Minutes of the AER's public forum on Powerlink's revenue application

Thursday, 20 April 2006 (9:00am to 12:30pm)

Marriot Hotel - Brisbane

Attendees: The meeting commenced with 46 registered attendees and 9 AER staff

Summary of forum

A summary of the discussions that occurred at the forum are under each agenda item.

1. Opening remarks by the Chair

Steve Edwell (Chair) opened the forum. He advised attendees that the forum was part of the formal consultation process on Powerlink's revenue reset application. He stated that:

- The AER is currently reviewing Powerlink's application and supporting information to ensure that they satisfy the information requirement guidelines. It has not yet made an official decision on whether to accept Powerlink's application and commence the public consultation process but indicated that, from its preliminary analysis, the application will likely meet the information requirements to begin formal consultation.

- Transitional arrangements for the revenue reset are being discussed with the AEMC but at this stage will be pursuant to the current NER and existing framework under the SRP with a few minor modifications.

- The AER has adopted an indicative timetable with a draft decision to be released jointly with its consultant's report in September 2006, and the final decision to be released in December 2006.

2. Presentation by Powerlink

The Chair invited Gordon Jardine (Chief Executive) and Merryn York (Revenue Reset Manager) to present Powerlink's application to the forum. Powerlink's slides can be found in the attached '.pdf' file.

3. Presentation by the EUAA

The Chair invited Roman Domanski (Executive Director, Energy Users Association of Australia) to address the forum. Prior to his formal presentation he made the following comments:

- The EUAA at this stage has no set position on Powerlink's application but has identified a number of areas it would like to see addressed, in particular the impact on price and reliability for end users. Mr Domanski complimented the AER on publishing a timeframe for Powerlink's revenue cap and welcomed the early consultation. He highlighted the need for the AER to standardise the TNSPs' information gathering process via the use of templates.

- Mr Domanski briefly discussed the EUAA's perception of Powerlink, stating that Powerlink was well run, had good quality staff and had shown leadership on important issues in the NEM. He indicated that Powerlink had shown that it was willing to engage with users.

- Mr Domanski commented that the application was lengthy and it appears that Powerlink has provided a good amount of information. However, he indicated that there are still some gaps in the application which will require close scrutiny by the AER. He also noted that Powerlink's application will be seen as a test for the AER, given it is the first revenue reset review conducted by the AER.

Mr Domanski made his presentation. The slides from the presentation can be found in the attached '.pdf' file.

4. Response by the Chair

The Chair responded to Mr Domanski's comments on the task for the AER. He stated that the AER had developed information templates in consultation with Powerlink for the application and that the intention is that these would be further developed into a standardised format for future revenue cap processes. However, he indicated that the move to standardisation via templates would not be at the expense of flexibility. The Chair indicated that the AER would discuss the information templates more broadly with the sector in the future.

The Chair also commented that Powerlink's last revenue cap was undertaken using an ex-post framework, whereby the ACCC provided a capex allowance at the time the revenue was being set and would undertake a prudency review of that capex at the end of the regulatory period. He noted that this revenue reset would be undertaken using an ex-ante capex framework whereby the AER will provide an upfront allowance based on a rigorous review of Powerlink's forecast capex.

5. Response by Gordon Jardine

Mr Jardine requested the opportunity to respond to some of the issues raised in Mr Domanski's presentation.

- Mr Jardine stated that the use of the capex/RAB ratio was not a valid metric as it contained mixed units of measure - capex reflected replacement cost and RAB was a depreciated historical cost.

- He stated that the figures for the opex/RAB ratios in the EUAA slides were not valid comparisons for two reasons. Firstly the comparative figures included in Powerlink's application and used by the ACCC in its comparisons contained only 'controllable' costs to ensure they could be compared across entities and across time. Specifically, these 'controllable costs' do not include grid support costs as these are essentially a capex substitute and are highly variable across entities and across time. In contrast, the EUAA figures included grid support costs and other elements. Secondly, the EUAA slides appeared to use different definitions of opex for forecast years vs the historical years. He therefore considered that the figures quoted by the EUAA were not a valid comparative measurement of the trend of opex/RAB over time or the comparisons with other entities. Powerlink believes the opex/RAB in its application are accurately constructed (and consistent with the approach used by the ACCC) to enable valid comparisons both over time and across entities.

- In response to Mr Domanski's recommendation that the AER consider how companies in competitive industries respond to increasing input prices (e.g. labour, materials) and why Powerlink should simply pass these increases on to users, Mr Jardine stated that:
  - Two major mining companies recently reported major blowouts in operating costs to shareholders and cited the same underlying drivers as Powerlink
  - rising operating expenses were generally outweighed by higher revenues. As costs rise many companies experience a much larger increase in revenue (e.g. mining companies exposed to the current resources boom)
  - capex is discretionary for most other companies but Powerlink has non-discretionary capex requirements.
- Mr Domanski queried why capex will need to increase substantially in the period 2006 to 2007. Mr Jardine responded that it was due to both increases in demand above those forecast at the time of the 2001 revenue cap decision and increases in input costs.
- Mr Jardine commented that generator connections were contestable and are categorised as unregulated assets. He stated that they do not form part of the regulated revenue application.
- In responding to Mr Domanski's concerns over the incentive framework for service standards, Mr Jardine commented that the 1 per cent revenue at risk is equivalent to about 5 per cent of its opex. He considered that this was a large number and incentivised Powerlink to strive for additional efficiency gains.

6. Comments by Bob Lim (Major Energy Users Inc)

Mr Lim requested the opportunity to comment on the presentations. He congratulated Powerlink on its application but also offered his support for the comments provided by EUAA.

- Mr Lim raised issues with the depreciated optimised replacement cost approach and agreed with Mr Domanski's assertion that it resulted in the overstatement of asset value. He further commented that the use of a CPI adjusted RAB amounted to a 'free lunch'.
- Mr Lim agreed with the EUAA that the Market Risk Premium (MRP) at 6 per cent was too high. Mr Lim indicated that he would provide to the AER, material which indicates that through regulatory gaming, network businesses have received an MRP of 12 per cent. Mr Lim stated that an equity beta of 1 is too high and noted that the South Australian Minister for Energy's submission to the AEMC suggested an equity beta of 0.8 should be adopted.
- Mr Lim questioned Mr Jardine on why he did not include capex in discussions on service standards incentives. Mr Jardine replied that, in establishing the service

standards framework, the ACCC explicitly aimed it at operational measures to improve service standards performance..

- Mr Lim further questioned Powerlink on the proposed mining developments that are used to justify some of the contingent projects in Powerlink's application. Mr Jardine clarified that the $5 billion in mining projects were committed projects.

- Mr Lim asked Powerlink for more details on the median price increase used for its costing based on Areva's estimated range of 1 to 10 per cent price increases for electrical equipment. Mr Jardine responded by saying that the specific assumptions could be used by suppliers if they were released. Mr Jardine further commented that given the ex-ante capex framework which prevented Powerlink from coming back to recover equipment price rises, it was prudent to use conservative assumptions.

- Mr Lim also questioned the currency used to source electric equipment supplies and other inputs, asking whether this was in US dollars and whether price increases were therefore less in Australian dollars. Mr Jardine replied by stating that the input prices paid would depend on where they are sourced from. Areva is based in Europe (and equipment from there would likely be priced in euros) but also has factories in 'low cost countries', and that pricing of equipment from those countries is typically $US. Equipment suppliers can also price in $A and take the currency risk.

6. Questions from attendees

Peter Price (Energex) queried why prices were rising as a consequence of the change to an 'as incurred' accounting approach. The Chair replied that, following extensive consultation, the AER has flagged a move to recognising capex from an 'as commissioned' approach to an 'as incurred' approach to provide businesses with greater incentives to manage capex efficiently. He further commented that the price increase due to the transition to the 'as incurred' approach was more of a timing issue and that in present value terms the two approaches were equivalent. The Chair also indicated that the AER would consider mitigating the impacts of the one-off price increase. Mr Jardine stated that he believed that it was more than a timing issue.

Mike Buckley (AER) stated that the AER was still examining the impact of the change in methodology on prices. Mr Jardine commented that the price increase was calculated using the value of the work in progress (WIP) multiplied by Powerlink's estimated WACC.

Mark Fallon (Queensland Department of Energy) noted that Powerlink's opex/RAB ratios were impressive and asked Powerlink how the benefits of being an efficiently run transmission company are acrrued to the TNSP. Mr Jardine stated that there was no benefit to Powerlink in having a lower opex/RAB than others, and that all the benefit passed to customers. Mr Domanski noted that the AER has an opex benefit sharing scheme as part of its regulatory regime. Mr Jardine stated that there would be a benefit if the actual opex could be reduced below the target opex and added that with such a low opex/RAB in an environment of rising costs there was no scope for operating below that level to attain such benefits. He stated that, instead, recent history shows that the sudden rises in input costs had caused Powerlink's actual costs to go above the target.

Norman Jip (TransGrid) asked Powerlink for its views on being the first TNSP to have its revenue cap application assessed by the AER. Mr Jardine stated he would have preferred not to be the first and that the challenge for the AER would be to come to grips with Powerlink's demand growth and rising cost environment.

John Dick (Energy Action Group) questioned what impact temperature sensitive load growth has had on the development of Powerlink's forecast capex requirement. Mr Jardine stated that temperature sensitive load in Queensland was generally due to air conditioning units and that the use of air conditioning was increasing. He also commented that the shape of the load curve for Queensland, being flat for a long period each day for most of the year, is different to other regions in Australia. He stated that a number of the initiatives for demand management were already in place, such as Energex's initiatives for hot water at peak times. Mr Jardine noted that the load forecasts that Powerlink gets from DNSPs already include the impact of demand side initiatives (i.e. are lower than they would otherwise be).

Mr Jardine further stated that the ex-ante approach automatically provided an incentive to manage capex by using demand management to defer augmentations in the regulatory period to below the forecast capex allowance.

John O'Brien (Hill Michael & Associates Consulting) congratulated Powerlink on the standard of its application however, he commented that there was no mention of non-regulated revenue or commentary on connection assets in Powerlink's application. Mr O'Brien indicated that this information would be valuable to ensure that there was not cross subsidisation between the two arms of the business. Mr Jardine stated it was not possible to forecast these projects, as they were contestable by nature. However, Powerlink has a computer system which separately identifies and captures regulated and non-regulated costs 'at source', and that this ensures there is no subsidisation of unregulated revenue.

Mr O'Brien commented that information on opex costs to asset base for its unregulated business could be used to provide an indication of the efficiency of Powerlink's regulated business operations. Mr Jardine replied that this measure would not be representative of efficiency as contracts for the provision of unregulated assets could potentially offer lower service price levels at lower reliability standards than the mandated requirements of the shared network, and that Powerlink had such arrangements in place. Nevertheless Mr O'Brien sought more information on the unregulated aspects of Powerlink's business.

Rainer Korte (ElectraNet) asked whether the AER was confident in meeting the nine month timeframe to assess Powerlink's application. The Chair stated that the AER had undertaken some preliminary work with Powerlink prior to lodgement of its application. Mr Edwell also noted that the AER was not compelled to deliver a decision within nine months and that the quality of the decision would not be compromised by meeting the timeframe. He noted, however, that the AER would aim for that timeframe.

Mr Lim expressed disappointment that the AER's consultant's report and the draft decision would be released concurrently. He stated that consultants occasionally make errors and it would be better to be aware of any error prior to the release of the draft decision. The Chair said the AER would appreciate submissions from interested parties on this issue, noting that there are pros and cons associated with both approaches.

Kevin Lewis (Fitch Ratings) commented on the use of a benchmark credit rating in deriving the debt margin. He noted that many public credit ratings of electricity transmission and distribution businesses in Australia include an element of implied government or parent support for the rated company. Mr Lewis suggested that where practical, the use of a benchmark credit rating should be based on the stand alone credit position (i.e. excluding any implied government or parent support) and suggested at present the average stand alone TNSP's credit rating in Australia is most likely in the range of ‘BBB+’ to perhaps ‘A-’.

The Chair expressed his appreciation to the presenters and attendees for their participation.

The forum closed at approximately 12.20pm.