland government's equity investment in Powerlink has accrued total returns of:

- 23 times the returns achieved by the Australian construction sector (Lend Lease)
- 15.5 times the returns achieved by the Australian telecommunications sector (Telstra)
- 10.5 times the returns achieved by the Australian minerals and resources sector (BHP)
- 10 times the returns achieved by the Australian banking sector (NAB)
- 3.6 times the returns achieved by Australia's most profitable supermarket (Woolworths)

No other ASX 50 stock comes close to Powerlink's returns

These extraordinary returns are being achieved, despite Powerlink being the most inefficient transmission network in Australia

Powerlink's Returns are Extraordinary from an Income and Capital Growth Perspective

Powerlink is an incredible investment – from both an income and a capital growth perspective

Income

- Powerlink's achieved an average annual 'return on equity' of 27%
- Most ASX50 companies have struggled to deliver 5%

Capital Growth

- Based on the recent TransGrid sale, the Queensland government's \$401
 million equity investment in Powerlink is now valued at around \$7.4 billion
 - i.e. it has grown by over 18 times over the past 15 years
- Most ASX 50 companies struggled to grow their shareholder value by 50% over that period, with the share prices of many companies actually reducing, e.g.:
 - Telstra's share price dropped by 11%
 - Lend Lease's share price dropped by 30%

THE NETWORKS' ACTUAL PROFITABILITY THE AER'S RESPONSE

The AER's Indifference To The Networks' Actual Profitability

- The AER has a track record in demonstrating a defiant indifference to the networks' actual profitability
- Every time stakeholders raise issues regarding the networks' actual profitability, the AER attempts to shut down the conversation and defend its existing 'rate of return' guideline
- It is clear that the networks' actual profitability is an "inconvenient truth" to the AER (and to the networks)
- The AER's focus on defending its 'rate of return' guideline is alienating consumers and other stakeholders from the network revenue determination process

The AER's Approach Is **Not** Informed By The Networks' Actual Returns

AER Statements

"We do agree that there is some merit to the analysis of profitability outcomes"

"If the service provider can outperform the regime within a regulatory control period, we can then use its outturn performance to inform our revenue decision for the next regulatory control period"

"Over time, this should encourage service providers towards efficiency and share benefits of the outperformance with customers"

CCP4 (Hugh Grant) Response

This sounds good in theory, but the AER's approach is <u>not</u> informed by the networks' actual returns

The AER has never performed an analysis of the networks' actual profitability, or used the outcomes of a profitability analysis to inform its 'return on capital' decisions, despite extensive calls from numerous stakeholders over many years for the AER to do so

Limitations in The CCP's Profitability Analysis?

AER Statement

"At the highest level, the CCP members' analysis attempts to draw conclusions about the regulatory regime based on a limited set of observed market 'outperformance'"

CCP4 (Hugh Grant) Response

This statement is blatantly incorrect

The CCP's analysis is based on an extensive long-term analysis of Powerlink's actual profitability over a 15 year period

This is the first time that such an comprehensive profitability analysis has been performed

It is extremely disappointing and galling that the AER is attempting to dismiss or discredit the CCP's profitability analysis without identifying any actual errors in the analysis and without performing its own substitute analysis

Furthermore, it is not the role of the CCP to perform this analysis – that is the AER's role, although it is clear that the AER has no intention of doing so

Concerns with The Reliability Of Powerlink's Reported Equity?

AER Statement

"The absence of reliable data on initial shareholder equity means it is difficult to accept the CCP members' profitability analysis"

CCP4 (Hugh Grant) Response

This unsubstantiated statement is concerning

Powerlink's shareholder equity has been taken directly from Powerlink's audited annual financial reports – reports that have been independently audited for compliance with Australian accounting standards and that have been signed off by Powerlink's Chairman and shareholder

On what basis does the AER consider that Powerlink's equity reporting in its audited annual financial reports is unreliable?

Errors In Powerlink's Initial Equity Stake?

AER Statement

"We consider that the CCP members have underestimated the value of this initial equity stake, and so overestimated the 'actual' return on equity and relative profitability of Powerlink"

CCP4 (Hugh Grant) Response

This unsubstantiated statement is incorrect

reported "share capital" was actually invested

The CCP's analysis meticulously tracks changes in Powerlink's shareholder equity in every year of the analysis and expresses the annual return on equity on the opening equity in each year of the analysis

It is extremely important to note that **Powerlink's reported initial equity (share capital) is most likely**

to have been over-estimated, rather than under-estimated

Powerlink's initial DORC valuation and balance sheet did not necessarily bear any relation to its actual investment. In reality, Powerlink was most likely fully debt funded and it is unlikely that Powerlink's

Despite those concerns, the CCP has not challenged Powerlink's reported "share capital" and has simply accepted Powerlink's' reported "share capital" in accordance with its audited financial reports Clearly, Powerlink and its shareholder have details on the initial contributed equity and the AER can source that information if required

If the AER does that, it will find that Powerlink's owner extracted major equity drawdowns shortly after Powerlink's formation. As outlined in the CCP's analysis, Powerlink's contributed share capital has been \$401 million for the majority of Powerlink's existence (i.e. since 1 July 2000)

Temporary Out-Performance?

AER Statement

"Some amount of outperformance is to be expected in an incentive regime"

"Even where market outperformance is observed, this does not mean that the outperformance was guaranteed in advance and may simply reflect an outcome towards the high end of the spread of possible outcomes"

CCP4 (Hugh Grant) Response

Of course, some level of out-performance is to be expected in an incentive regime

However, some amount of under-performance is also to be expected

The CCP's analysis demonstrates that Powerlink and Energex systemically outperformed the theoretical returns, achieving multiples of the regulators' theoretical returns in <u>every</u> year of the 15 year analysis period, with no single year of under-performance

This clearly demonstrates that there are systemic deficiencies with the AER's 'return on capital' determination approach

The Networks' Actual Returns Are Not Surprising

AER Statement

"Even where market outperformance is observed, this does not mean that the outperformance was guaranteed in advance and may simply reflect an outcome towards the high end of the spread of possible outcomes"

CCP4 (Hugh Grant) Response

This assertion is clearly incorrect

There is nothing surprising about the actual profitability levels being achieved by Powerlink

The returns are close to what is expected due to the excessive return on capital allowances arising from the AER's WACC/RAB inconsistency

The regulators' theoretical % ROE over the period varied from 11.8% in 2002 to 9.4% in 2014 – based on an assumed equity base (including RAB indexation) of 40% of RAB

When expressed as a percentage of Powerlink's <u>actual</u> equity investment, those allowances equate to an ROE of 24% in 2002, rising to around 34% in 2014

The Impact Of Including Non-Regulated Profits

AER Statement

"The CCP members' submissions appear to include one-off and unregulated revenue for Powerlink. This causes overestimation of Powerlink's profitability relative to the regulated benchmark"

2012/13 arising from its sale of ElectraNet

CCP4 (Hugh Grant) Response As Powerlink does not provide segregated accounts for its regulated and non-regulated

business, it was necessary for the CCPs' analysis to be performed on Powerlink's total business

The CCP carefully considered the impact of the inclusion of Powerlink's non-regulated business,

taking into account Powerlink's statements regarding the materiality of its non-regulated revenues and profits over the analysis period The CCP was also very careful in ensuring that its conclusions were not distorted by abnormal non-regulated events. For example, the CCP concluded that "Powerlink typically achieved an actual return on equity of 20-30 %" and ignored the 75% ROE that Powerlink achieved in

The CCP agrees that the AER needs to perform a profitability analysis on Powerlink's regulated activities. That will obviously require an appropriate allocation of Powerlink's shareholder equity between its regulated and non regulated businesses

Powerlink clearly has the required information and the AER should obtain that information

Is Powerlink's Non-Regulated Business More Profitable Than Its Regulated Business?

AER Statement

"The CCP members' submissions appear to include one—off and unregulated revenue for Powerlink. This causes overestimation of Powerlink's profitability relative to the regulated benchmark"

CCP4 (Hugh Grant) Response

The AER's assertion that the inclusion of non regulated profits results in an over-estimation of Powerlink's regulated profits is unsubstantiated and may be incorrect

Whilst in theory, it should be expected that Powerlink's non-regulated activities are more profitable than its regulated activities, in light of the excessive return on capital allowances being provided by the AER, that may be an incorrect assumption

The AER needs to perform a proper profitability analysis to test that assumption

The Use Of Nominal Or Real Dollars Does Not Change The Conclusions

AER Statement

"The CCP members start their analysis as at 30 June 2000 using figures taken from Powerlink's oldest available financial report. This is problematic because the book value of share capital (\$401 million) is used without adjusting for the time that has passed between the initial investment and the valuation date"

CCP4 (Hugh Grant) Response

The CCP's analysis tracks changes in the equity investment in Powerlink over the 15 year study period, with the annual return on equity being calculated on the basis of the opening equity in each year of the analysis

The analysis consistently uses nominal dollars for Powerlink and for the ASX50 comparator companies

Converting the figures to real dollars does not change the findings or conclusions of the analysis

Irrespective of whether the analysis is performed in nominal or real dollars, Powerlink achieved actual return on equity levels of many multiples of the returns realised by ASX 50 companies in all other industry sectors

33

Artificial Inflation of The Equity Base is **Not** Common Practice

AER Statement

"Revaluation Reserves should be included in the calculation of shareholder's equity, in accordance with commonly accepted valuation practices"

CCP4 (Hugh Grant) Response

Artificially inflating a businesses equity investment is <u>not</u> common practice for Australian businesses – it is unique to the monopoly energy networks that the AER regulates

In order to compare the networks' returns with the returns of other companies **on an 'apples for apples' basis**, the CCP's analysis used the commonly accepted practice used by all other Australian businesses

Of course, the profitability analysis could have been performed by using the energy networks' approach (artificially inflating the equity base), but that would not change the results and conclusions of the analysis

Irrespective of whether the analysis is performed using the networks' approach or the commonly accepted approach to valuing equity, Powerlink achieved actual return on equity levels of many multiples of the returns realised by ASX 50 companies in all other industry sectors

The AER's Misplaced Confidence In Its Approach Is Based On An 'Apples to Oranges' Comparison

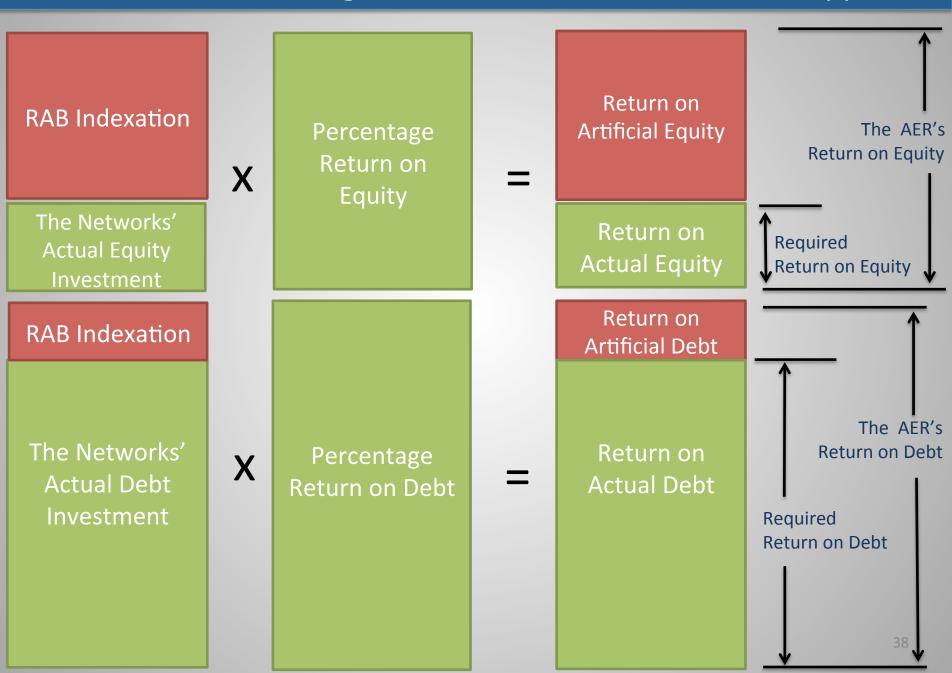
- The AER's misplaced confidence in its 'return on equity' determination approach is not based on an "apples for apples" comparison of the networks' returns with other companies
- It is actually based on an "apples to oranges" comparison, i.e.:
 - An (ex ante) estimation of the networks' expected 'return on equity' calculated on the basis of artificially inflated capital bases
 - An (ex post) estimation of the return on capital being achieved by other companies, calculated on the basis of actual capital bases
- These inconsistencies mean that the resulting ROE ratios are not directly comparable, as the it significantly underestimates the networks' actual ROE
- The AER clearly needs to compare the returns being realised by the networks and other companies on an 'apples for apples' basis
- Until the AER does that, any further debate on the issue is futile

RAB/WACC INCONSISTENCY ISSUES THE CCP's PREVIOUS ADVICE

RAB/WACC Inconsistency - CCP4's Previous Advice

- CCP4's critique focused on demonstrating that the AER's WACC estimation methodology is inconsistent with the RAB valuation methodology as it does not appropriately consider the impacts of RAB indexation
- The AER's methodology for determining the networks' return on capital allowances does not appropriately consider the impacts of RAB indexation, i.e.:
 - The AER's methodology for estimating the required percentage returns (for both equity and debt) is based on the returns that investors require on their <u>actual</u> capital investments
 - However, the AER calculates its 'return on capital' allowances by multiplying those percentage returns to <u>artificially inflated</u> capital bases
- CCP4's analysis identified that this inconsistency is resulting in the AER providing return on capital allowances well above the required levels e.g.:
 - Providing 'return on equity' allowances to Powerlink of around 4 times the required level
 - Providing 'return on debt' allowances to Powelink of around 10% above the required level

Excessive Returns Arising From The AER's Current WACC Approach



RAB/WACC Inconsistency – My Proposed Solution

My consistent position (over the past 2 years) has been that **the AER needs to modify its WACC estimation methodology** to reflect that the % returns are applied to artificially inflated capital bases

Alternative Solution That Retains The AER's Current WACC Estimation Approach? During my discussions with the AER on this issue over the past 2 years, it became

clear that the AER has no appetite for revising its WACC estimation methodology

■ This resulted in discussing a possible alternative solution for addressing the RAB/WACC inconsistency that could potentially allow the AER to retain its existing WACC estimation approach — e.g. applying its % returns to capital bases that are more reflective of the NEM networks' actual investment levels

value of the regulatory asset base" (NER Clause 6A.6.2 (a))
 This alternative solution was only ever contemplated on the expectation that the AER would work constructively to explore a potential solution to the RAB/WACC

I have always acknowledged that such a solution was potentially problematic as it

could violate the NER requirement for the AER to apply its rate of return to "the

inconsistency issue that enables the AER to retain its existing WACC estimation

Based on the AER's response on this reset, it is clear that the AER never had any intention of working constructively to explore such a solution
40

methodology

My Submissions Have **Never** Challenged RAB Indexation

My CCP submissions to the AER over the past 2 years have consistently emphasised that:

- I am <u>not</u> challenging the rule requirement to apply annual indexation to the ongoing RAB revaluations
- I am <u>not</u> challenging the AER's approach to offsetting RAB indexation in its calculation of the networks' depreciation allowances

RAB/WACC INCONSISTENCY ISSUES THE AER's RESPONSE

The AER's Response To The WACC/RAB Inconsistency Issues

The AER's Draft decision for Powerlink has:

- Ignored CCP4's primary recommendation i.e. that the AER needs to revise its WACC estimation methodology to reflect that its % returns are applied to artificially inflated capital bases
- Focused its commentary on misrepresenting and taking "pot shots" on the potential alternative solution, e.g.:
 - Suggesting that CCP4 is challenging the rule requirement to index the RAB despite me reiterating to the AER many times that I am not challenging that requirement
 - Suggesting that CCP4 is proposing solutions that would violate the NPV = Zero principle (based on the above misrepresentation)

It is extremely disappointing that the AER has devoted 15 pages in its draft determination responding to an issue that CCP4 did <u>not</u> recommend (removal of RAB indexation)

CCP4's ANALYSIS OF THE NETWORKS' ACTUAL GEARING LEVELS

CCP4's Analysis

CCP4 performed an extensive analysis that compared:

- The Queensland networks' <u>actual</u> investment levels with the AER's assumed levels
- The Queensland networks' <u>actual</u> gearing ratios compared with the AER's assumed levels

Theoretical vs Actual Investment Levels

Total Investment Levels

- Powerlink's RAB valuation is 1.55 times Powerlink's actual total investment
- Energex's RAB valuation is 1.39 times Energex's actual total investment

Equity Investment Levels

- The AER's assumed equity investment for Powerlink is 3.9 times Powerlink's actual equity investment
- The AER's assumed equity investment for Energex is 2.8 times Energex's actual equity investment

Debt Investment Levels

- The AER's assumed debt level for Powerlink is over 10% higher than Powerlink's actual debt level
- The AER's assumed debt level for Energex is 4% higher than Energex's actual debt level

46

Theoretical vs Actual Debt/Equity Ratios

As a percentage of their actual investment levels:

- Powerlink funded 16% of its investment from equity and 84% from debt
- Energex funded 20% of its investment from equity and 80% from debt

As a percentage of RAB:

- Powerlink's equity investment amounts to 10.4% of RAB, rather than 40% assumed by the AER
- Energex's equity investment amounts to 14.3% of RAB, rather than 40% assumed by the AER
- Powerlink's debt investment amounts to 54.4% of RAB, rather than 60% assumed by the AER
- Energex's debt investment amounts to 58% of RAB, which is close to the 60 % assumed by the AER

Outcomes Of The AER's RAB/WACC Inconsistency and Incorrect Capital Assumptions

CCP4's analysis demonstrated that **due to the combination of** the AER's RAB/WACC inconsistency and the AER's incorrect capital base assumptions:

- The AER is providing 'return on equity' allowances to Powerlink of at least 3.9 times the required level
- The AER is providing 'return on equity' allowances to Energex of at least 2.8 times the required level
- The AER is providing 'return on debt' allowances to Powerlink of over 10% above the required level
- The AER is providing 'return on debt allowances to Energex of over 4% above the required level

THE NETWORKS' ACTUAL GEARING THE AER'S RESPONSE

Powerlink's Extraordinary Returns **Cannot** Be Solely Attributed To Its High Gearing Ratio

The AER appears to be suggesting that Powerlink's extraordinary returns can be simply explained by its high gearing ratio

AER Statement

"A business adopting an above-benchmark gearing level accepts a higher level of risk than the benchmark. We would expect to observe, on average, higher returns as a consequence of this higher risk strategy"

CCP4 (Hugh Grant) Response

Powerlink's outperformance is <u>not</u> simply due to its high gearing ratio

Whilst Powerlink's high gearing ratio contributes to its extraordinary profitability, the main driver of Powerlink's extraordinary profitability is the inconsistency between the AER's WACC determination methodology and the artificially inflated capital bases that it applies its % returns to

2. RESPONSE TO POWERLINK'S LETTER TO THE AER (28 APRIL 2016)

Powerlink's Letter To The AER (28 April 2016)

- Powerlink's CEO (Merryn York) sent a letter to the AER on 28 April 2016 aimed at discrediting my presentation to the AER March Public Forum
- That letter contained a number of misleading and unsubstantiated claims
- It opened with the sweeping allegation that my presentation "contained a number of invalid assumptions, material errors and "unsubstantiated claims" yet it provided no credible evidence to substantiate those claims
- It is deeply concerning that, in the absence of a detailed understanding of the issues, many stakeholders may have been inappropriately influenced by Ms York's letter and her subsequent media statements

The Interrelationships of The Regulatory Framework **Have** Been Fully Considered

Powerlink CEO (Merryn York) Statement

"Powerlink considers that Mr Grant has undertaken his analysis selectively and in a way that does not recognise that the regulatory framework is an interrelated package of arrangements. By way of example, the current regulatory framework includes indexation of the regulated asset base. Correspondingly it also includes the use of economic depreciation (ie. offset by indexation) instead of straight line depreciation"

CCP4 (Hugh Grant) Response

This statement is incorrect and misleading

My critiques and proposed solutions carefully considered and are fully cogniscant of the relevant regulatory framework interrelationships, including the interrelationship between RAB indexation and economic depreciation

Powerlink is clearly attempting to distract attention from its extraordinary profitability and to confuse the debate by suggesting that the issues are more complex than they actually are

Nothing in Powerlink's letter changes the fact that Powerlink is achieving actual return on equity levels of many multiples of the returns realised by ASX 50 companies in all other industry sectors

Shareholder Equity Definition

Powerlink CEO (Merryn York) Statement

"Mr Grant appears to have interchangeably defined shareholder equity as either contributed shareholder capital or the sum of contributed shareholder capital and retained earnings"

CCP4 (Hugh Grant) Response

This statement is incorrect

My critique consistently defined shareholder equity as the sum of contributed share capital and retained earnings – i.e. the commonly accepted definition that is used by all Australian businesses outside of the energy network sector

Shareholder Equity Definition

Powerlink CEO (Merryn York) Statement

"Mr Grant appears to have inappropriately limited his definition of shareholder equity for Powerlink to contributed shareholder capital, excluding both retained earnings and asset revaluation reserves that would typically flow through as returns to shareholders"

CCP4 (Hugh Grant) Response

These statements are incorrect

As outlined above, my critique consistently defined shareholder equity as the sum of contributed share capital and retained earnings

That definition clearly includes retained earnings – i.e. it does <u>not</u> exclude retained earnings as stated by Powerlink

Yes – it deliberately excluded revaluation reserves to enable an 'apples for apples' comparison of Powerlink's returns with the returns of ASX50 companies

Those facts were all clearly stated in the analysis

Unclear Assumptions?

Powerlink CEO (Merryn York) Statement

"The lack of transparency through to Mr Grant's underlying analysis also means that it is not clear on what basis he has measured the returns on the other companies, nor is it possible to confirm if those measures are valid"

CCP4 (Hugh Grant) Response

The assumptions and definitions are clearly laid out in my submissions

All data on the ASX50 companies' returns was taken directly from the investor information section of their websites and from publicly available ASX information

Powerlink's Actual Equity Investment

Powerlink CEO (Merryn York) Statement

"In either case, he has omitted from his analysis asset valuation reserves. For example, as at 30 June 2014 Powerlink's financial statements showed Actual Shareholder Equity as \$2.582 billion. Mr Grant has calculated shareholder equity as at 30 June 2014 as \$791 million (the sum of contributed shareholder equity \$401m and retained earnings \$390m).

CCP4 (Hugh Grant) Response

Powerlink's shareholder has <u>not</u> invested \$2.582 billion, – its actual equity investment (at 30 June 2014) was \$791 million (comprising \$401 million in contributed share capital and \$390 million in retained earnings)

Powerlink's claimed \$2.582 billion figure obviously includes \$1.8 billion in RAB indexation (revaluation reserves)

Annual Return on Equity

Powerlink CEO (Merryn York) Statement

"Mr Grant asserted that Powerlink delivered a 20-30% return on equity and has compared this to ASX50 companies' typical return on equity of 5%. Powerlink considers this comparison has not been made on a like-for-like basis"

CCP4 (Hugh Grant) Response

This statement is blatantly incorrect

The CCP's analysis clearly identifies that, on an *like for like* basis, Powerlink achieved an average annual return on equity of 27% compared to less than 5% for ASX 50 companies

That fact is undisputable

Powerlink's 'Apples and Oranges' Comparison of Return on Equity

Powerlink CEO (Merryn York) Statement

"To be clear, Powerlink's actual average return on equity over the 15 year period is 7.6%, when presented on a like-for-like basis with typical ASX50 returns referred to by Mr Grant"

CCP4 (Hugh Grant) Response

This statement is blatantly incorrect.

The CCP's analysis clearly demonstrates that, on an 'apples for apples' basis, Powerlink achieved an average annual return on equity of 27%, compared to less than 5% for ASX50 companies

Powerlink's assertions that its average return on equity was 7.6% is clearly based on the inclusion of RAB indexation (revaluation reserves) in Powerlink's equity base

As demonstrated in the CCP's analysis, the inclusion of RAB indexation overstates Powerlink's equity base by a factor of around 4 - i.e. it understates Powerlink return on equity to around one quarter of what Powerlink is actually achieving

When expressed as a % of Powerlink's <u>actual</u> equity investment, Powerlink's 7.6% claim equates to an average annual return of around 30%

Unsubstantiated Claims Regarding "Estimates From Independent Sources"

Powerlink CEO (Merryn York) Statement

"Estimates sought from independent sources show that over the past five years, the annual returns on the S&P/ASX50 Index have been consistently above Powerlink's annual return on equity, contrary to Mr Grant's claims"

CCP4 (Hugh Grant) Response

This unsubstantiated statement is clearly incorrect

Firstly, Powerlink does not state which "independent sources" it is referring to

Secondly, Powerlink could only reach this conclusion by making comparisons on an 'apples and oranges' basis – i.e. comparing Powerlink's returns on an artificially inflated equity base with S&P/ASX 50 companies' returns on an actual equity basis

The publicly available S&P/ASX 'return on equity' information is expressed in terms of the companies' returns on their **actual** equity investment – not on **artificially inflated** equity

Over the past 15 years, Powerlink has averaged 27% on its <u>actual</u> equity investment, whereas most ASX50 companies achieved less than 5%

Artificially Inflating Shareholder Equity is Not Common Practice

Powerlink CEO (Merryn York) Statement

"It is common practice for all regulated network businesses in Australia to treat Asset Revaluation Reserves as shareholder equity"

CCP4 (Hugh Grant) Response

Artificially inflating shareholder equity is **not** common practice - it is unique to Australia's monopoly networks

In order to compare the networks' returns with the returns of other companies **on an** 'apples for apples' basis, the CCP's analysis used the commonly accepted practice used by all other Australian businesses

If the profitability analysis had been performed by using the energy networks' approach (artificially inflating the equity base), that would not change the results and conclusions of the analysis

Irrespective of whether the analysis is performed using the networks' approach or the commonly accepted approach to valuing equity, Powerlink is achieving actual return on equity levels of many multiples of the returns being realised by ASX 50 companies in all other industry sectors

Return on Capital – Summary of CCP4 (Hugh Grant's) Position

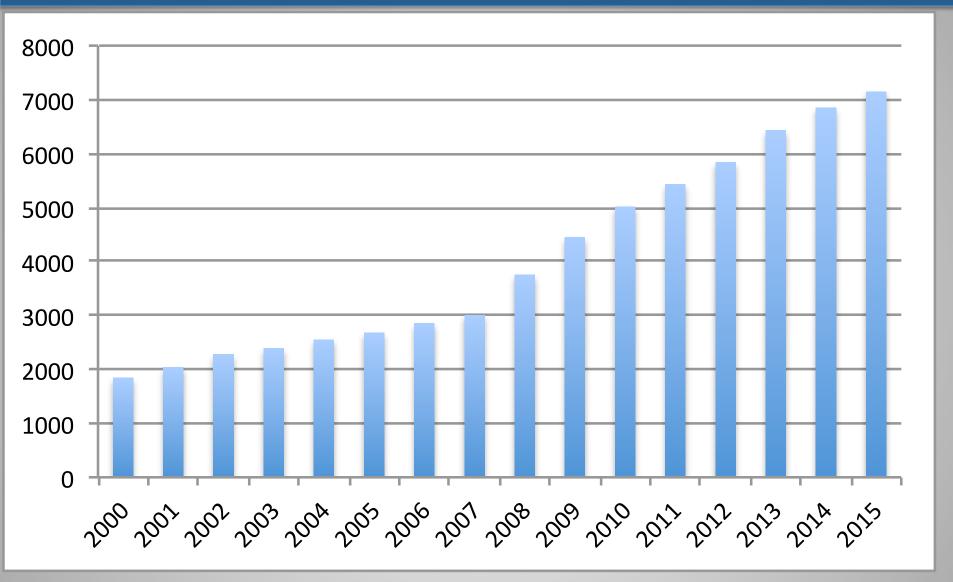
- Despite their best efforts, neither the AER nor Powerlink have identified any errors in CCP4's profitability analysis
- Systemic deficiencies in the AER's return on capital determination methodology are resulting in the networks achieving many multiples of the returns being achieved by Australia's best performing ASX 50 companies
- The AER's defiant indifference to the networks' actual returns and its focus on defending its current 'rate of return' approach is deplorable and is alienating consumers and other stakeholder from the network revenue determination process
- The AER's misplaced confidence in its 'return on capital' determination approach is based on an 'apples to oranges' comparison of the networks' returns with other companies, i.e.:
 An (ex ante) estimation of the networks' expected 'return on capital' calculated on the

basis of **artificially inflated** capital bases

- An (ex post) estimation of the 'return on capital' being achieved by other companies, calculated on the basis of their actual capital bases
- Rather than misrepresentating stakeholders' criticisms and defending its current approach, the AER needs to revise its 'return on capital' approach, informed by an 'apples for apples' comparison of the returns being realised by the networks and other companies
- Unless the AER is prepared to do that, any further debate with the AER on the issue is futile and consumers will need to explore alternative mechanisms to resolve the issue

3. POWERLINK'S EXTRORDINARY RAB GROWTH

Powerlink: RAB Growth



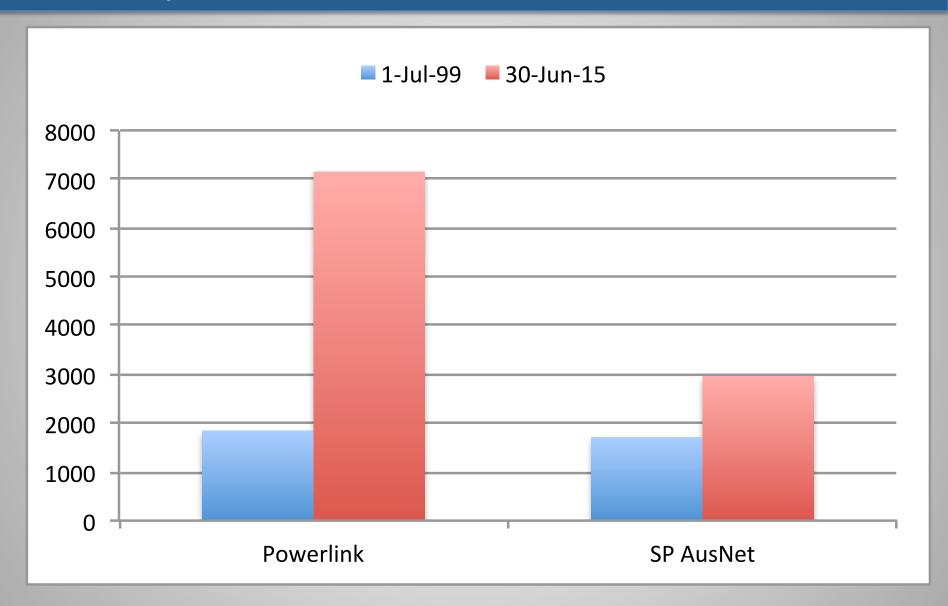
Sources: AER Roll Forward model and Powerlink's 2018-22 Revenue Proposal

Powerlink's 2015 RAB is assumed to be \$7.149 billion as stated in Powerlink's 2018-22 revenue proposal, rather than \$7.64bn assumed in the AER's 2013-17 Revenue Determination

Powerlink's RAB Growth - CCP4's Previous Submission

- CCP4's previous submission provided a detailed analysis (informed by various studies) of Powerlink's extraordinary RAB growth over the past 16 years
- That analysis demonstrated that Powerlink's RAB has grown much more significantly than all of the other transmission networks - both in absolute terms, and after normalisation for system outputs
- CCP4's submission emphasised the importance of the AER's capex determination for Powerlink incorporating an appropriate consideration of Powerlink's capital efficiency

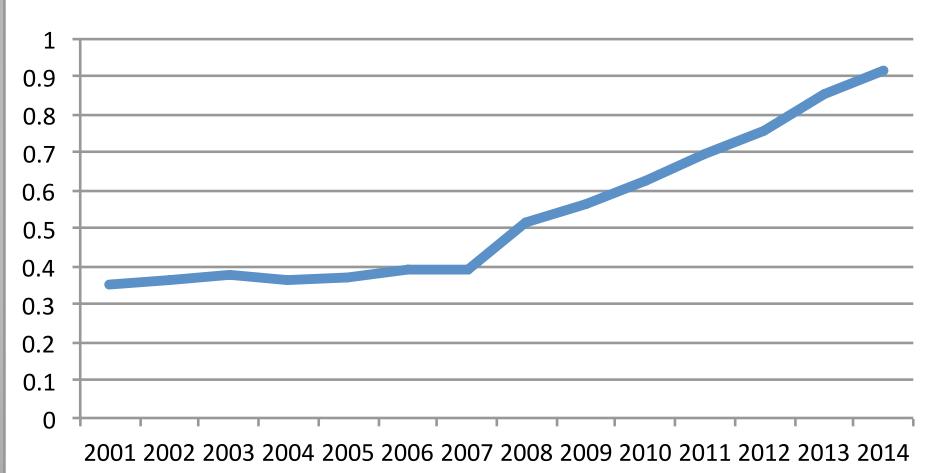
Comparison with SP AusNet's RAB Growth



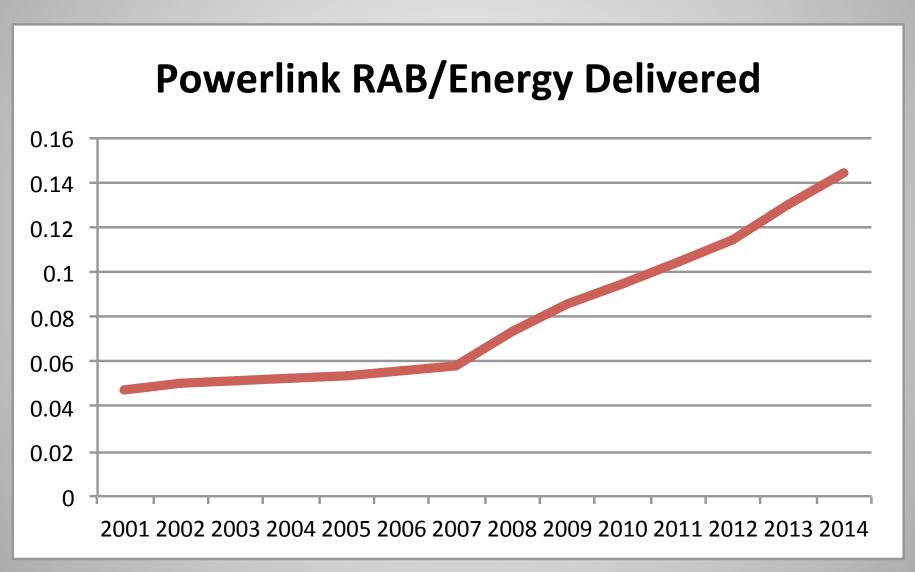
Powerlink's 2015 RAB is assumed to be \$7.149 billion as stated in Powerlink's 2018-22 revenue proposal, rather than \$7.64bn assumed in the AER's 2013-17 Revenue determination

Powerlink RAB: Normalised for Peak Demand



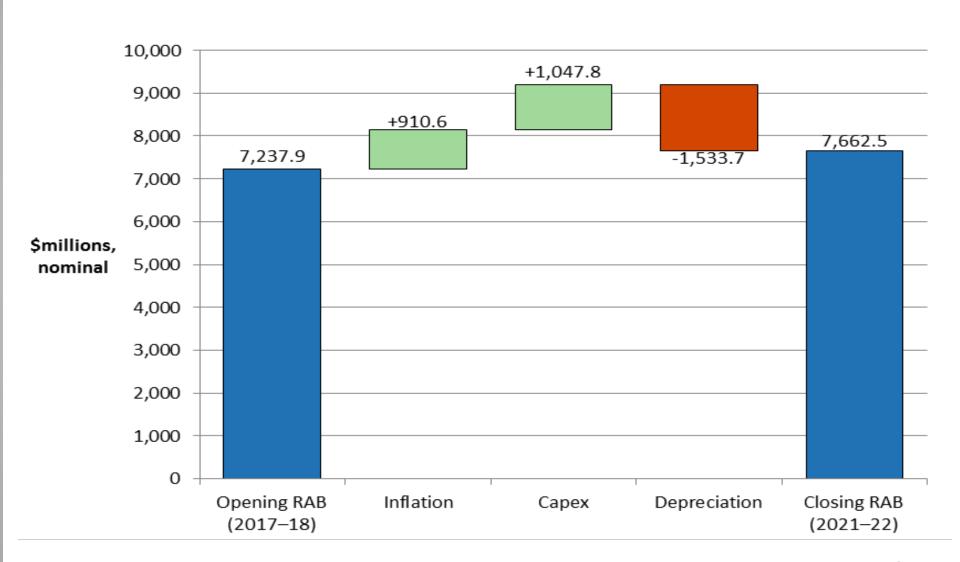


Powerlink RAB: Normalised for Energy Delivered





Powerlink's RAB Will Continue To Grow Over The Next 5 Years



4. CAPEX

POWERLINK'S POOR CAPITAL EFFICIENCY

Capital Efficiency: CCP4's Previous Submission

- CCP4's previous submission provided a 21 page critique of Powerlink's capital efficiency (informed by various studies and analyses) that demonstrated that:
 - Powerlink is the most inefficient transmission network in the NEM, by far
 - Powerlink is much less efficient than the other transmission networks, having incurred significantly higher capex over the past decade, both in absolute terms and after normalisation for changes in network outputs
 - SP AusNet has invested much less and later than Powerlink to achieve the same outcomes
 - SP AusNet's efficiency has not been at the expense of safety or reliability
- CCP4 urged the AER to have significant regard to Powerlink's poor capital efficiency in its determination of Powerlink's capital expenditure allowances
- Based on a preliminary review of the AER's draft capex determination, I consider that the AER has had insufficient regard to the CCP4's critiques and recommendations
- I will provide a detailed critique of the AER's lack of consideration of Powerlink's capital efficiency in my formal submission

REPLACEMENT CAPEX

CCP4's Previous Submission – Powerlink's Proposed Repex

CCP4's previous submission provided a comprehensive critique of deficiencies with Powerlink's repex proposal and the AER's repex assessment methodology demonstrating that:

- Powerlink's proposed repex is materially overstated
- The AER's repex assessment approach is too high level, overly reliant on acceptance of the networks' past asset replacement practices and does not apply the degree of rigour required to fully address the major deficiencies with Powerlink's repex proposal

CCP4's Previous Submission – Repex Assessment Recommendations

CCP4 recommended that the AER needs to refine its repex assessment methodology, having greater regard to:

- Powerlink's very poor capital efficiency and excessively high regulatory asset base (RAB)
- The implications of Powerlink's very high excess capacity level
- The implications of Powerlink's very low asset utilisation levels
- A critical assessment of the outcomes (e.g. system performance outcomes) that Powerlink's proposed repex programs and projects will deliver
- Determination of <u>efficient</u> repex allowances rather than basing its allowances on Powerlink's recent repex spend levels which have not been demonstrated to be efficient
- Detailed assessments of the prudency and efficiency of Powerlink's proposed repex projects
- Replacing Powerlink's proposed standard asset lives with the asset lives being achieved by other networks (Powerlink assumes much shorter asset lives than the other networks)
- A review of actual asset condition information ensuring that asset replacements are justified on the basis of robust assessments of asset condition together with risk assessments that identify the risks of replacement versus alternative options
- Ensuring that alternative options to asset replacement (e.g. revised maintenance strategies, asset refurbishments, life extensions, and other risk mitigation options) are appropriately considered
- An assessment of the extent to which Powerlink's previous replacement capex programs have 'preinstalled' its replacement capex requirements for the next regulatory period
- Ensuring that re-use strategies are more appropriately considered

CCP4 (Hugh Grant's) Preliminary Perspectives On The AER's Draft Repex Decision

- Based on a preliminary review of the AER's draft repex determination, I consider that the AER has had insufficient regard to the CCP4's critiques and recommendations
- I will provide a detailed critique of the AER's draft repex determination in my formal submission

BUSINESS IT CAPEX

Business IT Capex – CCP4's Previous Submission

- CCP4's previous submission provided a detailed critique of Powerlink's Business IT Capex proposal that identified that:
 - Powerlink proposed an average IT capex spend of around 2.5 times its actual spend during the 2002-07 regulatory period – a spend level that the regulator (the ACCC) considered to be reflective of Powerlink's efficient long-term needs
 - Powerlink's business IT capex has consistently been much higher than the other transmission networks
 - Powerlink has not demonstrated the business benefits it has realised from its major IT expenditure over the previous decade
 - Powerlink's proposed business IT capex projects were very poorly justified
- The CCP4 submission also:
 - Provided a critique of Powerlink's proposed IT programs and projects
 - Provided a critique of deficiencies in the assessment process that the AER applies to its assessment of business IT capex proposals (e.g. inadequate trend analyses, inadequate project reviews, insufficient demonstration of the business cases, insufficient integration of opex benefits into opex allowances)
 - Outlined CCP4's expectations regarding improvements that the AER needs to apply to its Business IT capex assessment process

CCP4 (Hugh Grant's) Preliminary Perspectives On The AER's Draft Business IT Capex Determination

 Based on a preliminary review of the AER's draft business IT capex determination, I consider that the AER has had insufficient regard to CCP4's critiques and recommendations

 I will provide a detailed critique of the AER's draft business IT capex determination in my formal submission

5. OPEX

CCP4's Previous Submission – Powerlink's Proposed Opex

CCP4's previous submission provided a critique of Powerlink's opex proposal that identified that:

- Powerlink is proposing a record-high opex spend for the next regulatory period,
 well above the efficient level
- Powerlink's proposed opex is around three times its opex spend over the 2002-07 regulatory period a spend level that was above the level that the ACCC considered to be reflective of Powerlink's efficient long-term opex needs
- Powerlink's 2016 opex spend is over 230% of its 2007 opex spend
- Powerlink's opex has increased by an average of 11% per annum since 2007, during which Powerlink's key system outputs reduced
- Powerlink's opex growth over the past decade has been much higher than the opex growth of the other transmission networks, both in absolute terms and when normalised for changes in system outputs

CCP4's Previous Recommendations - Base Year Opex

CCP4's key recommendations regarding the AER's base year opex assessment for Powerlink included:

- The application of the AER's "base-step-tend" method to the determination of base year opex will not will not determine efficient base year opex costs for Powerlink, as it will not address the material inefficiencies embedded in Powerlink's proposed base year opex
- The AER needs to set Powerlink's base year opex on the basis of benchmark efficient costs, not on the basis of Powerlink's historical costs, which have been demonstrated to be materially inefficient
- The AER's base year opex determination also needs to have greater regard to:
 - Powerlink's poor productivity performance over the previous two regulatory periods
 - The fact that Powerlink's opex growth over the past 10 years has been much higher than the opex growth of the other TNSPs, both in absolute terms and when normalised for changes in system outputs
 - The opex reductions that Powerlink should be realising from its major capex programs over previous regulatory period (e.g. opex reductions that Powerlink should be realising from its lower asset ages arising from replacing new for old assets and its reduced asset utilisation levels)

CCP4's Previous Recommendations – Labour Price Change

CCP4's key recommendations regarding the AER's labour price change assessment for Powerlink included:

- The electricity network sector is currently in a major contraction phase due to declining demand for its services, whereas the other sectors covered by Powerlink's labour forecasts are not
- The AER needs to determine efficient labour prices based on forecasts that consider the specific drivers of labour prices in the Australian electricity network sector
- Those forecasts need to take into account:
 - The electricity network sector is currently in a major contraction phase industries in contraction do not face <u>real</u> labour price increasing drivers
 - The evidence that demonstrates that Powerlink's current labour costs are excessive
 - The evidence that demonstrates that Powerlink's labour and workforce practices are inefficient
 - The interaction between labour price change and productivity change i.e. real labour price increases need to be compensated by offsetting productivity improvements
- An appropriate consideration of the above issues will confirm that Powerlink's labour prices should be reducing rather than increasing

CCP4's Previous Recommendations – Productivity

CCP4's key recommendations regarding the AER's productivity change factor assessment for Powerlink included:

- Powerlink had the largest productivity decline of the five Australian TNSPs in 2014, with a fall of 4.9 per cent
- Powerlink is proposing to apply an annual productivity change factor of 1.2% over the
 2018-22 period
- All of Powerlink's directly connected customers operate within capital intensive industry sectors that have consistently delivered much more significant productivity outcomes over the past decade
- There is no justification for Powerlink to continue to deliver lower productivity outcomes than other comparable industry sectors
- The AER needs to determine an appropriate combination of labour price and productivity change factors aimed at driving Powerlink's productivity back into line with the levels being achieved by other capital intensive industry sectors

CCP4 (Hugh Grant's) Preliminary Perspectives On The AER's Draft Opex Determination

 Based on a preliminary review of the AER's draft opex determination, it is clear that the AER has had minimal regard to the CCP4's critiques and recommendations

 I will provide a detailed critique of the AER's draft opex determination in my formal submission

Thank You

Hugh Grant

AER Consumer Challenge Panel Member