Ref. 2/902/5

30 August, 2006

Mr Mike Buckley
General Manager
Network Regulation North Branch
Australian Energy Regulator
PO Box 1199
DICKSON ACT 2602

Dear Mike,

EUAA SUBMISSION TO POWERLINK REVENUE PROPOSAL FOR THE PERIOD 1 JULY 2007 TO 30 JUNE 2012

The Energy Users Association of Australia made a submission to the AER as part of the consultation process associated with the evaluation of Powerlink's Revenue Proposal for 2007/08 – 2011/12. Powerlink appreciates the comments made by the EUAA regarding the leadership shown in the face of challenges and Powerlink's willingness to undertake serious engagement with end users.

Continuing engagement has occurred with the EUAA and Powerlink has met with the EUAA to discuss various elements of their submission. Following those discussions Powerlink has prepared the attached response to the EUAA submission.

The response discusses various errors in the EUAA analysis and highlights the importance of any comparisons of major elements between regulatory periods being carried out on an "apples versus apples" basis.

If you would like to discuss any aspects of this response further please contact us.

Yours sincerely,

Merryn York

Merryn York
MANAGER
REVENUE RESET PROJECT

Encl.

cc: Roman Domanski, Executive Director, EUAA
Bob Davenport, Director Policy & Regulation, EUAA

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POWERLINK RESPONSE TO EUAA SUBMISSION TO THE AER ON POWERLINK'S REVENUE CAP PROPOSAL FOR 2007/08 – 2011/12

Powerlink provides this information to the AER and other interested parties in response to the EUAA submission on Powerlink's revenue proposal. Powerlink appreciates the comments made by the EUAA regarding the leadership shown in the face of challenges and our willingness to undertake serious engagement with end users.

Powerlink has continued its commitment to serious engagement with end users by meeting with the EUAA to discuss its submission and clarify some matters prior to formulating this response. As a result of that meeting and subsequent exchange of information, Powerlink has identified a number of errors in the comparisons made in the EUAA submission. This response provides corrections to those errors, as well as comments and clarifications on the major points raised in the submission.

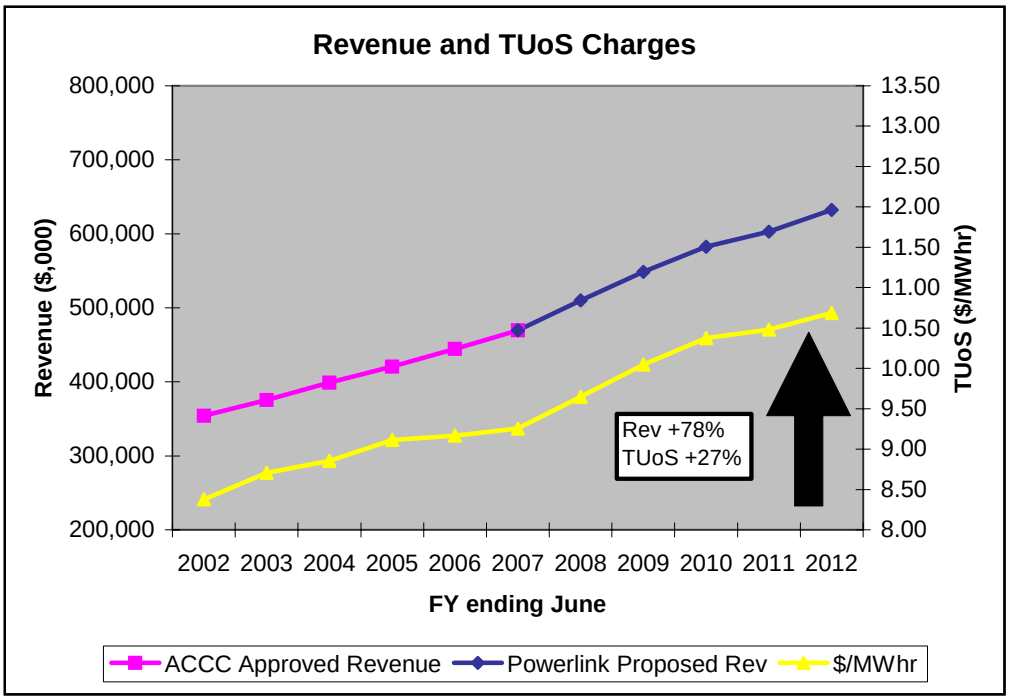
Customer Impact

The EUAA assessment of the customer impact is incorrect. The EUAA has mixed real dollars (2006) with nominal dollars in a manner which suggests that the impact on customers will be greater in the next regulatory period compared to the current period than will actually occur.

In a nutshell, the EUAA has adjusted the revenue during the current regulatory period (2002 – 2007) to real June 2006 dollars using CPI differences. However, for the coming regulatory period, the EUAA has used the nominal dollars provided on page 125 of the Powerlink Revenue Proposal. This is not an "apples versus apples" comparison.

The correct numbers which should have been used in Figure 7.1 of the EUAA submission are shown below.

Figure 1: Revenue and TUoS Charges



Based on the energy figures (sent out) reported in the NEMMCO SOO, the EUAA is correct that between 2001/02 and 2006/07 for the current regulatory period, consumers pay an average TUoS of between $8.35 and $9.25 per MWhr at an average **real** growth rate of around 2%.

The EUAA has then incorrectly compared figures of $9.25/MWhr (2006 $) forecast for 2006/07 with $10.22/MWhr in nominal 2007/08 dollars. The correct comparison would be $9.65/MWhr in 2006 dollars (forecast for 2007/08) or an increase of 4.2% in the first year of the next regulatory period – the one-off real step increase being due to the AER decision to change recognition of capex from “as commissioned” to “as incurred” for the coming period.

The correct comparisons over the 10 year period are a real increase in TUoS prices from $8.38/MWhr to $10.69/MWhr in 2006 dollars, an increase of about 27%, with only about 10% of this attributable to Powerlink Revenue Proposal for the next regulatory period.

In nominal terms, the increase in average TUoS attributable to Powerlink’s work program over the coming five years is the 5.5% cited in the Powerlink submission. As noted previously, this equates to about $3 per annum on the average consumer electricity bill.

Asset base roll forward

Powerlink can confirm that future capital forecasts do not include interest payments during construction. We can also advise that depreciation on assets under construction was not included in our Revenue Proposal. Powerlink agrees with the EUAA that the proposed policy of the AER in regard to depreciation of works under construction is not appropriate, particularly as it does not comply with any accounting standards.

Ex ante Capital Cap

Powerlink refutes any suggestion that the ex ante capital forecast included in its Revenue Proposal incorporates an allowance to meet unexpectedly higher demand growth. The forecast capex included is based on a probabilistic assessment of various scenarios – any of which could occur. The probabilities of the scenarios have been determined independently by ROAM Consulting. Powerlink has not included additional allowance in case demand growth is higher than forecast. Indeed there are a number of plausible scenarios under which demand growth will necessitate capital investment in excess of the allowance for which Powerlink has applied. This is the nature of the ex-ante framework which has been adopted by the AER.

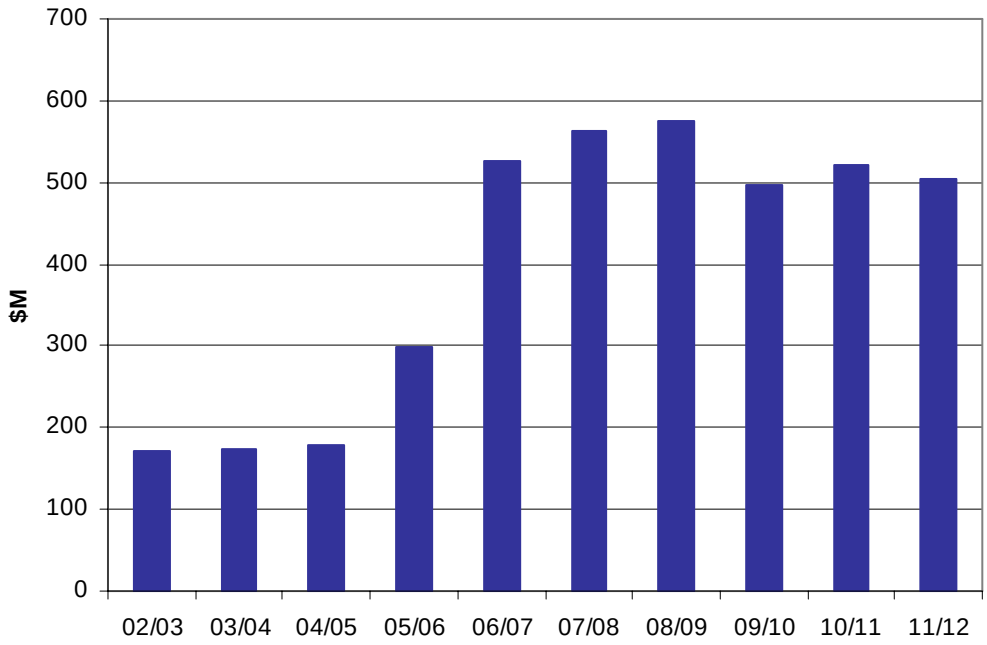
There is an asymmetric risk associated with changes in demand to which Powerlink is exposed. We would note that the weighted average capital expenditure in Powerlink's Revenue Proposal is lower than a scenario based solely on medium demand growth forecast. Powerlink would contend that far from being an attempt to game the regulatory process, using the weighted average is disadvantageous to Powerlink in that it creates higher risks that Powerlink will need to spend more to meet its obligations. Powerlink has requested that the AER consider this matter very carefully as the risk of Powerlink having too little capital expenditure allowance would have serious ramifications for reliability of supply to customers.

Forecast Capex

The EUAA has stated that Powerlink is proposing to spend, on average, over 220% of the amount spent in the current regulatory period and over 250% above the average amount approved by the ACCC in 2001. Figure 2.3 of the EUAA submission provides figures for this comparison. In any comparisons it is critically important that Powerlink, the AER and the EUAA all take the care to compare "apples with apples" to avoid sensationalising the change.

In arriving at its figures, the EUAA has incorrectly compared capitalisations during the current regulatory period ("apples") with capex (as incurred) during the next regulatory period ("oranges"). Powerlink provided the correct comparison of actual and forecast capex (both quoted on a consistent "as incurred" basis) in the presentation made at the AER's public forum on 20 April 2006. The comparison is shown below.

Figure 2: Capital expenditure ($ nominal) actual and forecast (as incurred)



Powerlink's capex during the current period on an "as incurred" basis is $1.5 billion[1]. Proposed capex for the next regulatory period is $2.44 billion ($06/07) or $2.66 billion ($ nominal), a 77% increase between the current and next regulatory periods. This is nowhere near the sensationalistic figure of 220% or 250% suggested by the EUAA. Powerlink acknowledged in its Revenue Proposal that this is still a sizeable increase, some of which is attributable to the significantly increased input costs (a contemporary insight into which is provided by recent media reports on the ever-escalating capital cost estimates for the PNG gas pipeline).

Powerlink has provided extensive details of the capital expenditure plan in the information templates provided with its Revenue Proposal[2]. This very detailed information has been provided for all projects included in the probabilistic capex forecast, and includes the estimated cost of those projects, the commissioning date for each scenario it occurs in and the probability of its occurrence. The information that EUAA's consultants, SKM, need for

[1] Queensland Transmission Network Revenue Proposal 2007-2012 p79.
[2] See www.aer.gov.au

the variations in timing of projects is contained in the information templates – refer sheet labelled 'Network Varied'.

Replacement capex

It should be noted that secondary systems and communications system assets have a notional life of 15 years. This is actually decreasing due to the technological advances in this type of equipment. Details of all replacement projects proposed are contained in the information templates submitted with the Powerlink Revenue Proposal.

Capex/RAB benchmark

As we have noted previously, capex/RAB ratio is not a valid metric as it contains mixed units of measure – capex reflects replacement cost in the current construction environment, which is significantly higher than historic costs, while RAB is a depreciated historical cost.

Comparisons with other TNSPs are not valid for the same reason. To achieve a valid comparison, one would need to express the RAB in terms of modern day replacement value (undepreciated). Any differences would then have to be assessed against the drivers – load growth, and replacements.

Opex

The EUAA comparisons for opex have correctly excluded grid support costs, but the opex comparisons are still not "apples versus apples". The EUAA has included allowances in its forecast opex for matters which are not controllable opex and were not in the historic information provided, i.e. capex efficiencies, debt management costs and equity raising costs.

In contrast, the opex trends and comparisons used by Powerlink in its submission and public forum presentation are based on controllable opex, to enable "apples versus apples" comparisons.

The EUAA has also quoted SKM studies regarding economies of scale. No supporting evidence regarding the "previous SKM studies" has been provided, and as such it is not apparent whether those studies are directly applicable to a transmission network with the geography and utilisation of Powerlink's, or to one operating in the current labour and materials markets. Powerlink is unconvinced of the applicability of the cited factor to this particular set of circumstances. In addition, the EUAA has applied the factor only to the augmentation category of the capex forecast. Powerlink acknowledges that replacement

capex does not increase the maintenance requirement for assets where a "like for like" replacement has occurred, and has taken this impact into account when forecasting opex requirements. However, other assets, such as IT assets, connection works, buildings, etc., all require maintenance and will contribute to an increase in the opex requirement. It is unclear why the EUAA would consider such assets did not require any maintenance expenditure.

In preparing its controllable operating expenditure forecast, Powerlink has taken the following into account, all of which lower the opex requirement compared to simple extrapolations:

- offsets for replacement of assets;
- economies of scale for a larger network; and
- targeted efficiency programs.

Opex/RAB

Again the EUAA has not compared "apples with apples" in its comparisons of opex/RAB. Various revenue decisions from the ACCC have included comparisons of opex/RAB. During revenue determinations, the ACCC has received a lot of information from the regulated businesses and is able to assess which components of opex should be included in the comparisons it undertakes to ensure consistency. In Powerlink's case, the ACCC excluded grid support, other allowances and refurbishment expenditure from the opex allowance for the purposes of opex/RAB comparisons. Powerlink has made its comparisons on the same basis. The EUAA figures do not allow for valid comparisons to be made.

In addition, the EUAA has quoted the AER's April 2006 regulatory report on TNSPs as a source of information. TNSPs have advised the AER on several occasions that there are inaccuracies in the calculations performed in those reports – indeed the RAB values used in the reports are from the statutory accounts, and not from the regulatory accounts which are used for revenue determination purposes.

If the EUAA determined the opex/RAB in accordance with the method set out by the ACCC (as Powerlink has done) it will find that Powerlink's opex/RAB is as per the Revenue Proposal[3]. Powerlink's operational expenditure costs are at the frontier of efficiency and Powerlink intends to maintain its position as the most cost effective transmission entity in the NEM.

[3] Powerlink notes the correction to figures for SP AusNet advised in its submission to the Powerlink Revenue Proposal.

Historical capex

The EUAA is aware of the changes in the regulatory model for capex between the past/existing "ex post" regime and the future "ex ante" regime. Likewise we believe that the EUAA is aware that the regulatory model does not allow capital expenditure in the current regulatory period which is above the ACCC decision allowances to be 'simply billed to customers during the next regulatory period on the regulated businesses assertion that the overspend was efficient'[4].

The current framework includes a comprehensive ex post prudency check for capex undertaken during the current regulatory period. This is an integral part of the review being undertaken by consultants engaged by the AER. Only capex found to be prudent will be included in the regulatory asset base.

Powerlink takes offence to any suggestion that it has simply ramped up its capex in the second half of this regulatory period 'to increase its opening RAB in the next regulatory period resulting in higher revenues'[5]. Powerlink has been very transparent in publicly revealing the reasons for the increase in the second half of the regulatory period. The reasons are the large difference between the actual demand over recent years and the forecast demand at the time of the last revenue determination (as shown in Figure 3.1 of Powerlink's Revenue Proposal) as well as the significant increases in input costs for provision of electricity transmission infrastructure, examples of which are shown in Figure 2.5 of Powerlink's Revenue Proposal. Given the significant difference between the 2000 demand forecast (used in the previous revenue decision) and actual demand increases plus input cost increases, it is entirely understandable that significant differences occurred between the 2001 capex allowance and the actual capex requirement. Indeed, it is arguably surprising that the differences are not larger.

Powerlink has utilised network support (including generation and demand side response) where it is available and economic to defer transmission augmentation. The current framework includes a check of the augmentation requirement, the choice of options including demand side options and efficient implementation. All the aspects raised by the EUAA form part of the prudency assessment to be carried out by the AER and its consultants.

[4] EUAA submission to AER review of Powerlink Revenue Proposal 2007/08 – 2011/12 page 12.
[5] Ibid page 12.