Ref. A2501708

28 April 2016

Ms Paula Conboy
Chair
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Paula,

POWERLINK 2018-22 REVENUE PROPOSAL - AER PUBLIC FORUM

This submission responds to matters raised by Mr Hugh Grant in his presentation at the Australian Energy Regulator's (AER's) Public Forum held on 15 March 2016. Mr Grant is currently a member of the AER's Consumer Challenge Panel (CCP) and is one of three sub-panel members assigned to provide input on Powerlink's 2018-22 transmission determination process.

Powerlink supports the role of the AER's CCP in representing consumer views in a regulatory determination process. It has proactively sought the CCP's involvement and input in the formulation of the Revenue Proposal and other related stakeholder engagement activities.

Mr Grant's presentation to the AER Public Forum contained a number of invalid assumptions, material errors and unsubstantiated claims relating to Powerlink's historic financial performance and forecast capital and operating expenditure. Powerlink is concerned that, in the absence of more detailed knowledge of the regulatory framework and the facts, some stakeholders may inappropriately rely on Mr Grant's presentation and subsequent media statements in the consideration of its Revenue Proposal.

Analysis of historic financial performance

In his presentation, Mr Grant focused on the regulatory framework governing the returns that can be earned by network businesses and used Powerlink's historic financial performance as a case study to convey his views.

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.

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- Accrued total returns

Mr Grant concluded that Powerlink has accrued total returns of $9.4 billion and *'has returned over 23 times the equity investment*[1]*'* over the past 15 years. This statement is incorrect.

To measure the change in the market value of Powerlink's equity, the $9.4 billion figure derived by Mr Grant is based on a hypothetical, assumed "unrealised" sale of Powerlink at 1.65 times its Regulated Asset Base (RAB), which is the implied multiple from the recent sale of TransGrid. Apart from the fact that no such transaction has occurred for Powerlink, the TransGrid multiple will reflect factors specific to that sale.

Powerlink considers that it is invalid to include the "unrealised" proceeds from an assumed sale of Powerlink and claim that this reflects the actual historical return on the shareholder's equity investment.

Powerlink also notes that to properly assess its accrued total returns, an objective measure of the change in the market value of its shareholder equity is required (which for listed companies is typically done through historic share price observations over a defined period). Given the inherent limitations on obtaining such information for Powerlink, it is more appropriate to analyse and compare annual return on equity, discussed in more detail below.

- Annual return on equity

In various parts of his presentation, Mr Grant appears to have interchangeably defined shareholder equity as either contributed shareholder capital or the sum of contributed shareholder capital and retained earnings. In either case he has omitted from his analysis shareholder equity related to Asset Revaluation Reserves[2].

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).

This has resulted in the total value of shareholder equity being significantly understated by Mr Grant, and has consequently inflated his assessment of Powerlink's annual return on shareholder equity.

Specifically, 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. 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. The lack of transparency through to Mr Grant's underlying analysis also means that it is not clear on

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[1] Consumer Challenge Panel - Powerlink public forum presentation - March 2016, Mr Hugh Grant, p.40

[2] It is common practice for all regulated network businesses in Australia to treat Asset Revaluation Reserves as shareholder equity, commensurate with the existing regulatory arrangements for indexation of the Regulated Asset Base (RAB) and calculation of economic depreciation included within Maximum Allowed Revenue. Further, it is a standard 'textbook' assumption that revaluation reserves are included in shareholder equity, reflecting the fact that any changes to the value of an asset will flow through to shareholder value. For example, refer: Beal, D., Goyen, M. and Shamsuddin, A. (2008). Introducing Corporate Finance, second edition, John Wiley and Sons Australia Ltd, p.511.

what basis he has measured the returns on the other companies, nor is it possible to confirm if those measures are valid.

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. Indeed, 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.

Analysis of capital and operating expenditure

Powerlink has also identified a number of concerns with Mr Grant's commentary on its capital and operating expenditure that it wishes to clarify for the AER and other stakeholders.

- Increases in replacement and information technology (IT) capex in 2007/08

Mr Grant claims that in making its Revenue Proposal for the 2007/08 to 2011/12 regulatory period, Powerlink stipulated that increases in replacement and information technology (IT) capital expenditure were "*once in a generation*"[3]. Further, Mr Grant claimed at the AER's Public Forum that Powerlink has over time sought to maintain expenditure levels at artificially high levels set in 2007/08 due to once in a generation needs. These claims are incorrect.

In its 2008-12 Revenue Proposal, Powerlink clearly articulated that as its asset base aged, it was expected that further programs of replacement capital expenditure would be required. Specifically, Powerlink stated that *"significant investments made 40 - 50 years ago are now reaching end of life and signal the start of a wave of replacements"*[4]. In addition, Powerlink foreshadowed that *"by the end of the next regulatory period (30 June 2012), significant levels of network assets will be at or beyond the end of their economic life".*[5]

Regarding IT capital expenditure, Powerlink foreshadowed in its 2008-2012 Revenue Proposal the potential for ongoing higher levels of IT capital expenditure, stating that *"an increase in business IT spending is evident in the later years of the current period and going forward. This is required to accommodate the need for large amounts of information and data to be provided about the transmission network, virtually in real time, to allow effective decision making".*[6]

Further, Powerlink notes that the AER's transmission determination for the 2008-12 regulatory period resulted in minimal adjustment to the level of replacement and IT capital expenditure proposed by Powerlink.

- Statements regarding reinvestment capital expenditure

Mr Grant makes a number of unsubstantiated claims regarding Powerlink's proposed reinvestment capital expenditure that are each addressed in turn below.

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[3] Consumer Challenge Panel - Powerlink public forum presentation - March 2016, Mr Hugh Grant, p.57.
[4] Queensland Transmission Network Revenue Proposal, Powerlink Queensland, April 2006, p.69.
[5] Queensland Transmission Network Revenue Proposal, Powerlink Queensland, April 2006, p.68.
[6] Queensland Transmission Network Revenue Proposal, Powerlink Queensland, April 2006, p.74.

Asset condition information

Mr Grant commented that Powerlink provided very scant asset condition information in its Revenue Proposal[7].

In its Revenue Proposal, Powerlink has sought to align with the AER's approach regarding the use of top-down expenditure forecasting techniques, particularly the AER's Repex Model. This model relies on detailed data about Powerlink's existing asset base and a combination of engineering and statistical analysis of the distribution of replacement ages for different classes of transmission assets.

Powerlink has been mindful of stakeholders' expectations for supporting information with this change in approach. During the development of its Revenue Proposal, Powerlink worked with the AER during and subsequent to its Framework and Approach process, its Customer and Consumer Panel members and other industry stakeholders (including the CCP members themselves) to seek input on an appropriate level of bottom-up supporting information for its forecast reinvestment expenditure, which has been included with its Revenue Proposal[8].

Pre-installed replacement capex

Mr Grant claims that Powerlink has "pre-installed" a large proportion of its future replacement needs, based on his claims of "extraordinary repex spend" over the previous decade.[9]

Powerlink considers that Mr Grant's claim that it has pre-installed replacement capex to be incorrect. Powerlink's forecast reinvestment capital expenditure relates to entirely different assets, with different risks in different locations across its network, as compared to assets the subject of reinvestment over the past decade. Powerlink has not proposed reinvestment capital expenditure for assets in the forthcoming regulatory period that have been the subject of capital reinvestment in previous regulatory periods.

Powerlink also notes that Mr Grant's claims of "extraordinary" levels of reinvestment expenditure over the previous decade are contrary to its actual behaviour during the current five year regulatory period. Non-load driven capital expenditure (substantially related to asset replacement) is expected to total $875.2m, a reduction of $594.0m (or 40%) from the AER's allowance of $1,469.3m. An essentially flat forecast for electricity demand has enabled Powerlink to further consider alternative solutions and optimise its reinvestment expenditure to levels significantly below what was initially allowed in its transmission determination.

Powerlink's system capacity

Mr Grant claims that Powerlink has not sufficiently demonstrated that it has considered system capacity and levels of utilisation in proposing reinvestment capital expenditure[10]. This claim is incorrect.

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[7] Consumer Challenge Panel - Powerlink public forum presentation - March 2016, Mr Hugh Grant, p.58.

[8] Including detailed condition assessment and planning data for power transformer replacements, supporting project packs for approximately 50% of forecast capital expenditure and Area Plans that provide a detailed outline of network planning and asset condition drivers across Powerlink's transmission network.

[9] Consumer Challenge Panel - Powerlink public forum presentation - March 2016, Mr Hugh Grant, p.58

[10] Consumer Challenge Panel - Powerlink public forum presentation - March 2016, Mr Hugh Grant, p.58

In its Revenue Proposal, Powerlink provided as supporting information Area Plans in Volume 3 of its Asset Management Plan.

Area Plans have captured Powerlink's integrated asset planning process that takes into account future changes in demand, network capacity levels and the condition based risks of related assets in the network. Each Area Plan has systematically assessed the enduring need for transmission assets given the current system capacity and flat forecast demand outlook. Area Plans have also analysed and identified a number of opportunities for asset retirement and network reconfiguration as an alternative to asset replacement during the 2018-22 regulatory period.

Powerlink's efficiency

Mr Grant also claims that Powerlink is the most inefficient transmission network in Australia[11] and that there is extensive evidence that Powerlink's operating expenditure is the most materially inefficient of the 5 Australian TNSPs[12].

Powerlink notes that the AER is still in the early stages of developing its approach to transmission benchmarking and that since the first benchmarking report was published in 2014, it has been actively working with the AER to address data inconsistencies that materially impact benchmarking outputs. The AER recently acknowledged the existence of such inconsistencies in its 2015 Annual Benchmarking Report.[13]

In preparing its Revenue Proposal, Powerlink also sought independent expert opinion from Huegin[14], focused on operating expenditure productivity. Huegin concluded that:

- Powerlink's operating expenditure partial factor productivity (PFP) performance has improved since 2006, indicating that Powerlink has been able to deliver increased aggregate output over the period with less labour and materials inputs; and
- Powerlink's operating expenditure performance is similar to its NEM peers when important operating environment factors (OEFs) such as load and energy density, population density and capitalisation policy are considered.

Powerlink also notes that in previous Annual Benchmarking Reports and other revenue determinations[15], the AER has consistently identified limitations in making comparisons of the relative efficiency of TNSPs under the current benchmarking specifications.[16] In particular, the AER stressed that *'because our models do not incorporate OEFs, the comparison of productivity levels between firms should be treated with caution'.*[17]

In its Revenue Proposal, Powerlink recognised that its performance can still be improved. Driving efficiency and reducing costs is a key area of focus for Powerlink, and a key component of placing downward pressure on electricity prices. Powerlink is driving efficiency by:

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[11] Consumer Challenge Panel - Powerlink public forum presentation - March 2016, Mr Hugh Grant, p.43.
[12] Consumer Challenge Panel - Powerlink public forum presentation - March 2016, Mr Hugh Grant, p.81.
[13] Final Annual Benchmarking Report, Electricity Transmission Network Service Providers, AER, November 2015, p.13.
[14] Powerlink Operating Expenditure Benchmarking Review, Huegin, December 2015.
[15] Attachment 7 - Operating expenditure, Final Decision TransGrid transmission determination, AER, page 7-21.
[16] Draft Annual Benchmarking Report, Electricity Transmission Network Service Providers, AER, November 2015, p.16 and Final Annual Benchmarking Report, Electricity Transmission Network Service Providers, AER, November 2014, p.21.
[17] Final Annual Benchmarking Report, Electricity Transmission Network Service Providers, AER, November 2015, p.13.

- Taking a different approach to assessing options for reinvestment needs in a low demand growth environment;
- Reviewing its organisational structure, reducing indirect costs and adjusting resource levels to ensure Powerlink is operating efficiently and is competitive; and
- Implementing strong productivity growth in its forecast operating expenditure based on delivering cost efficiencies in field maintenance and key support functions.

Summary

Powerlink supports the objectives of the AER's CCP in representing consumer views as part of a regulatory determination process. However, Powerlink has significant concerns regarding aspects of Mr Grant's presentation and the inappropriate reliance or weight that stakeholders may place on his analysis given his current position as a member of the AER's CCP.

When considering Mr Grant's input on the matters noted above, Powerlink requests that the AER have regard to the accuracy and validity of such input.

Powerlink also notes that while this submission responds to specific aspects of its Revenue Proposal, in the context of claims made by Mr Grant, the AER will make a determination that considers all aspects of Powerlink's proposal as a package.

Should you have any questions regarding this submission, please contact Ian Lowry.

Yours sincerely,

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CHIEF EXECUTIVE

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